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Stock Market Books

The Best Beginner’s Stock Option Guide About How to Become a Professional Trader With Stock Market for Beginners & Options Trading Crash Course

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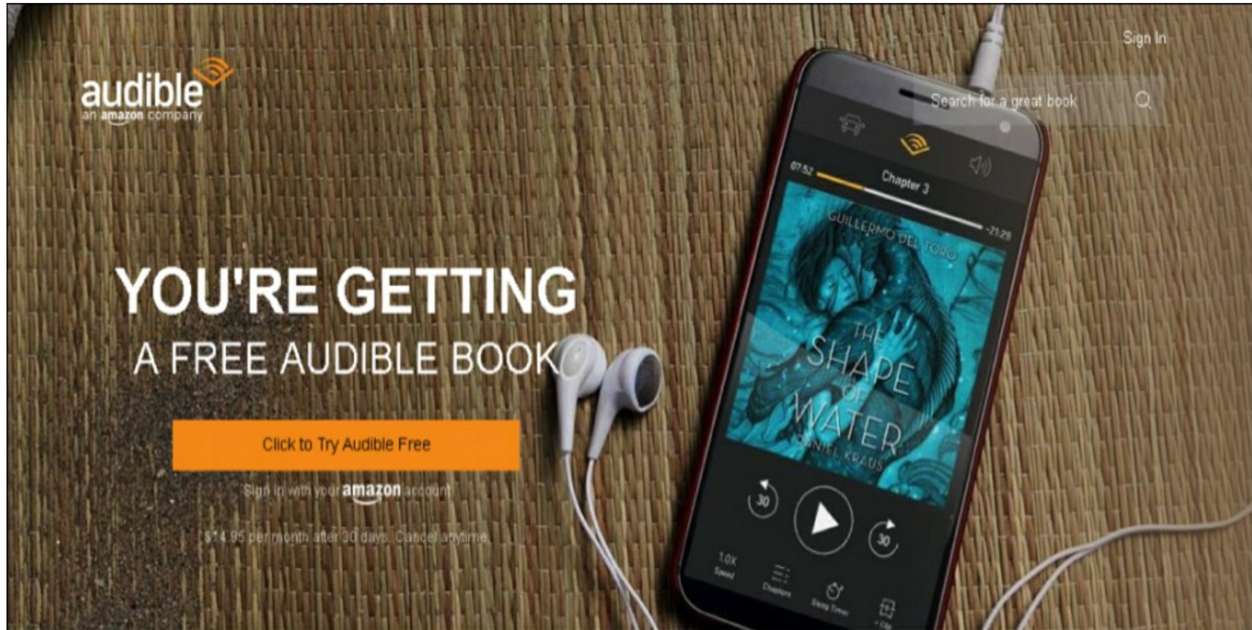

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Trading Stock Options

Learn and Understand How Everything Works and What Pitfalls you MUST Avoid as a Beginner. Learn How Top Investors Lower Their Cost Basis Using Stock Option Trading

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Introduction

Welcome to trading stock option. My name is Gimm Livmor, and I have made a living trading stock. In this book, I am going to teach you what I have learned over the years the hard way, but things that have completely transformed my financial situation.

You see, I was a lot worse off than many readers are today when I began my stock trading career. I was living in poverty but managed to scrape together $5,000 overtime. I knew that I had to change my situation and improve my life, so I began investing in stocks. Slowly at first, so that I would not put much money at risk at any one time.

I had some wins and some losses, but gradually I learned the ropes of stock trading. Pretty soon, I was getting more consistent in earning profits. After a period of a few years, I was able to turn my initial investment of $5,000 into $100,000!

Now obviously I cannot guarantee that you will have the same success. However, I will teach you what I have learned, and this will help you start off in the right direction. I also want to emphasize that yes, it is possible for anyone to earn profits trading stocks!

In this book, we are going, to begin with a review of stock options. For clarity, this is not trading options on the derivatives market. Rather, I am going to be discussing stock options offered by employers. This is an opportunity to build wealth that many people overlook or fail to take full advantage of.

After this, we will discuss the long-term value investing philosophy promoted by Warren Buffett, so that you can learn a relatively safe and surefire way to build wealth. We will learn how to be successful trading stocks in good markets and bad so that you can build wealth over the long term no matter what happens.

After we learn the basic philosophy behind successful investing, we will learn about how to become an independent stock trader. I will guide you through the process of setting up a brokerage account, how to trade stocks, and mitigating risks. We will also cover the basics of how the stock market works for those who are not educated in this.

Then we will talk more about employee stock options in detail.

For the rest of the book, we will talk about many of the important issues surrounding investing. This will include the issues surrounding ETFs, and whether or not they are better than buying individual stocks. We will also talk about different metrics used to determine whether or not a stock is a good investment and what to look for. We will also cover IPO investing and tax issues surrounding stocks.

I wish all readers the greatest success in trading stocks, and hope that you can start building wealth the way that I did!

Keep in mind that past performance is not a guarantee of future success, and that the information provided in this book is not to be taken as financial advice because it is offered for educational purposes only, and not being aware of any readers specific financial situation I am not in a

position to offer anyone advice. If you have questions or need advice for your situation please contact your own financial advisor.

Thanks!

Chapter 1: An Overview of Employee Stock Options

If you have the opportunity to invest in stock options at your place of employment, this is not something that you should pass up. Many people fail to take full advantage of this because they don't fully understand what it is about and what it can do for them, while others prefer to have cash in the here and now. This is a mistake for most people. Any type of ownership stake that you can get in a corporation, including your own place of employment, is something that can help you build significant wealth over time. In fact, it is one of the best ways to build wealth over time short of you starting your own business. And even if you were to start your own business, there are very good odds that your business is going to fail! But if you are working for a corporation that has become large enough to offer you stock options, this is a sign of a stable company that is growing, and that has a lot of potentials. For some, this can represent an unprecedented opportunity to grow wealth.

Of course, as an investor, diversity is always the number one rule that you should keep in mind. So don't make the mistake of thinking that I am suggesting you let your entire future ride on your own companies stock options. I am not suggesting that at all. Rather, if you have the opportunity to invest through employee stock options, this is just one more part of your toolkit that you should use in order to increase your own personal wealth and secure your financial future.

In this chapter, we will introduce the basics behind the concept.

What are Employee Stock Options?

Many companies offer employee stock option plans. These are offers of stock to employees. The offer will give the employee the right to buy shares of stock in the company. They are called stock options because the purchase is optional; it is a right on behalf of the employee and not an obligation or requirement.

The employee stock options are going to be time-limited. Typically, these will have an expiration date that will be a given number of years in the future. The company will offer the options to employees at a certain price, and if the company is publicly traded, this price can be compared favorably to the market price of the stock in many cases. The terminology that is used is whether or not the employee stock options are "in the money" or "out of the money." If the price that is offered to the employee is lower than the price that the employee would have to pay buying the shares on the open market, they say that the stock options are "in the money." They are "out of the money" otherwise. Whether or not this is the case can be important if the employee is running out of time to exercise their right to buy the stocks. It will also depend on the financial health of the company and its long term prospects. Of course, as an employee of the company, you might have a better idea than a member of the general public as to what the long term prospects of the company may be since you might know about products that are in development by the firm that can have a large impact later.

In many cases, stock options can be worth a lot of money to employees. They can represent an opportunity to build and grow your own wealth as a part of a larger self-directed investment plan.

Employee stock options come with many specific characteristics, properties, and requirements.

Knowing what these are will help you navigate the world of employee stock options and help you decide how to move forward with your investment plans.

Granting of Employee Stock Options

Employee stock options, technically speaking, are derivative options similar to those used to trade on the options market, but they are given to employees and management executives at the company. However, there are some differences. First of all, employee stock options often come with an expiration date that can be years in the future, giving the employee a significant amount of time to decide whether or not to buy the stock. Second, the options are granted to employees, that is given by the company to the employees as a part of their compensation plan. In the case of employee stock options, the other party in the transaction is the company itself. Employee stock options are often issued by publicly traded companies, which is very helpful when trying to determine the true value of the options since the employee will be able to compare the offered price to the current market price. However, employee stock options can also be offered by private companies. In this case, determining the real value of the stock might be difficult, but the employee will be able to weigh different factors to determine whether or not it is worth buying the stock. For example, if the company is growing or has major products in development, and this is attracting a large amount of investment, it is probably worth it to the employee to invest in the stock. This will enable the employee to not only benefit from being employed at the company, but they can also benefit from growing with the company as well.

At a later date, if the company ends up going public, this can be a tremendous opportunity for employees to become wealthy overnight. If you are working for a private company that you believe will go public in the future, and you have the opportunity to buy stock in the company, this is something that you must do. When the company goes public, oftentimes the price of the shares will go up by a large amount compared to what you have paid for them. You can sell your shares and acquire large amounts of cash. Consider that when this has happened in the past, companies like Microsoft minted many new millionaires. Of course, few people are lucky enough to work for a company like Microsoft, but you don’t have to work at a company that big and successful to benefit from an IPO.

Employee options are *call* options, which gives the holder of the option the right to buy shares of stock at a specific price. No matter what time period a company chooses to use, the options come with a defined expiration date. If the employee chooses not to buy the stock, and they expire, the employee is out of luck. You have to exercise your right to buy stock on or before the expiration date. If you don’t do so, they say that the options expire worthlessly. The bottom line is that if this happens, you have passed up your opportunity to own shares of stock in the company, through this method.

In the case of employee stock options, the company will offer them a favorable price per share to the employee. Therefore it is usually advantageous to exercise the options. Of course, if the company is publicly traded, the price of the stock can drop in the marketplace, meaning that it won’t be favorable for you to exercise your rights to the shares. That is because you must pay the price specified in the option for the shares of stock. So in the event that the price of the stock declines, the employee would be in a situation where it is not worth it for them to exercise the options.
When you are given stock options by the company as a part of your compensation, we say that

the company has granted you the stock options. This is because you are not required to buy them yourself on an options exchange. In short, the company is giving you options in lieu of higher pay, and members of the public would have to buy these options on the exchange.

However, you should be aware that you cannot trade the options. While a member of the general public can buy options on the exchanges and trade them to earn profits, you cannot trade the options themselves if they have been granted by the company. The only way that an employee can benefit financially from these types of options is by exercising them to buy shares of stock in the company.

Vesting Date

Stock options that are issued to employees come with a vesting date. The vesting date places a limitation as to when you are able to exercise your options. The vesting date will be at some point in the future. So you will be granted the stock options, but you will not be able to exercise them before the vesting date arrives. The vesting date is something that will be written into the options contract. Ordinary stock options that are traded on the exchanges do not have vesting dates, and American type options can be exercised at any date on or before the options expire. That is not the case with employee stock options that are issued by the company they work for. In part, a vesting date may be incorporated so that the company gets a bit of assurance that the employee will work at the company for a given period of time before the employee decides to leave and work somewhere else.

For example, suppose that you start a new job at Acme Widgets Corporation on June 1, 2020. As a part of your compensation plan, Acme might offer you options to buy 1,000 shares in the company. Hoping that they can use the prospect of owning stock in the company to keep you interested in working there, they may have a vesting date of January 2, 2021. That means that you could not exercise the options until January 2, 2021. This provides some incentives for you to keep working for the company.

When the vesting date has passed, your stock grants are “vested.” That means that you then have the right to exercise (see below).

Many companies have a 90-day rule. That is, if you are vested and you choose to retire or leave the company, you have 90 days within which you can buy the stock. If you are vested and leave your place of employment, if you don’t buy the stocks within 90 days then after that you have given up your rights to buy the stock using the options. This means that if you wanted to buy the stock after 90 days, you would have to buy shares on the open market and at the market price. Of course, if it was a private company, then you would no longer be able to buy the shares.

Grant Price

The grant price is the price specified in the options contract that you can use in order to buy shares of stock from the company. The grant price plays the same role as the strike price does for a publicly-traded options contract. This means that no matter what the market price of the stock is, the employee has the right to buy shares of stock at the grant price if they have become vested (that is the vesting date has arrived, and the options have not expired). Companies do this in order to offer a benefit to their employees. Of course, if the company is publicly traded, they have no control over the market price, and it may not always be in a favorable position for those who are interested in exercising their stock options.

Vesting Equally

If you hear from your employer that the stock options are vested equally, this will also be

accompanied by some time frame. Let’s say that it is five years, starting with year one. If you are granted 100,000 shares of stock, at year 1 if the shares are vested equally, then 20,000 shares of stock will be vested at the end of year 1. Then at the end of year 2, 20,000 more shares will be vested, and so on. This will give you the opportunity to exercise your options in pieces along the way.

You may also hear the term “cliff vesting.” If stock options are cliff vested for one year, that means you have to stay working at the company for at least one year before you can exercise the options.

Exercising Employee Stock Options

Exercising employee stock options simply means that you purchase the stock. When this is done, that means that the options contract itself is voided, and in its place, you get the shares of stock.

If the company is traded publicly, you are going to want to keep an eye on the market price of the stock. This is going to help you determine whether or not owning stock in the company at a price offered in the stock options, makes it worth exercising them. For example, if you are working for a company whose shares are trading at $14 a share on the open market, but the company has offered you shares of stock at $20 a share, it is not worth exercising the options. This is the out of the money condition. In options trading, out of the money options are never exercised for obvious reasons.
How would you get in this situation? At the time you started your employment, the company shares might have been trading at $30 a share, but the company had a vesting date many months or years in the future, so you were not able to exercise the options while the market price was higher than the price set in the options.

Companies seek to offer the stock at a discount, so in many cases, you will find that it is beneficial to exercise your rights and buy the shares. For example, maybe the employer issued stock options at $20 share, but by the time of the vesting date, the stock is trading at $40 a share. As a result, you have the opportunity to benefit from owning the shares.

Employee Stock Options – Terminology

Let’s go through some of the terminology associated with employee stock options so that all readers are familiar with and understand them. There are just a few things that you need to be aware of when it comes to employee stock options. These include:

- Issue Date: That is just the date that the options were issued to the employee or “granted.”
- Grant price: If the employee decides to buy the stock, the stock must be sold to the employee at this price.
- Market price: This is the price of the stock on the open market if the company is publicly traded.
- Vesting date: The employee cannot exercise the stock options before this date.
- Expiration date: If the employee has not exercised the options by this date, the options expire, and the employee loses the benefit. If the company is publicly traded, they can still buy shares of stock, but they are on their own.

Stock Price and Private Companies

Although private companies are not traded on stock markets, and so there is technically no "market price," the company has a valuation that comes from the revenues and profits of the company. Often privately traded companies inflate their value based on the future prospect that a product the company is developing or just starting to sell may have. As a result of fluctuating or increasing revenues and possible profits, the value that shares of stock in the company may have will change, even if there was some arbitrariness that came with associating them with a specific value in the first place. As a result, employees can still benefit from having the shares available at a discount as to what the company would charge outside investors to pay for shares in the company.

Should you put your all in the company?

One mistake that employees often make is putting all of their investments in the company that they work for. In the old days, this may have made sense. But today only someone who was ignorant of the principles of good investing would do such a thing. One of the most important rules when it comes to investing is diversification. This rule still applies even if you are given the opportunity of employee stock options. So, in this case, you should definitely not put all of your investment dollars into the company even though you work there. At most, you should probably put 10% of the money you have for investing purposes for the company. If the company is publicly traded, this won't be an issue, because you will be able to sell your shares on the market. Then you can use the profits from the transaction (assuming that the options were in the money at the time you exercised them – and there would not be a good reason to exercise them if they were not), in order to buy shares in other stocks or funds.

Some Common Mistakes

It's easy to make mistakes when it comes to employee stock options. For one, most people are not truly financially literate. In fact, we could probably say that most people are not financially literate at all. To make matters worse, stock options go beyond stocks themselves, and so people can have a hard time understanding the process and what is really involved.

In the old days, people would work for a company for a long time period, often for their entire working lives. That is no longer the case. Today, most people are going to change jobs multiple times before they retire.

As a result, if you are granted employee stock options, one of the things that you need to be aware of is what the policies are in the plan if you leave the company. Not knowing these important bits of information is something that is a major mistake when it comes to employer stock options.

When you are offered employee stock options, you need to familiarize yourself with the policies that are in place with regard to what happens if you leave the company before exercising the options. You will need to know what happens if you are fired (most likely the options would be null and void) if you are laid off, if you retire, or if you find a job elsewhere. As we mentioned above, in most cases, assuming that you are leaving the company on decent terms and were not fired, there will be a 90 day period where you can still exercise the options. This is given because the options were a part of your compensation plan as an employee. Therefore, if you leave the company but you haven't exercised the options, you need to find out right away if the vesting date has passed. If it is a public company, you need to be keeping an eye on the market price of the stock so that you exercise your options when they are in the money. Do not exercise out of

the money employee stock options unless you are looking at a stock that you are interested in investing in over the long term.

Know the tax laws

When it comes to investing, you need to know the tax laws when it comes to any financial transaction. You might find that you are in a position of owing a large amount of taxes if you acquire shares of stock and decide to sell them right away. We are going to discuss the issues surrounding taxes and investing in chapter 10 of this book.

Know the vesting period

Employers want to give incentive for employees to stay at the company, so the vesting period is not going to be a short time frame. They are interested in keeping you there (that is, giving you the incentive to stay) for at least a year. Most companies that have employee stock options have a vesting period of 1 to 4 years. Remember that the options are probably going to expire in 90 days at any time you leave the company. So you need to have these dates firm within your mind. The typical expiration date for a company offering stock options is 5-10 years after the vesting date. So if you are planning on staying at the company for a while, you will have a significant time frame over which to monitor the stock and only exercise your rights to buy the shares when the stock goes in the money, if it is not in the money when the vesting date arrives.

Are Stock Options for You?

Whether or not stock options are right for your particular situation is something that is going to depend on your financial state and where the company is along its growth cycle. If you are working for a public company that has good prices offered in their stock option plans relative to the market price, then it is a no brainer to buy the shares, at least for the purpose of selling them in order to make a profit. If you are anxious to move to another job or retire, and the market price makes the options out of the money, then it is not worth exercising or worrying about your employee stock options.

Private Company Stock Options

If you are working for a private company, the picture can get more complicated. Many times, you will find that a private company is offering stock options as compensation because they are not able to pay salaries that compete at market prices. If the company is a startup, this can provide employees with a chance to directly share in the company's massive growth should it occur. In a private company, however, employee stock options may not be liquid for a long time, if ever. There is not a public market for stocks held in private companies, and so it may be very difficult for employees to actually convert their shares of stock into cash. If the company is acquired by an outside buyer, then this would be one such opportunity, but it may require waiting around a long period of time for something of this nature to happen. The second major possibility is that the company will go public with an IPO, and once the company is public as an employee with shares of stock, you can then sell them on the open market.

How an IPO Can Turn Employee Stock Options Into Large Amounts of Money

There is no doubt that you have heard the stories about employees at startup companies that went public and became millionaires. The process could work something like this. You get a job at a new company, that has a lot of promise because it will disrupt some market. The company is short on cash in the beginning, and so it will offer you 50,000 shares of stock through a stock option plan with a grant price of $0.50 a share. So it would cost you $25,000 to buy all the

shares.

You work for the company for five years, and then it becomes public. After the IPO, the stock price is $14 a share.

Your expiration date is still a year into the future. You could exercise the options now, which would certainly be a smart move. So let's say that you decide to do that, so you have to spend $25,000 to buy the shares at $0.50 a share. At the time you joined the company when it was just starting, $0.50 a share might have been all the shares were objectively worth. And remember that with stock options, the price that is paid for the shares must be the grant price, no matter what the market price of the shares happens to be. That is the rule that is legally in force until the expiration date. Of course, the company appreciates the loyalty of the employees that have stuck with the company to this point and so it won't be unhappy with this situation.

However, now that the stock is publicly traded you can immediately turn around and sell your shares for $14 a share. You can sell some or all of the shares. That is entirely up to you. If you decided to sell all of the shares, you would earn $700,000 from the sale, for a net profit (ignoring taxes) of $675,000.

You could also wait and see. If the company has good prospects, in a year it might be trading for $30 a share, and then you could sell your shares for $1.5 million. Alternatively, you could hold onto the shares for the long term. It's entirely up to you, and nobody can force you to sell the shares.

Chapter 2: The Oracle of Omaha

In this chapter, we are going to discuss the solid principles of long term investing. These are the principles followed by and promoted by Warren Buffett and others. This is why we are titling the chapter "Oracle of Omaha."

The basic fundamentals behind this type of investing are focused on investing in companies for the purpose of building long term wealth. This is not a get rich quick scheme, but rather a process centered on picking solid investments that you can stick with for many years in order to build wealth for the future. At some point down the road, you can start cashing out your stock for a profit. The reason this works is that if you are careful about what companies you invest in, and you are getting out of bad investments when then signals are there, you are going to find that you have gained considerable wealth over the years.

Over the long term, while there are many ups and downs in between including recessions that can sometimes be extremely severe, stocks appreciate in value. Of course, not every stock is going to appreciate in value, because many companies fail, or at least fail to hold onto their market share and don't realize the potential they once had. But many companies will grow in size with the economy, and usually, this growth will outpace inflation. At the end of a ten, twenty, or thirty-year time span, the value of the stocks that you hold will appreciate in value by a large amount.

Investors who follow this type of plan can then take advantage of that wealth of appreciation by slowly converting their holdings into cash. You can use this cash to buy the things you've always dreamed of, to travel, or simply to maintain the kind of middle-class lifestyle that you are used to.

Fundamentals and their role in long term investing

The first thing we need to think about when considering long term investing is the fact that we are looking for companies that we can stick with for many years, if not decades. That means that you have to get a full understanding of where the company stands at the time you are investing, and you also need to keep up with the state of the company as time goes on.

A large part of this is a periodic evaluation of the company's financial statements. You need to know how the company's profit and revenues are trending, and you should evaluate this information on an annual basis to keep up with their fortunes. Of course, one bad year doesn't indicate that you should abandon the investment, you are looking to see how the company is faring over time. Three and five-year trends are important to look at.

The Intelligent Investor

Warren Buffett's style of investing begins with a concept promoted in the book *Intelligent Investor* written by Benjamin Graham. In the book, Graham promoted the idea of finding value stocks. These are stocks that are priced below the true value of the company. Then, according to Graham, you would hold these stocks until they rise to their true value.

The basic idea behind a value stock is that the company is trading at a share price that is below where it should be. Each company in the stock market has an *intrinsic value*. This is the value you would give the company based on its financials, that is what are the income and cash flows

for the company, and how is the company growing year to year. You can use intrinsic value to estimate the price of a stock.

There is not a specific formula to use. Rather, you would compare the intrinsic value of the company to other companies in the same sector or industry. Then you would compare the stock price of the company. If the company has a low stock price relative to other companies in its sector that are performing at a similar or lower level financially, then you know the stock of the company is underpriced, making it a value stock.

There are other factors that cannot be quantified that would be looked at in order to determine whether or not a stock is a value stock or not. For example, you would look at the research and development going on at the firm. If a low priced pharmaceutical stock, for example, is for a company that is working on a breakthrough diabetes drug that is expected to be approved by the FDA and be on the market within five years, then you know the company has intrinsic value that isn't being priced into the stock.

Another factor that can be examined is the management team. If the company has a solid management team that is well respected in its industry, but the stock of the company has a relatively low price, this can be a reason to consider it a value stock.

Fundamental Analysis in Detail

The main way that professional investors determine whether or not a stock is underpriced, priced just right, or overpriced, is to use fundamental analysis. Fundamental analysis is not the same as technical analysis. Investors that are long term investors don't use technical analysis at all. Technical analysis is a tool that is used to guess which direction the stock price is going to move over the course of a few hours, days, or maybe weeks. If you hear anyone talking about technical analysis, then they are not investing, they are speculating. And they are certainly not following the methods used by Warren Buffett. Technical analysis is only looking at the behavior of prices of the stock over short term periods, and it doesn't matter at all what the company is, who is managing it, or what the company's long term plans are.

Fundamental analysis, in many ways, is the exact opposite of technical analysis. When you are doing a fundamental analysis of a company, you are not at all concerned with the short term price movements of the company. You don't care how it's moving day to day, or even over the course of weeks. In fact, you don't even care what the share price is, other than looking for stocks that are undervalued relative to what the intrinsic value of the company would indicate the stock should be priced at.

The first thing that is considered in fundamental analysis is the state of the sector from an economic perspective. While we are often concerned with recessions and bear markets, individual sectors can have their own recessions or downturns while the rest of the economy is doing well, or vice versa. For example, you could focus on the oil and natural gas industry. In the early days after the recession that followed the 2008 financial crash, the industry began to see the widespread use of fracking. As a result, while the rest of the economy was either declining or barely beginning to recover, the oil and natural gas industry was undergoing the beginnings of its own economic boom.

Those kinds of relative differences, economically speaking, between sectors are something that

needs to be considered first, so that you would have an idea of what a good price for a stock would be. In the example above, you would expect the value of energy stocks related to oil and natural gas to be priced above average for companies with the same underlying cash flows.

The main factors to consider with fundamental analysis are revenue, earnings, profit margins, and the annual return on the stock price. You will also want to know how much debt the company is carrying. The most important factor here is going to be the growth or decline in the amount of debt. Just like looking at the financial health of a household or individual, a company that is showing an increasing debt load is probably not a good investment. However, if a company is decreasing their debt load, even if they have a large amount of absolute debt, that could be a sign that the company may be a good investment going forward if they are showing improvement in other numbers as well.

There are three financial statements, all publicly available, that you should look at when considering the fundamental analysis of a company. These include the income statement, the balance sheet, and cash flow. Let's examine each in turn.

Income Statement

The income statement provides important information about revenue and profits for the company. You can examine income statements annually and by quarter. An investor will be looking for trends in the income statements. For example, is gross profit increasing each year, or stagnant or declining? A stock that is underpriced relative to its competitors in the same sector but that shows an increasing gross profit for the past 3-5 years might be a stock that is a valuable investment. When looking at quarterly data, you should look at the same quarter for each year, in order to account for seasonal differences in economic activity related to the company.

There are many other things to look at on the income statement besides gross profit and revenues. For example, you should check the operating income or loss. But don't check it blindly. Of course, the general hope would be to see steadily increasing operating income. You certainly don't want to see operating losses – in general. However, the future potential of the company might figure when looking at these numbers. Research and development is an important operating expense, and as we cited above, if you were looking at a pharmaceutical company and it had a declining operating income because it had massively increased spending on research and development, then the operating loss may not be an important factor to consider. We know that spending now on research and development is definitely something that can pay off later for a company. Other companies might be on the cutting edge and have a potentially disruptive product that could mean the stock is going to have a lot more value down the road as compared to its current status. For example, Tesla has large operating losses, but many investors are big believers in the future promise that electric cars hold, and so they may be willing to put up with operating losses now, in the belief that Tesla will experience future growth later due to the advantages it has holding potentially disruptive technology as an asset.

At the bottom of the income statement, you will find net income, and also net income applicable to common shares. These values are going to be something to look at, and again you want to look at trends. If the company shows steadily increasing net income year to year, over the course of 3-5 years, this is an indication that this could be a value stock.

Balance Sheet

The next financial statement that you want to look at when doing the fundamental analysis of the company is the balance sheet. The balance sheet is something that you can use to see the assets and liabilities of the company. You will want to compare the total current assets and total current liabilities. While you are going to want to look at total current liabilities and see what the trends are, be sure to also compare total current liabilities to total current assets on a percentage basis. If the company has increased debt loads year to year, but it's growing so much that as a percentage of total assets the debt is decreasing, then this is still a company that is financially healthy. You will also want to check long term debt and accounts payable.

At the bottom of the balance sheet for a publicly-traded company, you are going to find information about stocks. Here you will find the total number of shares that are available, along with the retained earnings of the company and treasury stock. If a company is paying out dividends (not all companies do), retained earnings are going to be the amount of net income that the company keeps for itself or retains. The reason that they will retain some of the net income is so that they have profits on hand that can be reinvested into the company. This may be done in the form of increasing spending on research and development, or building new manufacturing plants or hiring more workers. If a company pays no dividends, then it's going to keep all of its net income as retained earnings.The capital surplus of the company will also be listed here. This is the net worth of the company that is not classified as retained earnings.

Treasury stock is shares of stock that the company is keeping for itself and not currently offering to the public. It could, for example, be shares of stock that it has "bought back." The shares are then kept in the treasury of the company as an asset. It could later offer them to the public.

Cash Flow

The last financial statement that you want to examine when doing fundamental analysis is called cash flow. The first line of a cash flow statement is the net income of the company. Ideally, you will want to see the net income increased year over year. You will also want to compare the net income of the company to the net income of similar companies in the same sector that have higher stock prices. For readers who are not clear on the definition of net income, this would be total sales minus the cost of goods sold. The costs will include all expenses such as administrative expenses, depreciation, marketing, taxes, and so forth.

On a cash flow statement, you will find some information on operating expenses below the net income listing. So you will see depreciation and some other items. Investment activities by the company will also be listed.

At the bottom of the cash flow statement, you will see any information available on dividends paid by the company and net borrowings. If the company is not paying dividends, this line will be left blank. Net borrowings are the total borrowed funds used for the operating expenses of the business.

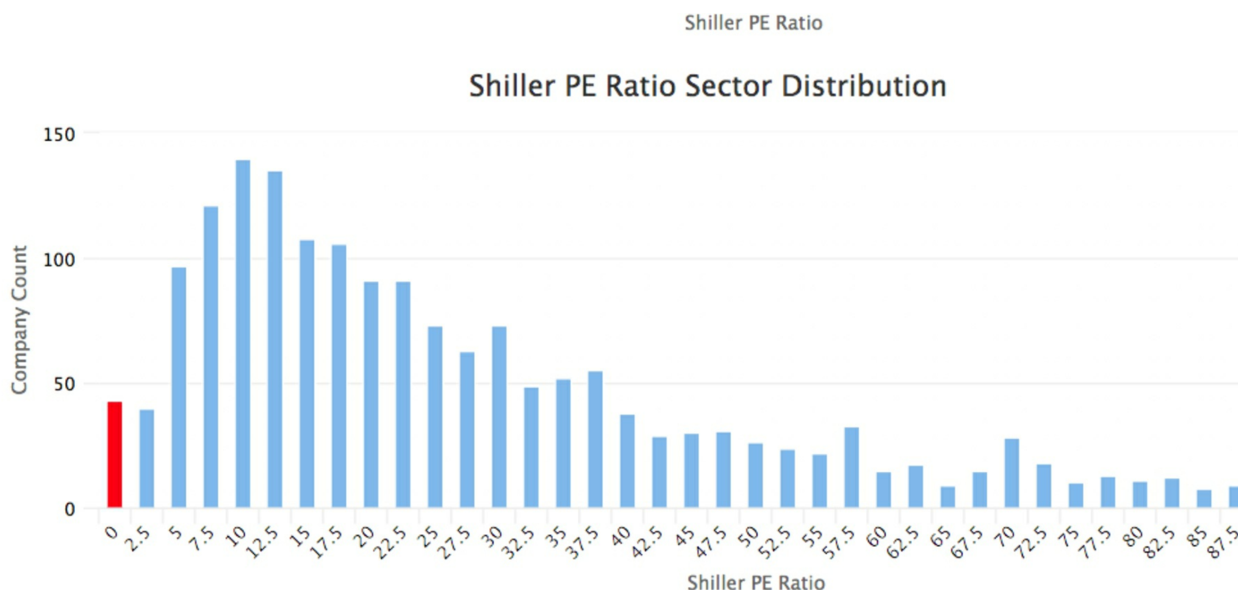
Why the company's value is important

For the value investor, or for that matter any investor, the price paid for a stock is going to be determining the long term return on investment. Of course, you are still taking a risk by investing in a value stock. Even though the financial statements may be indicating that the stock should be priced higher than it is, the market may not come to agree with that assessment, and the price might not rise as expected. Also sometimes stocks that you would consider overpriced relative to

their underlying value may continue to increase in price because of hype or expectations. Emotion often plays a role in the pricing of stocks, and high-tech stocks, for example, are going to generate a lot more emotion and excitement than a utility stock, to take an extreme example. That can be true even if the high tech company is not even earning profits. A stock in a more slow-moving industry could be earning a lot more profits, but investors will be drawn to the high tech stock because of the perception that it will earn high profits in the future.

Nonetheless, you are playing the odds of probability in the stock market. We can confidently say that the probability is going to favor value stocks increasing in share price over time if they have good fundamentals.

One way you can quantify value is by looking at the Shiller PE10 valuation of a stock. This will give you an idea as to the risk of the investment and the implied long term returns. A low Shiller PE10 value means that the investment is a lower risk investment and that it's likely to have a higher rate of return in the future. Conversely, a higher Shiller PE10 value means the investment is higher risk, and it is more likely to have lower rates of return in the future. The Shiller PE10 ratio averages the data over a 10 year period and accounts for inflation. By using the Shiller PE10 ratio, you can average out temporary fluctuations that occur over time. For example, you can account for a year or two of unusual earnings by the company, or average out stock market crashes like the 2008 financial crisis or boom times as well. So the Shiller PE10 will give you an averaged price to earnings ratio that can be used to more accurately interpret the price to earnings ratio of the company and its value. A low value indicates that the company is a good investment. You can compare values between companies, sectors, or by using the S & P 500 index. You can also look up important information such as the distribution of companies by Shiller PE ratio for a sector.



Shiller PE Ratio for Tech/Social Media sector, calculated by Guru.com

Inefficient Pricing

You will often hear the term "inefficient pricing" when we are discussing value investing. The idea behind this concept is that the pricing for certain companies in the market is often inefficient, that is not representing the true value of the company behind the

stock. So you should not be looking at the stock price alone in order to determine the true value of the company, and the idea behind inefficient pricing is that over the long term, the market is going to revert back to the true valuation of the company.

The Warren Buffett Strategy

With the ideas of fundamental analysis clear in our minds and what to look for, we can discuss the strategy used by Warren Buffett in picking investments. This is a good strategy to use if you are looking to hold onto stocks for the long term. That is, you are looking to hold onto your investments for at least a 5 year period, but more typically one to three decades of time.

Of course, things will change as time goes on. Although a stock might be a solid value investment for the next 3-5 years, that does not guarantee that it is going to be a solid value investment for the next 10 or 20 years. So once a year, when companies release their 4th quarter earnings, and you are able to completely review their data for the previous year to see how things are going, you can evaluate whether or not the company is still worth investing in. You are not required to hold all of your investments if they are not working out, and you should be looking for better investments if you find stocks in your portfolio are not performing as hoped.

Now let's consider the most important principles that Warren Buffett follows in his investing.

Stick with Your Investments and Don't Panic

One of the biggest enemies of investors is emotion. You see nearly everyone following the lemmings over a cliff, whether it's buying up an overpriced stock or getting out of the stock market at the slightest downturn. The two emotions that people experience in the stock market that are destructive are greed and panic. When it comes to greed, people will buy up stocks hoping to strike it rich, preferably over the short term. It is completely natural to experience this emotion. However, you should not give in to it because it's a destructive emotion when it comes to investing. You will find yourself paying too much for stocks, often buying up shares at peak prices before they drop back down. Remember that although it happens occasionally, in the vast majority of cases nobody is going to get rich quick. Building wealth is something that takes time, usually a long time. Therefore you should be methodical in your stock purchases. If you are feeling some kind of adrenaline rush, or a sense that you have to buy up stocks NOW in order to get the growth in value that you are expecting, these are red flags that indicate you should take a step back.

Of course, the worst impulse when it comes to the stock market is selling off your shares in a panic, when there is a bear market or a given stock is declining. People do this all the time, getting out of the market when there is a short term downtrend so they can supposedly preserve their cash. This is the true lemming behavior, and it's a major contributing factor to crashing stock prices. Warren Buffett is not someone who is going to dump his shares over a short term fluctuation. Remember that you are in your investments for the long term, which means for decades, or at a minimum at least five years. A recession is going to be a mere blip over the course of 10 or more years, and often even over five years of time. Even during the Great Depression, stocks rallied and began increasing in 1933. And as we know, the Great Depression was an anomaly. It could happen again, but the chances of it happening are low. Beyond the Great Depression, most recessions are short-lived, and the markets often begin their recovery before the economy fights its way out of a recession. If you are investing with a time horizon of ten or twenty years, a downturn that lasts 9 months to two years at the most is not going to be important in the end. So avoid the impulse to sell and hold onto your investments instead.

People who panic and exit the markets, only to get back in later, often end up having to buy back shares at higher prices.
In short, Warren Buffett advises that investors never sell when they panic.

Invest like it's your business

Warren Buffett tells investors that they should act like they are buying the company. All too often, people invest in their gut feelings. They get excited about say Amazon or Netflix, and so throw all their money into these stocks, without looking at the fundamental analysis. If you were going to buy a local business to generate income for yourself, would you invest in that fashion? No, you would not. If you were buying a business, you would pour over its financial statements with a fine-tooth comb. You'd want to know what the plans are for the future and what has been done to take the company in that direction. You'd want to have a clear picture of any debt that the company had taken on and so forth. Warren Buffett advises that you look at stocks in exactly the same way. Even though you are only buying into a small fraction of the company with the stocks that you buy, you are counting on this company providing for your future wealth and retirement. So you should treat it as if you were investing in it for the long haul.

Invest in Quality

Warren Buffett aims to invest in quality companies. Ideally, he would like to find value stocks that are underpriced, but he is also willing to pay the fair market value for a company that is a quality investment. Something that naïve investors fall for that is often promoted by internet gurus looking to sell people "systems" is investing in cheap stocks, because they are cheap. This is not something that fits into the Warren Buffett investment strategy. You should absolutely stay away from penny stocks, and Warren Buffett is not someone who would put his money in low-quality companies just because they have cheap stock prices. It's important to note that the goal of investment using this method is to find companies that have solid fundamentals but relatively low stock prices, or companies with solid fundamentals that also have fair stock prices. You are not looking to invest in a company that is in poor shape and has mediocre prospects going forward, just because it has a cheap stock price and you would hope to earn profits because the price might bump up at some point. That is a game played by gamblers. If you are using the Warren Buffet investment strategy, you are not going to be gambling with your investments.

Look for Competitive Advantages

Seek out companies that have important competitive advantages that will help the company beat out its competition over the long run. This can include new product development, established branding, or the ownership of strategic assets like important patents. Using the example of a pharmaceutical company again, if there is a company that holds several patents on diabetes drugs, that would be a competitive advantage. It's not just the patents themselves that hold value, the fact that the expectations are that diabetes will continue increasing in the population in the coming years means that the company is well placed for success with its competitive advantages of being able to respond to these changing conditions.

Seek out companies that can weather bad times

Another characteristic that Warren Buffett has long sought is looking for companies that are able to weather downturns in the economy. This can include both major recessions and downturns in the sector where the company is located. Many older companies have shown tremendous resilience, surviving, and even thriving during major economic downturns. A good example is

IBM, which has been around for a century, surviving both the Great Depression and the 2008 financial crisis, coming out of both even stronger than it was before. Another characteristic that IBM has is that it has been able to redirect and retool itself for changing market conditions. It is an extremely adaptive company that makes it a good long term investment.

Invest in what you understand

Warren Buffett believes that you should understand the industry a company is in and the products that the industry produces. If you are trying to invest in a sector that you are clueless about, you can't truly evaluate whether a company is a good investment or not. You should be able to look at the products the company is offering, and have a reasonable understanding of their market potential. This means that you need to understand the sector and where it's going. If you know nothing about oil and natural gas, or solar power, then energy companies are probably not a good investment for you. If you are not familiar with real estate, then investing in real estate trusts or exchange-traded funds focused on real estate might not be a good move. Pick a few sectors and learn about the sector as much as you can, so that you can understand the ten year future of the sector and realistically evaluate the sector and the companies in the sector to have an idea of where things are going.

Keep cash available for investing

Warren Buffett advises investors to be prepared for upcoming opportunities. You don't want to sink 100% of your cash into stocks, because new opportunities are always coming up, and you don't want to be in a position where you are not able to take advantage of them. You should be ready to jump into a new stock without having to sell off your existing investments when the investment in a new stock is warranted by the fundamentals of the company and value pricing of the stock. The words "missed opportunity" should not be part of your lexicon. So in order to avoid missed opportunities without having to disrupt your existing portfolio, you should have some cash available at all times to get into new stocks. When you use up the cash, your next goal should be to replenish that supply of cash for when the next opportunity arises.

Have Clear Financial Goals

To follow this type of strategy, you should have clear financial goals in mind. This means that you should know where you want to be in ten, fifteen, and twenty years from now. If you have no idea of where you expect to be in different time frames, then you cannot plan your investing accordingly. Don't have vague goals like "I want to be a millionaire." You should have specific goals that you can use to compare your results to in order to judge the performance of your plan and make the necessary adjustments. If you know that you want to have $100k in stock in five years, then you can figure out how much you need to invest and how often you need to invest. Then when you reach the goal, you can work toward the next goal, which could be $250k in investments.

What the Warren Buffett Investing School Boils Down To

The philosophy that we have described in this chapter comes down to two items. The first is long term investing, and the second is value. So you are looking for value stocks that are priced below market given the value of the company in real terms, and you are looking to hold these investments into your retirement.

Again remember that you are not trying to force yourself into holding investments for the long term, if a company turns out to be a bad choice then you should exit the position and find a better

one that is going to help you meet your financial goals.

Chapter 3: Investment Tactics

In this chapter, we are going to discuss the tactics that should be used in conjunction with the *strategy* of Warren Buffett value investing outlined in the previous chapter. Many people misrepresent the methods that we are going to discuss in this chapter as strategies, but in fact, they are tactics, and the strategy is the method you use in order to reach your ultimate financial goals. Tactics are techniques that you employ in your day-to-day operations in order to keep the strategy on track.

There are three main tactics that are used by long term investors in order to further their investment goals and keep their plans on track. These include diversification, dollar-cost averaging, and rebalancing of your portfolio. We will discuss each of these in turn.

Diversification

The most important tactic that you can incorporate into your investing is diversification. The reason is pretty simple and straightforward. First of all, no matter how careful you are in your fundamental analysis, mistakes are going to be made. Also, companies are not always going to stay on the same track going forward. A company might be on solid footing now, but the management may make many mistakes in the coming years, or there could be changes in management or competitors can arise that outcompete the company that you thought was a great investment, causing it to falter.

We have no control over these things. Therefore the best method that can be used to protect yourself is to avoid putting all of your investment money in a single company. In fact, you should avoid putting all of your investment money in a small number of companies. The more companies that you invest in the better off you are, at least in theory.

In practice, you should select a set of companies that you can comfortably manage. The specific number of companies is going to vary from person to person. The more companies that you pick, the more time you are going to have to devote to fundamental analysis and keeping track of stocks and company earnings reports going forward. So there are going to be limits which are different for each person and their living situation. Someone who is a fulltime investor may be able to keep track of a few dozen companies. But someone who has a “day job” and isn’t available for more than a few hours a week as far as devoting time to their investments, is not going to be able to keep track of more than a handful of companies.

Therefore we can’t say what the exact number of companies to invest in should be. That is going to depend on your situation, but we can say that one company is certainly a bad idea, and 3-4 companies are certainly not enough. Most financial advisors would agree that at a minimum, you should be investing in 7-10 companies. Many financial advisors believe that a good number to shoot for is 20 companies.

If you are not able to invest in more than seven different companies, then perhaps investing in funds is more appropriate. In chapter 9, we will talk about exchange-traded funds. We will discuss the details there, but exchange-tradedfunds allow you to buy shares on the stock market in funds that invest in large numbers of companies. This will help you get the diversified exposure that you need in order to have a healthy portfolio, without having to try and dig up enough companies to do this on your own. You can even invest in funds that are themselves

invested in dozens, hundreds, and even thousands of different companies. You can also invest in sectors, different asset classes, and more.

It is important to not only diversify your investments by picking different companies to invest in. They should be in different sectors as well. You don’t have to invest in every sector in order to have a diversified portfolio, but you should invest in three different sectors at a minimum. Of course, here we want to be careful, remember one of the dictates of Warren Buffett is that you need to understand what you invest in.

Therefore it’s not a good idea to investigate in sectors that leave you feeling clueless. You should pick sectors that you have some general level of understanding in. Or at the very least, if you are considering investing in a sector or industry, take some time to do research and learn all you can about the sector by educating yourself about it. Your education needs to include the past history of the sector as well as an analysis that tells you what companies are poised to dominate the sector in the coming decade. You need to become fully educated in the different products and services offered in the sector, and what analysts think is going to be important going forward.

It’s also important not to be investing in sectors that are too closely related, as that would really be the same as investing in one sector. For example, social media and the internet can be considered as distinct, but in reality, social media is a sub-sector of the internet. So while investing in some social media and internet-related companies might be advisable, it is better to invest in 3-4 companies in those areas, while choosing a different and totally unrelated area, like brick and mortar retail (Walmart, Dollar Store, etc.) or pharmaceuticals.
The reason that we seek diversification in our investments is for risk management. This plays out on two levels. The first level where this is influential is in picking out companies to invest in, recognizing that some of the companies are going to fail while others are going to be very successful in the future. At the present day, nobody has a crystal ball that they can use to predict the future. All we can do is use the fundamental analysis in order to play odds. So while we can use probability to our advantage and pick companies that are likely to be successful over the long term, unforeseen events and changes are going to ensure that some of them will fail. The level of failure can happen over a wide range of possibilities. The stock may continue to increase in value, but it may lag that of its competitors. New and different sectors may emerge that make the current sector irrelevant in the future. Consider how unexpected changes can have massive ramifications. We’ve already talked about fracking, but consider how revolutionary that was. In 2006, oil and gas looked like dinosaurs, and the United States looked as if it would be stuck in a position of having to import the oil and gas it would use. At that time, you would have been making reasonable bets if you were looking into either investing in overseas oil companies or avoiding oil and gas altogether in favor of renewable energy. But then fracking came out of nowhere and completely transformed the energy sector. Rather than having to rely on foreign imports, domestic oil and gas production skyrocketed over the next 10 years, even turning the United States into an exporter of oil and natural gas. Who would have seen that coming?

No matter what sectors you are investing in, you are not going to be able to foresee such changes in most cases. And when they occur, you are not going to be able to know how long they are going to have an impact. Sure, fracking is great for the oil and gas industry now, but where is it going to be in 20 years?

Diversification helps to protect you against these types of risk factors. At a minimum, invest in

three different sectors or industries. Then invest in three different companies per sector.

The bottom line is that the more diversified your portfolio is, the better off you are going to be going forward. So you should do the maximum amount of diversification that you can, and if at the present time you are not able to meet a minimum threshold of sectors and companies, then you should consider investing in exchange-traded funds instead so that your exposure is not too limited.

Dollar-Cost Averaging

The next tactic that is used by long term investors is called dollar-cost averaging. The purpose of this method is to avoid getting in a situation where you are buying too much of your stocks when prices are high. As you know, stock prices are constantly fluctuating up and down, and the market itself has many highs and lows including bull and bear markets that take pricing of individual securities along with it for the ride.

Now, over the long term the truth is no matter what you do, the odds are that in ten, twenty, or thirty years, prices are going to be much higher than they are today and so the individual fluctuations are not going to matter that much. But as an investor, you want to maximize your return on investment or ROI. In order for that to happen, so that you can grow your wealth to the maximum extent possible, you need to be buying at the best possible times, when you can get the best possible prices.
Of course, there is one problem with this idea. It comes down to the same basic facts that we discussed in the last section. And that is none of us has a crystal ball despite the claims of some to the contrary. It’s simply impossible to know at any given moment whether or not the price of a stock is the best price that is going to be available.

During a bear market, many people are interested in being able to buy stocks when they are “cheap” relative to what they are normally priced. This is a good goal to have, and during bear markets, one of the things that you might consider doing is accelerating your stock purchases.

But one of the problems that happen is people wait too long. They sit on the sidelines hoping to see the stock “hit bottom,” but then they find prices suddenly reverse and start rising, and then they end up with a missed opportunity, sometimes even finding that rather than buying cheap stocks they end up paying more for the stock.

Something that every investor needs to get inside their mindset is the fact that nobody knows when a stock or the market at large is going to hit bottom. In truth, you can’t possibly know at any given moment if you are paying low or high prices compared to where the stock is going to be in the future. People use technical analysis to try and glean when trends in pricing are going to reverse, but to be honest, that is a lot of gobbledygook. Human behavior is often irrational and impossible to predict, even if “most of the time” you can estimate when there are going to be trend reversals. The methods used in technical analysis are easy to fool by big trading institutions, that can create “signals” by buying or unloading huge quantities of shares simultaneously.

Dollar-cost averaging takes the basic facts into account by recognizing that we are not going to be able to determine with any certainty where tops and bottoms of the market are going to be over the short term. Therefore, it is a method that seeks to buy stocks at averaged out prices. The

average over any short term period is going to be low in most cases when compared against the average prices down the road, years and decades into the future. If the average over the short term is not low with respect to future prices, well then you have picked a bad investment.

Another goal that dollar-cost averaging helps you to meet is that it will get you on a regular investment schedule. For long term success in the markets and to build wealth over the long term, you need to invest regularly. Think of this in terms of putting money in the bank. Someone who starts young and puts $100 a month into the bank their entire lives can end up a millionaire by retirement. Dollar-cost averaging can help the stock investor enjoy the same benefits by getting you on a disciplined, and regular investment schedule.
At any given point, you should invest to the maximum extent possible. But to set up a dollar-cost averaging plan, you should figure out a set amount of cash that you are able to invest in the stock market on a regular basis. The amount that you choose should be reasonable so that you have a good probability of meeting your goal at each investment point. The amount that you invest each time can be adjusted with time as you increase your income.

The second part of a dollar-cost averaging plan, which is the most important part of the tactic, is to invest on a regular schedule. You can invest once a week, twice a month, or once a month. As time goes on, you can adjust the schedule as necessary, but the point is that you should have a regular interval that you use in order to make your investments.

By spreading out your investments in this way, you will average out the pricing of the stocks and reduce your risks, while ensuring that you are always investing and sticking to your plans. For example, you might have $500 available each month in order to invest. You can divide this into two investments of $250 each, every two weeks.

When you are able to do it, the best dollar cost averaging plan is going to be the one with more frequent investments. The reason this is the case is that by investing more frequently, you are more accurately averaging out the stock prices. Of course, if your broker charges commissions, you don’t want to be investing too much because those expenses can add up over time. But with that in mind, generally speaking investing $50 ten times a month is going to be a better price averaging plan than investing $500 once a month. Of course, the worst thing that you could do would be to invest $6000 once a year.

Before you start investing, look at your monthly budget to figure out a comfortable amount that you can invest each month. This amount should not be large enough that it would interfere with your abilities to pay your monthly living expenses, but it should be the maximum possible amount. Then take that amount and at a minimum, invest it in stocks that you want to include in your plan once a month. If you are able to do it, then invest twice a month or more.

Once you have set upon an amount to invest and an investment schedule, stick to it for the calendar year. Then the first week of each January, re-evaluate your situation and proceed with adjustments if necessary. If you are going to have more income over the coming year, you should definitely adjust the frequency and/or the amounts invested so that you are investing more and possibly more often than you did in the previous year.

Any time that you have extra money to invest, you can do this outside of your regular dollar-cost averaging investment plan. Remember that the rules should be followed but they are not

something that has to be written in stone, and adjustments can be made when they are warranted.

Buy More During Downturns

Any time there is a stock downturn, whether it’s an individual stock or the market as a whole, you should immediately buy more stock. This is one of the reasons that it’s important to have cash on hand. Of course, you don’t want to use up all of your cash on a single stock purchase. The reason being that you don’t know if the stock is going to keep dropping in price. If it does keep dropping in price, you are going to want to be able to buy more stock at the lower prices. But whenever there is a downward trend in price, you want to put money into the markets so that you can buy the stock at a discount. Of course, we are talking about normal circumstances here. If there is bad news about a company coming out, such as the company is engaged in some kind of fraudulent activity, that is probably not a good reason to be investing more in the company.

What we are talking about here are mundane or external causes. By mundane we mean one bad earnings report among an overall trend of increasing profits. Investors that unload all their Apple stock based on one quarterly report that misses “expectations” or even shows reduced profits are making a foolish play.

External causes can be economic or political in nature. These are news events and such that lead to overall market declines that turn out to be temporary. In fact, these are the reasons that you should use in order to buy more shares.

Rebalancing Your Portfolio

Most investors have their portfolios arranged by class in percentages. They may want to seek out a certain level of aggressive growth, a certain level of value investing, and they also might want to protect a certain amount of their capital. In other words, they use asset allocation to build a portfolio that helps the investor to meet his or her goals over the long term. Asset allocation refers to the way that you have distributed your investments, so for example if we were talking about asset allocation over stocks and bonds, an investor might have 50% of their investments in stocks and 50% in bonds, while a more aggressive investor looking for more growth with higher risk tolerance might have 70% of their investments in stocks and 30% in bonds.

When you first build your investment plans, determining your asset allocation is going to be one of the first things that you do. Someone who needs to raise cash quickly is going to be devoting more of their investments to aggressive growth stocks. Someone who is looking to preserve their money is going to be putting more of it into bonds or money market funds. Everyone has different goals, and you will have to look at your own goals and then breakdown your investment allocations accordingly.

Once you have that setup, you are going to let your investments run for a year and be making your stock purchases at regular intervals in order to meet your goals. So if at the beginning of the year you’ve decided to invest 65% in stocks, 20% in corporate bonds and 15% in cash, at each point when you make investments you will divide them up this way.

Of course, some investments are going to overperform, and others are going to underperform, with time. So by the end of the year, your portfolio might not be structured in the way you set out to have it structured. You might find that instead, you end up with 70% in stocks, 25% in corporate bonds, and 5% in cash.

At the end of the year, it's time to look at your asset allocation and see if it's remained the same. You will also have to look at your own goals. At the end of the year, your goals might be different than they were at the beginning of the year.

In any case, what you're going to have to do is rebalance your portfolio, either to stay consistent with your original goals or to change the portfolio so that it will help you to meet your new goals. If the percentages in each asset class have changed, and you want to stay consistent with your original goals, you may have to buy and sell assets in order to bring things back into alignment.

Using the previous example, we would have to sell off some stocks and corporate bonds in order to reduce their percentages in the overall portfolio. Then, you would reinvest the proceeds as appropriate to bring yourself back to 65-20-15.

Keep in line using the tactics

The tactics outlined in this chapter are easy to follow, and they are going to help you stay on track to meeting your overall financial goals. The disciplined investor is going to be the one who has the most success over the long term. That means using the Warren Buffett strategies outlined in the previous chapter, in conjunction with using diversification, dollar-cost averaging, and rebalancing your portfolio in order to stay on the road that will lead you toward your financial goals.

Chapter 4: Dividend Stocks

A part of the Warren Buffett investing philosophy is to look for solid companies that pay growing dividends. This can be an important part of your wealth-generating strategy. In the near term, the income from dividend-paying stocks can be used to buy more stocks than you would have been able to purchase otherwise. In other words, rather than taking out the dividends in order to generate income, you would use them to purchase more stock. Of course, by the time that you get close to retirement, you can use the dividend income in order to have cash payments that you can use for income four times a year, as dividends are paid out on a quarterly basis.

The kinds of companies that pay dividends tend to be older and more mature companies. They may be growing companies, but they will be growing at a more modest and sustained rate. These companies may be dominant in their sectors and have a solid market position that is difficult for competitors to challenge. Their share price may be relatively low, compared to upstart challengers or similar companies in the same sector. In other words, in many cases, stocks that are considered to be solid dividend stocks are the kinds of stocks that a Warren Buffett would invest in.

In this chapter, we will learn the basics behind dividend stocks so that you will be educated enough to start investing in these companies and adding them to your portfolio.

What is a Dividend?

Quite simply, a dividend is a cash payment that a corporation makes to the shareholders each quarter. The payments come out of the company's profits. Not all companies pay dividends, those that do are usually more mature companies that have a solid market position, and therefore they are not seeking out aggressive growth. This is not always the case, however. The classic example of dividend companies are older technology companies like IBM and Microsoft, or well-established companies like GE. Other examples include older retail companies like Walgreens or well-established pharmaceutical companies like Abbvie.

Newer, very aggressive companies like Amazon, Facebook, or Netflix are not paying dividends. Rather than share some of their profits with shareholders, these companies are busy reinvesting every last penny that they are able to invest in order to build out their company and expand their market share. However, some companies are in between. The quintessential example of this is Apple, which is a company that has grown very aggressively over the past 20 years, and it's about the same age as Microsoft. However, Apple pays a dividend even though it is considered one of the most aggressive growth companies that are out there in recent years.

Dividends are paid out as cash payment four times a year, at every quarter. However, each company will have its own date when it pays dividends. As an investor, one of the things you will have to familiarize yourself with is knowing when each company you invest in pays out its dividend payments. This is something that you can look up. Knowing the date when this happens can be important as to not only knowing when you get dividend payments but also knowing if you are even eligible to receive the payment for the given quarter.

For any stock, you can look up the ex-dividend date. This is the date by which you must own the shares in order to be eligible for the quarterly dividend payment. The company will have a recording date which is usually two days following the ex-dividend date when they record all

stockholders that had shares the day before the ex-dividend date. These are the shareholders that will actually receive dividend payments. So you don't want to be buying your shares on the ex-dividend date.

Dividends are also often paid out for many exchange-traded funds. Whether they are or no is actually up to the manager of the fund. In the case of exchange-traded funds, the dividends that are paid out for all the stocks that pay dividends in the fund directly to the fund. They are then divided up by the shares in the fund, and then if dividends are paid out you will receive payments in proportion to the number of shares that you have in the exchange-traded fund. The dividend payments may be relatively small in some cases, because the fund may not have all stocks paying dividends, but the dividend payments are going to be spread out over the entire investment in the fund.

If a fund manager decides not to pay dividends, the money will be used to buy more shares in the fund on your behalf. So either way, even if the exchange-traded fund does not pay out the cash dividends, if it holds dividend-paying stocks you will benefit by having more shares purchased on your behalf that you will then own.

Dividend Payments and Yield

Two of the important characteristics of a dividend are the yield and the actual payment. Of course, if you are looking to earn a certain amount of money, the amount of the actual dividend payment is going to be something to consider. Payments range over a wide range of values, and they are quoted in annual amounts. So to get the amount that you will receive each quarter simply divide the reported amount by 4.

Many dividends pay in the annual range of $1.50 per share up to $20 per share. As an example, IBM pays around $6 per share annually, while Apple pays around $1.59-$2 per share. While the amount of the dividend payment can help you determine how many shares you need in order to get a certain level of income from the dividend payments, you also need to consider the yield. This is the ratio of the dividend payment to the share price. That gives you an idea of how much you have to invest, rather than just knowing how many shares that you need. If there is a higher yield, this can indicate that the share price of the stock is relatively low in comparison to a stock with a low yield.

There are a couple of things to look for when considering dividend-paying stocks beyond the fundamentals discussed in the second chapter. First of all, you want to be able to review how the dividend payments have changed with time. A stock that shows a long term history of increasing dividend payments is going to be a preferred investment. At the very least, the dividend payments should be keeping up with inflation. You can look up the history of dividend payments for any company.

If the company tends to be one that slashes dividends at the slightest excuse, that may be one that you want to stay away from. You are going to be more interested in dividend stocks that try and keep investors happy even when the stock or the economy at large may be going through some temporary difficulties. In recent times, you can check to see how stocks dealt with the great recession in order to find the best dividend-paying stocks when it comes to the company dealing with hard times.

In addition to the history of dividend payments, you will want to look at a couple of things. One is the dividend payout ratio. The dividend payout ratio is the fraction of its net income that it pays out to investors. Generally speaking, any value of 60% or lower is considered healthy. This indicates that the company has a lot of profits leftover that it could use to increase dividend payments. In addition, it shows that the company is making dividend payments comfortably. That also tells you that the company has some profits leftover that it can reinvest in order to keep the company growing and for research and development, and that it's less likely to need to take on debt in order to keep operating.

On the other hand, if the number is approaching 100%, that is something you need to watch out for. This may be a red flag that the company has some bad fundamentals, and so it is trying to make up for that and keep investment in the stock appealing by paying high dividends. Some companies will even be paying over 100%. In that case, an investigation is necessary. Are they paying more than 100% in a temporary fashion? If it's just a phenomenon occurring over a couple of quarters, then it might not be a catastrophic warning sign. But something to consider, especially if this is a continual practice, is that the company is having trouble or taking on too much debt. The company may even be using debt to keep dividend payments higher than they would be otherwise. This is not only bad news as to the future health of the company and possibly for its stock price but also an indicator that they may not be able to keep up their dividend payments over the long term.

The amount of debt that a company is taking on can also be an important factor when investigating dividend-paying stocks. A company that takes on a lot of debt can be problematic for many reasons. Of course, more debt can mean less health, but at the same time, a company can be healthy and temporarily take on some debt. On the other hand, something that needs to be considered is that when a company takes on debt, they are required to make interest payments on the debt, and when the debt matures they have to pay back the principal. Those may be obvious facts, but what may not be so obvious is the fact that a company that has to make ever-increasing interest payments is also one that might have trouble finding money left over in order to make consistent dividend payments.

As an investor in dividend-paying stocks, the last thing that you are going to want is a stock that you cannot rely on for income. So all of these factors need to be considered when looking for a good stock to invest in.

Using Dividend Paying Investments for Diversification

One of the most interesting things about dividend-paying stocks is that there are many which are specific for different sectors, that will help you diversify your overall portfolio. One of the most popular ways that people invest in order to get dividend payments on the stock market is to invest in real estate investment trusts, which go by the shorthand name of REIT. These companies trade on the stock exchanges and you buy shares of stock in them and receive dividend payments just like you would for a corporation, however, these are not corporations. They are a special class of business organization that is called a trust, and they payout 90% of their profits to investors. They often have relatively low share prices and high yields, making them an attractive investment if you are looking for high yield dividend payments. Moreover, they are invested in a wide range of real estate projects, from cell phone towers to old age facilities while also investing in conventional real estate projects like single-family homes,

apartments, commercial office space, and retail space. Investors can also sign up with fundrise, which enables them to invest in real estate and receive dividend payments. These are generally considered reliable investments because they get their money through the rental income stream that goes to the properties themselves.

There are other options that you can also invest in using the stock market. MLPs are a type of partnership that is actually traded on the stock exchange, that lets you invest in finance and energy companies. Most MLPs are involved in the oil and natural gas business. There are also BDCs, which are business development companies. These types of organizations invest in distressed companies or offer to finance through unconventional means for companies that might have credit problems and therefore not be able to get traditional bank loans. These types of companies tend to have high dividend yields, and most have low share prices.

DRIPS

A DRIP is a dividend reinvestment plan. The nature of this plan is to automatically use your dividends to buy more shares of stock. You can elect to have this setup with your broker. The time to use DRIPS is when you are in the growth phase of your investment career, and so you are waiting until later in order to cash out your stocks to get income from them. In the case of dividend stocks, of course, you are not going to be selling off your shares. You are going to be interested in holding your shares in order to receive the cash income from your dividend payments. Typically this is going to be something that you are interested in doing in retirement. Before then, you are going to want to continue growing the number of shares that you own so that you can maximize your income later.

DRIPS provide a way to add more power to this by purchasing more shares as you go along. So if you are investing in a $30 stock that you earn $120 in the given quarter from in the form of dividend payments, you can reinvest that $120 back into your stock to buy four more shares of it each quarter. Over the years, the extra shares that you acquire by investing using DRIPS can really add up, helping you to grow your wealth even more over time. This is the smarter way to invest even though the temptation at times is going to be to take out the money and spend it. The best thing to do is to have your broker set this up to work automatically until you tell them otherwise so that the temptation on your end is removed as a factor.

Then when you reach the point where you are ready to retire, you can change your election as far as DRIPs are concerned and start receiving the cash payments for the income that you seek.

Dividend Stocks – The Bottom Line

Dividend stocks are something to consider investing in as a part of your overall investment plan. However, it’s important to be realistic about dividend-paying stocks. Most of them pay relatively small payments on a per-share basis. What this means as far as a practical matter is that you are going to need to acquire a large number of shares in order to get significant dividend income from them. For example, if a stock pays $6 dividend payments, you need 7,000 shares in order to earn $42,000 a year. If the stock is trading at $100 a share, that means you would need to invest $700,000 in order to get that income. Of course, there are stocks and other types of investments such as REITs that pay a wide range of yields, and so the amounts required vary. Also, people should be thinking in terms of long term investing, but it's clear that to make money from dividends you are going to be needing to develop a serious investment program as a part of your overall strategy.

Chapter 5: Becoming a Stock Trader

Most people have their investments, if they have investments at all, managed by someone else. In most cases, this is going to be in a 401 (k) through their employer. Many people who take the next steps in investing outside of that will do it passively, handing over a large amount of cash for investment in a mutual fund or an individual retirement account or IRA.

With that in mind, taking direct control over your investing and becoming an individual, self-directed investor is quite a different approach for many people. They are not sure how to do it or even where to start. The issues that we have discussed so far are definitely going to be important, but you have to know how to actually buy and sell stocks in order to get going with your plans. The first step in this direction is opening a brokerage account.

In this chapter, we are going to introduce you to the basic setup of opening your account and how to trade stocks. The process is really not that complicated, but it can be daunting for the new investor.

What is a brokerage?

As an individual investor, you are not going to run down to the trading floor of a stock exchange and place your own orders. Investors use a middle man that accomplishes this for them. That middle man is called a stock brokerage, or simply a brokerage or broker. There are many companies that fill this role today, and it’s pretty easy to find them. Just google “Brokerage,” and you can find many websites that will do this for you.

For people new to the life of trading stocks as an individual, this can be an intimidating process because you may not really know who is legitimate and who isn’t. We can start with some of the big names in finance, that you may recognize. We hope that in this book, we are able to give readers enough information that they can comfortably open a trading account with some level of confidence. Of course, you are going to want to be sure that the money you invest in your account is safe and secure, and that you are not being taken by a shady broker that can charge high commissions.

The first rule of thumb is to stick to brokers that are licensed and located in your own country. In the United States, brokers are strictly regulated by the U.S. Securities and Exchange Commission, or SEC.

As we said, there are many famous financial names, but not everyone may be aware of them. Let’s start with the top four. These include Fidelity Investments, Charles Schwab, Ally Bank, and Merryl (formerly Merryl Lynch, a very old company). These are not “the top 4” in terms of quality or recommendation, but we have listed four companies that have been well known in the investment world for decades, and therefore these are definitely companies that you can trust as far as having an account that is safe and so forth.

However, there are many others. Two companies that gained a lot of fame as brokers during the go-go stock days of the dot com era in the late 1990s are TD Ameritrade and E*Trade. Actually, both companies were formed long before the dot com boom, TD Ameritrade began operation in the early 1970s, and E*Trade opened its doors about ten years later.

There are many newer platforms, some of which are operated by older companies and some that are independent. You can invest in using websites called think or swim, and tasty works. These forums are more geared toward speculators and options traders, however.

There are also some newer platforms that operate in the mobile app space. Robinhood is the most famous example. It's become very popular with new investors because it's extremely easy to use and it also comes with zero commission trading.

If you choose any of the brokers above, you won't have any problems. Some are preferred by some financial experts over others, but all are reliable and fairly easy to use. You can also access all of them via a desktop computer or mobile app, which means they are user-friendly and readily accessible.

Commissions

One of the issues with brokers is commissions. As a long term investor, this is less of a concern than it would be if you were trading at a high-frequency level. The industry range of commissions tends to be over $5-$7 per trade. So it's not a huge expense unless you are making several trades a week. That said, keeping expenses to a minimum is something that a lot of investors like to do and with good reason. There are many companies that offer zero commission trading, Robinhood being one of the more recent entries into this space. If you can completely eliminate commissions, that is certainly helpful for your overall bottom line.

Some, like Charles Schwab, offer no commission trading on certain exchange-tradedfunds. This can be helpful if you happen to be investing in the funds that they allow this for, but for your other trades, you will still have to pay commissions. Some may offer reduced commissions under certain circumstances.

Generally speaking, while its certainly attractive to be in a situation where you can trade without paying any commissions at all, most long term investors are not going to be too concerned with the commissions paid because they are not going to be trading all that frequently. Also, the dollar magnitude of the commissions is not all that high in most cases. Something that has to be weighed is the amount paid for the commission against the longevity of the broker. That is many brokers like Charles Schwab have been in business for some time, while others like Robinhood that charge zero commissions are relatively new. The thing to do is get online and research the different brokers to see which one appeals to you the most.

In order to set up a brokerage account, you will have to enter basic information about yourself, such as name and address. You will also have to electronically connect a bank account that can be used to fund the brokerage account. Some brokerages have a minimum funding requirement while others will let you fund it with whatever amount you choose.

Margin Accounts

A margin account lets you borrow money and stock from the broker. You have to put up 50% of your own cash to fund any trade. The amount of cash that you put up for a trade is called the margin. So for the stock market, you have 2:1 leverage, which means that you have twice the purchasing power of the actual dollar amount used to fund the margin account. To open a margin account, you must deposit $2,000. A margin account should not be used for long term investing, because you have to pay interest on any borrowed funds. The primary use of a margin account

would be for trading so that you could return the funds borrowed in a prompt fashion.

How to Trade Stocks

Once you have funded your account, you can start buying shares. The details of how to do it vary, because they are specific to the brokerage selected. But essentially this will involve looking up the stock that you are interested in buying or selling, and then after that, it will be like buying something on Amazon or any other website. You just specify how many shares you want to buy, and if you have the adequate amount of funding in your brokerage account, you can just buy the shares. Some brokerages will allow you to instantly fund your account, but with others, you may have to wait until the bank actually deposits the money.

Money Management and Risks

It’s important that you do proper money management when buying stocks, especially if you are looking to trade. One rule that always applies is that you should never invest more money than you can afford to lose. So, each month limit yourself to putting in a specific amount into your account that should you lose the money, it will have no impact on your day to day life. Of course, losing money always has an impact, but what we mean here is that if you lost the money, you will still be able to pay your rent or mortgage, buy your groceries, and so forth.

We have talked about the risk management techniques for long term investing; these involve diversification, dollar-cost averaging, and rebalancing your portfolio. If you are interested in trading, then you are going to focus your risk management efforts on ensuring that you are not going to lose more than a certain portion of your account value on any given trade.

Chapter 6: How the Stock Market Works

In this chapter, we will briefly review the concept of the stock market and the roles of different players. We will formalize the concept of stocks and how stocks are valued in the marketplace.

What are stocks?

Stock is a term which refers to the capital that a company raises by issuing shares. When you buy shares, you are giving the capital (the "stock") to the company that it can use to fund its operations. So the company can use the money raised by issuing shares of stock to hire employees, fund marketing and advertising efforts, build new manufacturing plants, or any other activity that the company needs funds to carry out.

The "stock" of the company is divided up into individual shares. So a company could start out with a "stock" of a million dollars, and divide that up into 10,000 "shares of stock" that it could then sell to the public for $100 a share. When you buy a share, you own a "share" of the company. Of course, to own 25% of a company worth $1 million, you would have to buy $250,000 worth of shares, or 2,500 shares.

Like anything else, once you've bought something you have a right to sell it. The cumbersome way to deal with this would be to sell it back to the company, who could then find another buyer. However, as soon as the concept of stock in a company was devised, people developed markets for secondary trading of shares of stock. So rather than going through the company, and having the company deal with the problem of finding new investors, people could trade stocks back and forth amongst themselves. This was the birth of the first stock markets.
This created a situation where the value of the shares, and therefore of the company itself, would change with time. As the company became seen as more valuable, perhaps because it was making more profits, people would bid up the prices of shares sold in the stock markets. More people would be interested in buying an ownership stake in a successful business, and many of them would be willing to pay more money in order to own shares of the stock.

At the same time, companies that were not doing well would become less valuable. If a company was losing money or simply not operating at a very profitable level, fewer people would be interested in owning stock in the company. Those that did who wanted to get out of their ownership stake would lower the prices they are willing to accept in order to get rid of their stock. As a result, the price of the shares of a company having problems will drop in value.

The role of brokers

In modern stock markets, you don't get in your car and drive down to some market in order to sell your shares of stock, which we might imagine that you are carrying around as certificates in an envelope. First of all, today's markets are all electronic. But we do have trading floors. Your orders to buy and sell stocks happen on the trading floor, but you are not directly placing them.

You are placing your orders to buy and sell shares of stock through a middleman that is the broker you are using. So you pay them a fee, and they actually carry out the trade for you, as we mentioned earlier. The trades are not automatic although they often seem that way today with the fast-paced electronic transactions. You actually have to find a buyer when you sell a share of stock. The buyer has to agree to the price you are asking for the transaction to occur. When you enter into a trade, there is no telling who you are trading with. It could be another individual

trader like you, a hedge fund, or an institutional trader such as a large pension fund.

Types of Orders

When trading stock, there are several types of orders that can be placed. The basic order type is a market order, and this is the default type of order that is placed. If you don't specify any order type, your broker is going to place a market order. These are the specific order types that can be used:

- Market Order: This is an order that will buy or sell shares of stock at the prevailing market price. Most of the time market orders are carried out very quickly, in the blink of an eye in today's electronic trading world. However, if a stock is rapidly dropping in value or rising in value, a market order might not be carried out. Under most circumstances, this is not going to happen.
- Limit Order: This is an order to only carry out the buying or selling order at a price that you specify. For example, if a stock is trading at $50 a share, you might enter a limit order if you are only willing to buy it at $49 a share. So you can specify this as your limit price, and the order will only be carried out if the stock price drops to $49 and you find someone willing to trade at that price. There are two types of limit orders. The default type of limit order is good until the end of the day order. So if it is not carried out by the end of the day, the order will be canceled. You can also set up good until canceled limit order. The order will remain in place until it's either fulfilled or you manually cancel it.
- Stop Loss: A stop-loss order is an order to automatically sell shares of stock that you buy if the share price drops to a value that you specify. Stop-loss orders are used by day or swing traders in order to get out of bad trades. It will not be executed if the share price of the stock does not drop to the value specified. However, if the share price does drop at or below the value specified, it will be carried out automatically and your shares will be sold.
- Stop Limit: Also known as a take profit order. This is analogous to a stop-loss order. However, this is an order to sell the stock if the price rises to a value that you specify. The order will only be carried out if the price rises to the given value.

Bid/Ask

Pricing of stocks is determined by supply and demand.

At any given time, you can see what values traders are using to bid for prices. Bid, is the value being offered by traders looking to buy a stock. That is it's the highest price they are willing to pay in order to buy the stock. If the stock price is dropping and for some reason, your sell order doesn't go through, that may be because the bid price has dropped well below the price you are asking for in your market or limit order. Ask is the price that people who are trying to sell the stock are asking for it. These are average values, of course. When there is a large bid-ask spread it can be hard to sell the stock unless you are willing to adjust your price down to the bid value and sell it in a limit order. The market price is not going to match up with the bid price in many cases, but if the bid-ask spread is narrow and the stock is one that has a high trading volume, it is easy to find a buyer.

Your broker will provide you with the tools needed to find the bid and ask as well as the market price for any stock that is being traded.

Volume

Volume is the number of times or number of times that the stock was traded in the last trading period. Depending on the time scales you are using on your stock charts, the volume could be the number of times the stock was traded per minute, per hour, or per day. In most cases, when the volume is reported, the volume of trading for the previous trading day is given.

P/E Ratio

The price to earnings ratio, or P/E ratio, is a metric that is commonly used in order to estimate the value of a given stock. There is not an absolute standard that is used for the P/E ratio. What you have to do with the P/E ratio, is look at the value of the stock and then compare it to different metrics. The most important comparison to make is to see how the P/E ratio compares to the values of its nearest competitors and the sector itself that it is trading in. If it's a large company, you can also compare it to the average P/E ratio for the S & P 500 index. For different sized companies, you can compare to other relevant indexes. If this value is high relative to other companies in the same sector and that is about the same size, that can mean that the stock is overpriced. But it can also simply mean that the stock is highly prized. The company might have a disruptive product it is releasing, for example.

Company Size

Something you will be interested in when it comes to investing in the company size. Traders are not interested in company size, so much as they are only interested in how much the stock might be moving on a given day. However, long term investors need to keep track of company size because the size of a company is something that can be associated with many things. First of all, for publicly traded companies, the smaller size means that the company probably has a lot of room to grow. So smaller and mid-sized companies are considered to have growth potential, and those looking to have aggressive growth in the value of their stock portfolio are going to want to put more of their investment capital in these types of companies. However, the smaller companies are not as stable as large companies that are hard to knock off their pedestal like Apple or Boeing. They are often new, and they are also often more likely to fail as time goes on. This is the trade-off that is made here, smaller companies have a lot of growth potential, but they also carry a much higher risk of failure – and so the investor will have some risk of losing some or even all of their investment capital. The problem is ahead of time you can't know which companies that are small now are going to be the giants 20 years down the road. Companies are classified according to size or market capitalization, which is the amount of money invested in the company.

Companies are generally divided by market size in the following way:

- Nano-Cap: $50 Million or less. High risk, but could have large potential gains. These are usually "penny stocks," which means the share price is $5 or less. They are risky investments but popular with traders because they can have large price movements over short time periods.
- Micro-Cap: $50 million to $300 million. Still high risk but more stable than nano-cap stocks.
- Small-Cap: $300 million to $2 billion. Getting better, larger companies that are more likely to weather storms, lots of growth potential, but still relatively risky.
- Mid-Cap: $1 billion up to $5 billion in valuation. These are good stocks that kind of

balance the risk with potential rewards. Companies this big are not nearly as risky as the others considered so far, but they do have more risk than large-cap firms, generally speaking. The trade-off is more growth potential, provided that you are able to pick the right firms to invest in.

- Large-Cap: $5 billion or more. Large companies that are lower risk, but also offer lower average growth potential.
- Mega-Cap: The biggest of the big, with $200 billion or more in market capitalization.

How to Mitigate Risk While Still Going for Growth

The way to mitigate risk among mid-cap and small-cap companies while taking advantage of the growth potential is diversification. Most of us are probably not going to be able to determine which mid-cap or small-cap companies are going to be growing by significant amounts over the coming years, but if you have a diversified portfolio of these kinds of companies you significantly increase your odds of getting some winners. The best way to do this is by using exchange-traded funds that might invest in hundreds or more of these companies. That way your risk is spread out, and the fund itself will be picking the best companies to invest in, and that can give you exposure to these companies with lower overall risk. Then you can take advantage of the aggressive growth that the winners among the small and mid-cap firms have to offer.

Also, keep in mind that many large-cap and even mega-cap firms are also still experiencing strong growth. High-tech companies are an example of this.

How to Invest in the Stock Market

Many people are invested in the stock market through their employers, using a 401k plan. These plans may invest in individual stocks, or they may buy into mutual funds, which are pooled funds of money that buy large amounts of shares in a diverse array of stocks. Another way that people invest in the stock market is by investing in mutual funds on their own, through a mutual fund company. There are small mutual fund companies that you can probably find in your own town, or you might invest in large mutual fund companies online such as Vanguard or Fidelity.
Individual investors can also use an individual retirement account or IRA to invest in the stock market. IRA’s are limited because of the tax benefits. You can invest $6,000 a year before age 50, and if you are 50 or older, you can invest $7,000 a year into an IRA. An IRA has tax benefits. For a Roth IRA, which has income limits, you will be able to withdraw the money from the IRA in retirement tax-free. If the IRA is a traditional IRA, you can deduct your investments into the IRA on your current taxes, but you will have to pay taxes on the money that you take out of the IRA in retirement.

Using a brokerage, you can also buy and sell stocks on your own. This is the way to proceed if you want to have a self-directed investment plan. Of course, it’s possible to have a multi-leg investment plan. That is, you could use an IRA, and also do self-directed stock investing outside the IRA.

As we will see there is also the possibility of investing in the stock market as an individual investor while buying shares of exchange-traded funds. While there are some differences, this is similar to investing in mutual funds, but this is something that you would do as a self-directed investor.

Chapter 7: Swing Trading

We have already spent a great deal of time talking about long term investing with stocks. This is my preferred method of working with the stock market. You invest in companies for the long term with the goal of building long term wealth. However, there are certainly ways that you can trade stocks in order to earn short term cash. The main ways that this is done include day trading and swing trading. Day trading is a highly specialized field that involves a lot of money and risk. In order to be a day trader, you must deposit $25,000 in a margin account. Day trading is a regulated activity, and your broker will differentiate between day traders and others that are not considered as day traders because day trading is a high-risk activity.

However, there is another method of trading which is considered not as risky, called swing trading. The method behind swing trading is to focus on the swings that occur in the stock market on a regular basis in order to earn profits. So it's basically a buy low and sell high philosophy, but the swing trader holds their positions from days to weeks, and so is not at as high of a risk as a day trader. For this reason, it is not a regulated field. In this chapter, we are going to talk about swing trading as an alternative method.

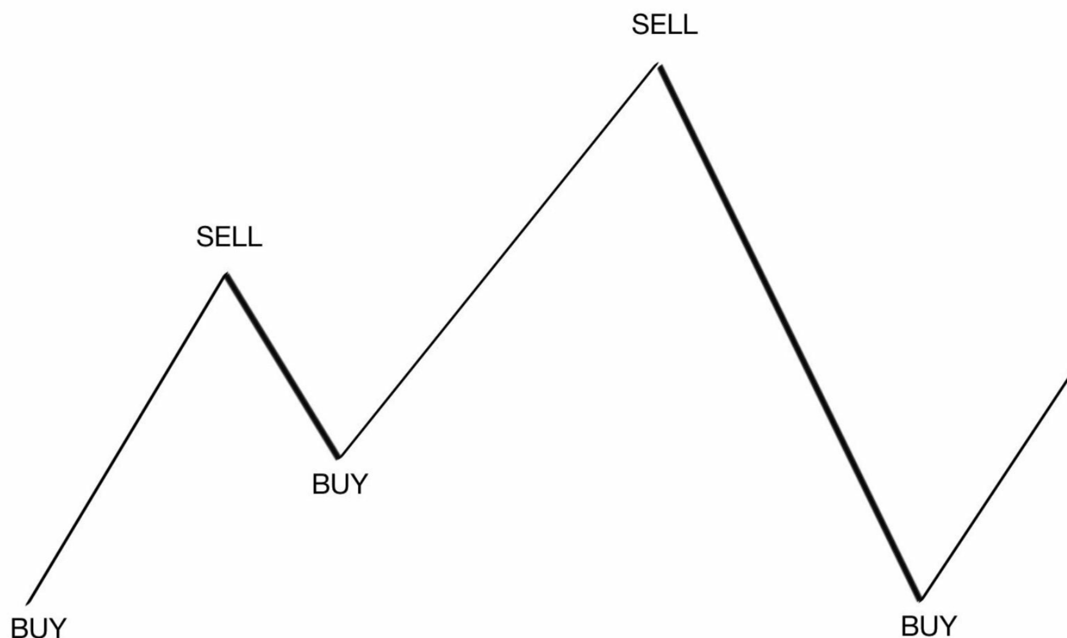
Why Swing Trade?

Swing trading is an entirely different style and method as compared to long term investing and the methods used by Warren Buffett. In fact, Warren Buffett would not approve of swing trading at all, and he would consider it to be a form of gambling.

His attitude may be a bit harsh, however. Day trading, which is a form of trading that requires full-time attention to the markets and you cannot hold your positions overnight without carrying serious risk, might be more akin to gambling. However, with swing trading, we wait for the inevitable ups and downs that always occur in the markets.

But what is the purpose of swing trading? While the goal of long term investing is to build wealth over time, swing trading is not investing. It is a business that is focused on earning cash profits in the present.

As a swing trader, you are not really interested in the underlying stock, other than asking the question – is the price of the stock going to move by a significant amount in the near future.



As seen in the figure above, the price of a stock is going to go up and down in repeated fashion, depending on the time period involved. The idea behind swing trading is simple – you buy low and sell high. So you can be said to be trading with the swings.
So if a stock is trading at a relative low of $50 a share, a swing trader may buy a large number of shares in anticipation of it rising to a recent high of $55 a share, then they can sell at that point and take the profit of $5 a share. A swing trader can trade using a margin account, but if you are able to and willing to put up your own cash to cover the trades, you don't have to use a margin account in order to engage in swing trading.

Types of Stocks to trade while swing trading

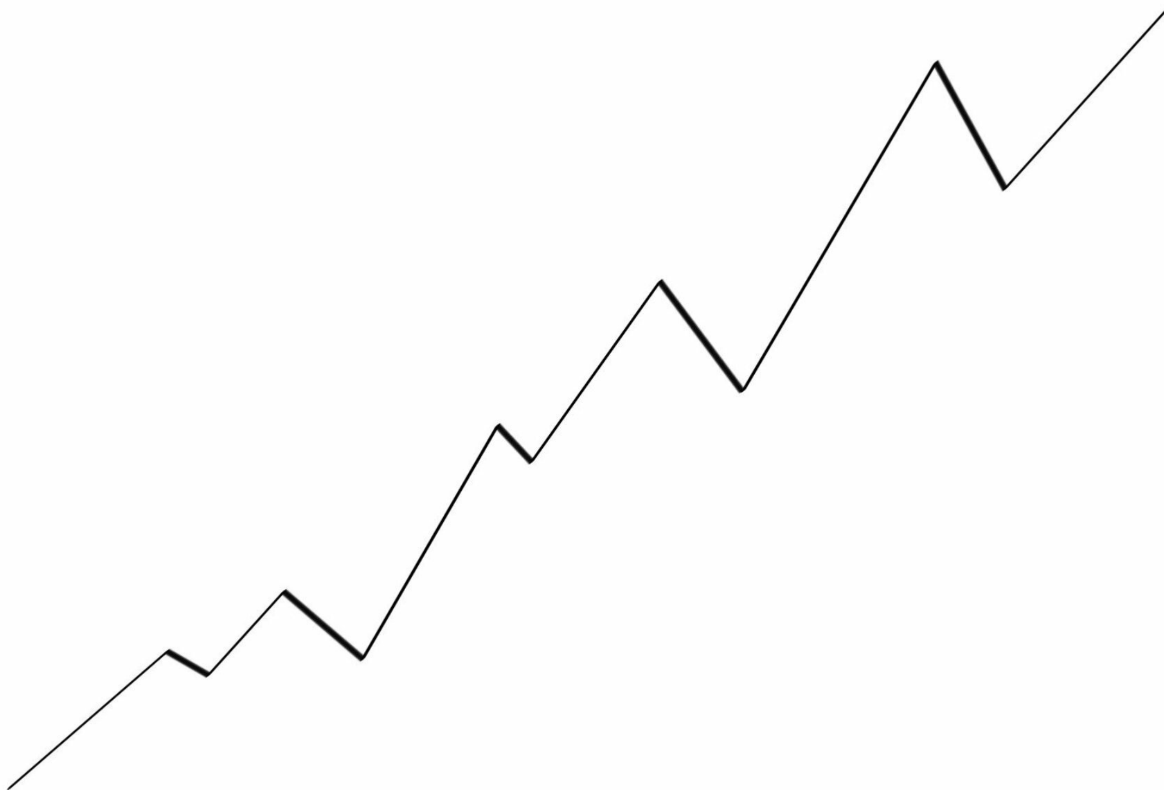
You can trade any type of stock while swing trading. The key to swing trading is to look for stocks that are having or expected to have large price swings in the market over the near term. Different swing traders have different time frames, but all swing traders are going to hold their positions at least overnight. Some are looking to make gains over the short term, so maybe over a couple of days or a few days. Other swing traders are willing to wait several weeks in order to sell their shares, or even over the course of a couple of months.

There is not a set time for swing trading, in the way that there is for day trading. When you are swing trading, you will hold onto your positions until the time is right to sell. Of course, this is not always going to work out, and you might have to exit your position and take a loss. There is always risk involved in swing trading.

So rather than looking to trade specific stocks, a swing trader is trying to find stocks that are volatile and having a lot of price movements. If a stock crashes down to a relatively low price, the swing trader will see this as an opportunity to buy stock at a discount, so that he or she can sell it later on when the price rebounds to a higher level.

Trending stocks are the ideal type of trade for the swing trader. Sometimes stocks will go into a long term trend where the price may move up and down by small amounts over short time periods, but over the course of a week or months, the stock is on a long term upward trend.

The chart below illustrates the concept of a long term, upward trend.



Shorting Stock

It's also possible for a trader to make money shorting the stock. This means you are betting that the price of the stock is going to drop. As you can imagine, stocks don't just go into upward trends. They also go into long term downtrends if there is bad news about the company. If there is a bad earnings call, a stock can suffer through a catastrophic decline for a day or two, or even up to a week. These kinds of price drops offer opportunities for people to profit by shorting stock. In order to short stock, you need to have a margin account. Then you borrow shares of the stock that you think is going to drop from the broker. Then you sell them on the open market. Let's say that you can borrow shares of a stock that is trading at $100 a share, so you borrow 500 shares and sell them for $50,000. Now suppose that the company has a bad earnings call. Then

the share price drops to $35 a share. So you can buy them back at this reduced price for $35,000. This means that you’ve made a profit of $15,000. Now you also have the shares back in your possession, which you can then return to the broker.

Chart Patterns

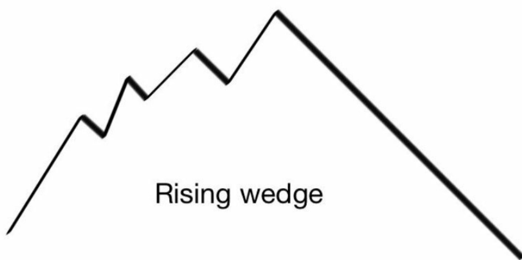
In order to be a successful swing trader, you need to understand stock market charts and technical indicators. A part of this is recognizing chart patterns that generally indicate that a current trend is about to reverse. In other words, if the stock has been declining in price, certain chart patterns will indicate that the stock is about increasing in price. Conversely, there are chart patterns that can indicate when a stock that has been on an upward price trend is about to reverse course and begin a downward trend in price.

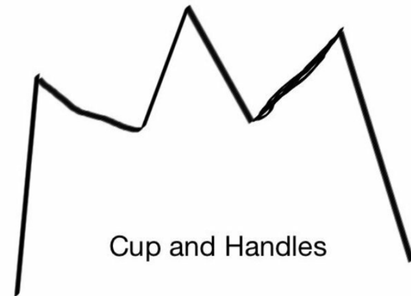
If you are buying stock in the hopes that the price is going to rise, you are said to be “long” on the stock. In this case, you are looking for the reversal of a downward trend in order to find the best possible price to buy the stocks. Then you will wait until the price rises to a point where it begins showing signs that it is going to decline again. At this point, you will sell your shares.

If you are looking to short the market, you are going to use the same signals to buy and sell shares. However, you’re going to enter your position at the peak, while the trader with the long position is exiting their position at the peak price. So when you see that the signals are there for a trend reversal after there has been an upward trend in price, you will borrow the shares from the broker and immediately sell them. Then you will wait until the stock price declines in value and starts showing signs of another trend reversal. We can have reasonable assurance that the stock has reached a low price before it is going to go up in price again. Then we can go ahead and buy the shares back, and return them to the broker.

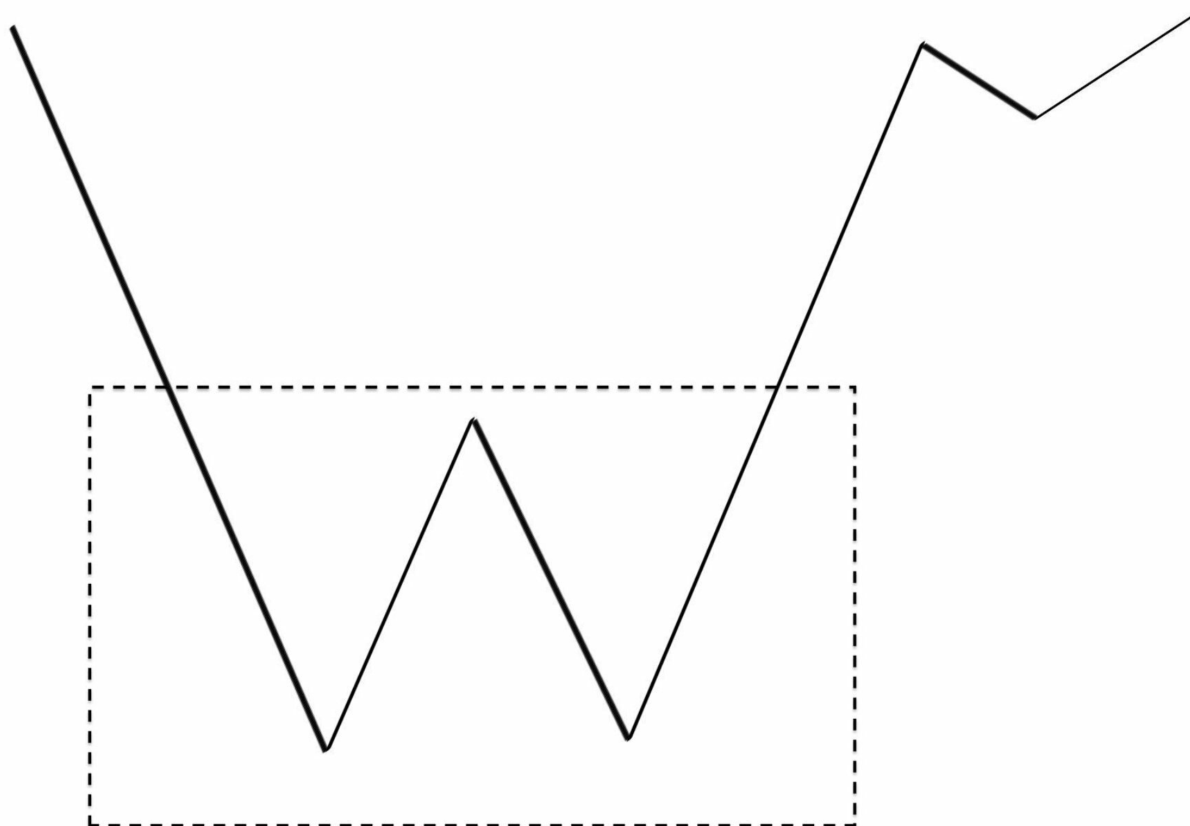
What you are going to look for are signals that the price trend is “trying” to continue, but there simply isn’t enough momentum. Let’s start by considering an upward trend in price. When the price has peaked, the stock may be overvalued, and although some buyers are going to continue entering the market, they are not going to be able to bid up the price of the stock very much, or for very long. So you will see small price peaks, perhaps repeated, but the price just won’t go any higher. This indicates a shifting momentum, and it's only a matter of time before the price will drop back down.

The patterns that you will see are called head and shoulders, cup and handles, double top, and the rising wedge. The shape of these patterns is shown below.





The same patterns will occur at the end of a downtrend, but they are going to be flipped over. So in a downtrend, a point will be reached when bearish investors are still trying to get rid of their stocks, but the trend has lost momentum and people are starting to bid up prices again. An example of this is shown below, with the inverted double top.



Candlestick Charts

Most traders will use candlestick charts in order to get more detailed information about the behavior of traders and price movements. Candlesticks are red or green bars on stock charts. The bars have small lines that may stick out one or both ends that are called shadows or various wicks. The wicks indicate the high and low prices for each bar, where a bar represents a trading period of a length that you can define on the chart. Day traders might be looking at one minute and five-minute trading sessions. Swing traders may look at short term trading sessions when looking to enter and exit a trade but generally swing traders are interested in longer-term price shifts and so will be looking at daily candles in most cases.

The color of the candle indicates whether the price rose during the trading session, in which case the candle is colored green, or whether the price fell during the trading session, in which case the candle is colored red. These are known as bullish and bearish candlesticks.

For a green or bullish candlestick, the bottom of the body or the bar is the opening price for the trading session. The top of the body is then the closing price for the trading session. This reflects the fact that for the trading session, the price closed higher than it opened at. For a bearish candlestick, the price closes at a lower price than it opened for the session. That means that the top of the bearish candlestick is the opening price for the trading session, while the bottom of the candlestick is the opening price for the trading session.

Traders learn different patterns that occur in candlestick charts that tend to indicate coming price reversals. For example, at the bottom of a downtrend, before a price reversal, you will often see a bearish candlestick followed by a much larger green or bullish candlestick, a trading session during which the closing price was pushed much higher. Or you may see the corresponding pattern in reverse at the top of an uptrend. That is, a bullish candlestick will be followed by a much larger bearish candlestick, that indicates the priced was pushed low during that trading session. This reversal pattern is called the engulfing candlestick.

Another common pattern that you look for indicating a reversal is three candlesticks of the same color, each with succeeding higher closing prices at the close of each trading session. This is called three white soldiers. Alternatively, you can be at the top of an uptrend, and then see three bearish candlesticks in a row with three successive lower closing prices. That indicates the trend is reversing.

An indecision candlestick is one that has a flat body, with no width. That is, the opening and closing prices are going to be the same or close to being the same for the trading session. The candlestick may have long wicks, which indicates the price was pushed high and low during the trading session but then ended up where it started. Sometimes there are no wicks at all. In either case, these are called indecision candlesticks. They also go by their Japanese name, which is doji candlesticks.

Another candlestick that is considered important is a hammer. This is a candlestick with a small body and a long wick sticking out of the bottom. This indicates that the price opened at a certain level, but was pushed down to a very low price during the trading session. But then it rebounded and closed higher. So this would be a green or bullish candlestick. You would look for it at the bottom of a downtrend, and it is taken as a strong signal of a coming uptrend.

If the candlestick is flipped over, you get a “shooting star.” So you will have a short body with a long wick sticking out of the top. In this case, we are looking for a bearish candlestick which will be red in color, occurring in the midst of an uptrend. This is taken as a signal of a coming downtrend since the price was pushed up high but ended up closing low.

There are many other candlestick patterns that you can study which are related to shifts or trend reversals. You can find them in any book on the day or swing trading, and there are many online resources that are available that can teach you all of the candlestick patterns that you need to learn how to recognize as a swing trader.

Technical Indicators

Technical indicators are purported to indicate future trends in pricing. The main ones that swing traders use are moving averages and the relative strength indicator, along with a more sophisticated tool that is called Bollinger bands. Let’s take a brief look at each of these. If you are more interested in pursuing swing trading, you should get a book specifically devoted to the topic where you can learn the details behind these tools.

Moving averages are pretty simple to understand. You simply take the closing prices of the past x number of trading sessions and average them together at each point. A moving average removes the noise from a stock market chart and produces a smooth curve. There are several ways that moving averages can be calculated, but the most common types of moving averages

that are used by swing traders include simple moving averages and exponential moving averages. The differences between the two are that an exponential moving average gives a larger weight to more recent prices.

The key to moving averages is that you can plot moving averages for different numbers of trading sessions. So, you can have a short period or a long period moving average, using a small number or a larger number of trading sessions to calculate the moving average. The trader will plot both on the same stock chart. Then they look at the movements of the short term moving average with respect to the long term moving average. If the short term moving average crosses above the long term moving average, that means that the trend is going to be an upward trend in price. On the other hand, if the moving average moves below the long term moving average, that would indicate a coming downturn in price.

Traders prefer not to work in isolation, in the sense that you don’t want to be stuck using only one clue in order to make your trades. What they want to see is multiple signals that all agree, so you would want to see candlestick patterns indicating changes in the trend that are confirmed with moving averages.

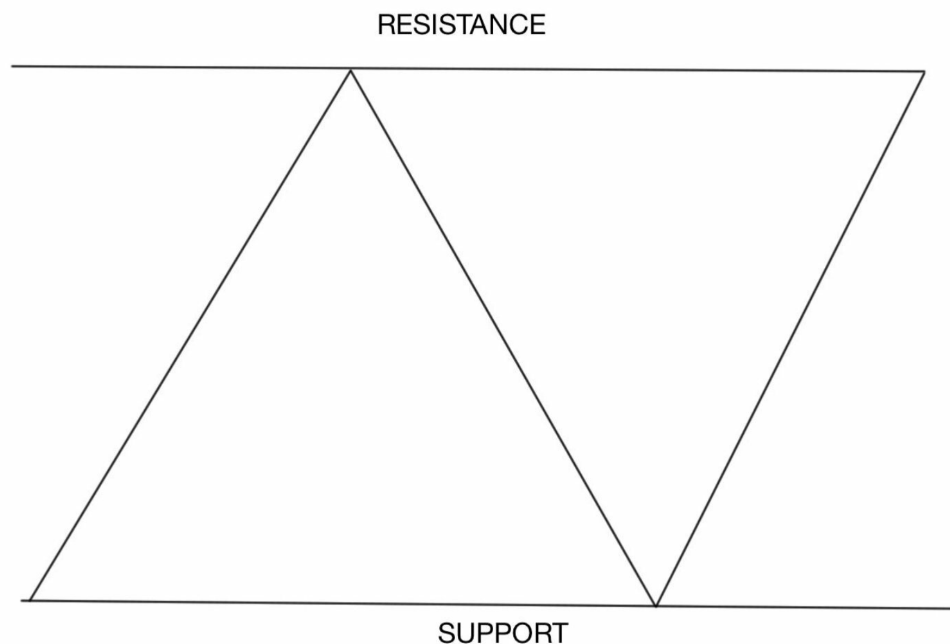
The relative strength indicator or RSI is very popular. This is a graph that you can add below your stock chart. The main thing that the RSI indicates is whether or not a stock is overbought or underbought. The RSI can range from 0 to 100. If the RSI goes above 80, these are overbought conditions. That is, the price has been big up too high with respect to the actual demand that exists in the market. This can indicate it’s a good time to sell shares. The best thing to do, however, is to use this in conjunction with other signals, in particular with the moving averages.

If the RSI drops below 20, the opposite condition is reached, that is the RSI is telling you that the stock is oversold. That means that the stock is likely to see a trend reversal and prices are likely to climb. Again, you will want to use the RSI in conjunction with other signals, and not use it in isolation.

Finally, we will take a look at Bollinger bands. The Bollinger band is made up of three curves. In the middle, you will find a 20 period moving average. Then there are upper and lower curves, which indicate one standard deviation above the average price and one standard deviation below the moving average. Traders expect a reversal when the price meets or exceeds the one standard deviation curve.

Support and Resistance

Sometimes, in fact, most of the time, a stock is not in a big trend. Instead, the stock is probably moving up and down in a relatively small range of prices. This is called ranging. There are opportunities for swing traders to make profits with ranging stocks since the price is bouncing up and down between two known price levels for an extended period of time.



The bottom price that the stock reaches is called support. The term support means that the stock is unlikely to break lower to the downside. You need to see the stock price touch the support level at least twice. The support level is a price at which you should buy shares.

If the stock is truly ranging, it will then rise up to a high price level where it's not likely or able to break above. Again, you will want to see it touch that price level two or more times. The resistance price level is the price at which you would sell shares.

Summary of Swing Trading

In this chapter, we have learned the basic techniques of swing trading. The basic idea is that you try and buy shares at a relatively low price. The low price might be the low or support price when the stock is ranging, or it might be a relatively low price that the stock is reaching before going up in a long trend. If the stock is ranging, then you sell your shares when the stock reaches the resistance price. If the stock is in a trend, then you sell your shares when you see that the candlesticks and indicators are showing signs of a trend reversal.

So the goal of swing trading is to take advantage of short term trends in order to make cash profits, that you get by selling off the shares. The time frames can be any that you are comfortable with, that also is long enough for the trends to play out. This can be two days, a week, or several weeks. This depends on the style of the swing trader or on the movement of the

stock.

Swing trading can be done on a part-time or full-time basis. Since swing trading is based on longer-term and therefore gradual price changes, it’s not necessary to sit at the computer all day long. Many people that engage in swing trading do it only an hour or two a day while keeping their regular jobs. Of course, if you can build it up to that level, you can swing trade full time.

Risk Mitigation when Swing Trading

Swing trading can be a high-risk activity, but you can take some steps to mitigate and minimize your risks. The first thing you want to avoid is losing a lot of money in a trade that doesn’t work the way you anticipated. This can be done by placing a stop-loss order, at a level of pricing that indicates the amount of money you are willing to lose on the trade.

Financial advisors, who are a bit of a conservative lot, are going to recommend that you only accept a 2% loss. This means that you are willing to risk 2% of your total account value on a single trade. If you have a $10,000 account, that means you would be willing to risk $200 on a single trade. That might not sound like much, but you spread this amount on a per-share basis.

Let’s say that you are trading AMD, which is about $30 a share. If you were to buy $3,000 worth or 100 shares, then you would be able to risk $200/100 = $2 per share.

So the way this would work, is you place a stop-loss order on the trade, set at $28. So if the stock price, which of course you are hoping is going to rise so that you can earn profits, drops to $28 a share instead, the shares will immediately and automatically sell and you will exit the trade. This will protect you from further losses, and at this point, you have only lost $200 from your account. So the losses were minimal. If the stock dropped by a large amount, you would have been protected from further losses.

If you want to, you can study the charts manually in order to look for the best time to sell your shares and earn your profits. Many people get into swing trading because they enjoy studying the charts and doing the analysis, and so they will be happy to engage in this type of activity.

Others, however, may want to enter a take profit order. For example, we can go back to our example of buying shares of AMD at $30 a share. If we are happy with a $3 profit per share and we are expecting the stock to rise to at least this value, then we can put in a take profit order at $33 a share. Remember this is also called a stop-limit order, and so you can place a stop-limit order specifying a price above the current market price and automatically sell your shares if the price goes to this level.

This way you can automate your trading, with the stop loss and stop-limit orders. This is a handy way to mitigate risk if you are someone who is only able to swing trade on a part-time basis. So while you are at work during the day or engaging in other activities, you don’t have to sit and watch the markets all day long.

Who is swing trading for?

Swing trading is for anyone who wants to make cash profits off relatively short term movements of stock prices. It is a for-profit business activity. You don’t have to set up an official business to do it, it’s possible to do swing trading and consider it an individual or sole proprietor activity. But as a swing trader, the point is you are looking to make fast cash, you are not investing. Also,

you are not concerned with the companies that you are trading, rather than hoping that they are going to have large price swings that you can earn profits from. The fundamental analysis that we talked about earlier is not of concern to the swing trade. They are not in it for the long term investment.

But the bottom line is that anyone who wants to make money can swing trade. That doesn’t mean you will be successful, swing trading is a pretty high-risk activity.

One question people have is can you swing trade and invest for the long term. In fact, you can. Some people have long term investment plans but also swing trade, either to make a living so that they can be all in with the stock market or even to raise funds to invest more in stocks. So you can keep a full-time job, invest in stocks for the long term, and then do swing trading on the side to raise extra money so that you can increase your stock purchases for more long term investing.

Chapter 8: Trader Psychology

In order to be a successful trader, you need to have a trader mindset. In this chapter, we are going to briefly discuss the successful mindset of a trader. It's important to be disciplined as a trader so that you can avoid the pitfalls that suck in novice traders and lead them to large losses.

Don't Let Emotion Rule Your Trades

One of the problems that happen with trading is that emotions can get intense when there are the possibilities of losing or earning a great deal of money over a short time period. This problem also impacts long term investors, who may become fearful of losing their money when they see stock prices collapsing.

In either case, we are talking about people ruling their investments or trades using emotion instead of the logic that is really needed to make good decisions. For traders, you can help get around this by automating your trades, at least to mitigate downside risk. That way you decide ahead of time what the amount of loss you are willing to accept on the trade is, hopefully by using the 2% rule. That rule has been arrived at by financial experts as a result of analyzing large numbers of trades and determining what a safe level of loss is that you can take on a single trade and largely keep your overall brokerage account relatively intact. That way, you are going to be able to live to trade another day, so to speak.

Long term investors often don't have this kind of protection. The reason is that you don't want to be placing stop-loss orders on long term investments, you are hoping to stay in these investments for the long term, after all. And that means that you are going to need to ride out drops in the stock market without panic. But all too often, long term investors – or people that think of themselves as long term investors, give in to the panic and join the other lemmings running off the cliff and they sell their shares. As we've said repeatedly, this is not something that you want to let yourself do. But, since there is no stop-loss order, you can place to prevent it, you are going to have to seek out discipline and avoid doing it using your own mental effort. This can be difficult during a major crash when you are going to see yourself losing a lot of money on paper. Remember that downtrends are buying opportunities, and so you should be buying up stocks instead of selling them. It's often best to go against the crowd in the stock market, especially when we are talking about small investors.

Traders also need to avoid getting sucked in by greed. In most cases, swing traders are looking at the possibility of making profits from relatively small price movements, and if the price moves to the point at which they need to take profits, but they don't, it can drop 50 cents a share or a dollar a share, and the trader might see the opportunity for profit evaporate. You don't want to hold on too long for profits in a trade, but many traders get overcome by greed and think if they just hold on a little bit longer, they can make big money.

Plan Ahead

This brings us to the next important trader mindset, which is planning. A trader, whether you are a long term investor or some kind of trader like a swing trader, needs to have carefully thought out plans in place that they can use in order to direct their actions when they actually enter a position.

Before entering a trade, a swing trader needs to have the stop loss value for the shares and the

take profit value already figured out before you actually buy your shares. A trader who is not planning, and *executing* specific plans are just groping around in the dark. Instead of doing that you should know beforehand what your goals are, and how you are going to reach your goals. You need to have specific ideas as to how much money you are going to make and how much you are hoping to make every week.

Have a trading routine

It's a good idea to have a trading routine. If you are trading full-time, then you want to have a morning routine that you use to start your trading day. This should include paying attention to financial news so that you can get wind of unexpected results that could impact your trades. Sometimes, there are going to be surprised, that means you might need to change your trading plans.

If you are only trading on a part-time basis, then you should still have a routine that you use daily to stay on top of your trades. Maybe you will do this in part on your lunch hour during workdays so that you can make sure that you are keeping up with the progress of your trades and you have the ability to make some adjustments. In addition, you should also have some time either in the early morning hours, or in the evening, or even both if you are able to, where you analyze your trades or study in order to find new trades to enter.

The specifics of your routine are less important than the fact that you either have one, or you don't. Those who don't have a routine are unlikely to be the ones that are successful as swing traders.

Keep Educating Yourself

As a swing trader, you need to recognize that this is a specialized skill. It's not a hobby, it's a professional activity. In order to succeed at any professional activity, you need to keep up with your education and keep honing and improving your skills. So you should study swing trading and the financial markets at every opportunity so that over time you are going to become a better trader.

Maintain a Journal

Traders and investors should keep a trading journal. Enter all your activities related to your trading as if it was a diary. You should also keep a section where you keep a record of your trades, including how much you paid to enter the position and how much you got out of it, including losses if they occur. You should also keep a net running total for each month and for the year. It's important to go on actual recorded information in order to know if you are succeeding or failing at trading, rather than going off the hope of a couple of recent wins and fooling yourself by neglecting to remember the losses that have also occurred.

Don't be impulsive

Next to panic when you are facing losses on a trade or greed when you think you can get more and more money, the worst kind of emotion or action that you can take while trading is making impulsive moves. Unfortunately, being impulsive is very common among novice traders.

Impulsive decisions often result from hyper-excitement. A trader might see a trend or hear some news that in their mind makes a trade a "sure thing." Then without doing any kind of analysis,

they enter the trade with no planning, and since there was no analysis done, they can quickly find out that the trade goes the wrong way and works against them instead.

Stick to One Trading Technique

Don't try to be a jack of all trades. So if you want to be a day trader, you should become a day trader. If you want to become a swing trader, then become a swing trader. You shouldn't try being all things at once, even if you hear that others are successful in doing so. Some people can do both styles of trading, while also maintaining long term investments. But most people are not going to find success trying to do everything. Pick one trading style and become an expert at it.

Become an expert on a small number of securities

The market, by its very nature, is volatile. This means that most if not all stocks provide plenty of opportunities to earn money by swing trading. It can help your swing trading if you primarily on a few different stocks. Pick 3-5 to use in order to do your swing trading. Learn the stocks inside and out, so that you know their 52-week highs and lows, and so that you have time to carefully study their charts and look for the right opportunities to enter trades. Having at most five means that you are going to be able to look at the stocks and find good opportunities for swing trading, while not getting overwhelmed. Having at least three ensures that at any given time, you are going to be able to find trades to enter.

Don't be afraid to wait on your trades

As a swing trader, you may be anxious to earn money from your trades, but there is not any rule that says you have to get out of a position before earning the profits that you hope to earn. Unless the stock has crashed down and just isn't going to rebound up to a level where you are able to earn profits, you should be patient and wait long enough for the price to rise to the appropriate pricing level for profits. Unlike day traders, which are high-pressure types that have to act fast, swing trading is a more relaxed and patient trading style. Have the patience to wait overnight, and even weeks if you have to in order to realize your profits.

Don't be afraid to sit on the sidelines

Sometimes, the opportunities to swing trade and earn profits – while still doing the careful analysis – are not going to be there. As a swing trader being anxious is not going to be a helpful characteristic. You are going to want to be able to sit on the sidelines if necessary, waiting for the right trade before you jump into a position. Remember that at the end of the year, your total annual results of wins and losses are what is going to matter. Being constantly in trades is not what matters. So if you have to wait a few days or even a week to find a solid trade that is likely to be a winner, then be prepared to wait. It is better to wait a few days to get into a winning trade than it is to be impulsive and then have your money tied up in less promising or even losing trades, while you see the good trades pass you by.

Chapter 9: Stocks vs. ETFs

In this chapter, we are going to investigate an important topic that is mostly something that needs to be considered for long term investors. And that is whether or not you should invest in stocks or if you should invest in exchange-traded funds, or ETFs, instead. Let's start by understanding what an ETF is for those who are not familiar with the concept.

What is an ETF?

To learn what an ETF is, you start by imagining that there is a large pool of money that you have available for investing. We are talking a large amount that a Wall Street firm might have. They decide to start a fund, which is going to be built by investing in an array of different assets. Then they can sell shares in the fund by dividing it up into small amounts. So in other words, they create shares of stock, but instead of buying stock in a company you are buying stock in the fund.

For the sake of being more specific, let's say that they have $10 million. They decide to create a tech fund, and so they use this $10 million to buy shares in companies like Apple, Microsoft, IBM, Amazon, Facebook, Intel, and so forth. The fund manager might pick out 20, 50, or 100 stocks to invest in. So they use the $10 million to buy shares in these companies, and then they divide up the $10 million into shares that they start off valued at $50 each. So, there are 200,000 shares available when the fund is initially offered. So you can buy shares in the fund at $50 each, and then as the underlying stocks increase or decrease in value, the share price is going to track them and increase or decrease in value. The fund, of course, will have a life of its own. People who want diversified exposure to these companies are going to be interested in buying shares in the fund, and when these companies are doing well, more people are going to be interested in buying shares, and they will bid up the price of a share in the fund.

There are many different ways that you can construct the fund. You could divide up the shares equally among the different companies in the fund. Alternatively, you could spend an equal amount of money purchasing shares in each company. Another Wall Street firm could buy shares in the same companies so that they could offer a similar fund. But, they might divide or allocate the shares differently among the companies because they think that they have found a better way to build the fund so it will have higher returns.

Wall Street Firm A could allocate the fund as follows:

- 15% invested in Apple
- 10% invested in Facebook
- 8% invested in Microsoft
- 6% invested in IBM

However, Wall Street Firm B might weight things differently, even if they are investing in the same companies:

- 13% in Facebook
- 10% in Apple
- 9% in Amazon
- 7% in IBM
- 5% in Microsoft

Over time, the different weightings may lead one fund to outperform another. In our hypothetical example, we could imagine that Fund A has annual returns of 10%, and Fund B has annual returns of 7%.

These funds will collect dividends, as well. While Apple, Microsoft, and IBM pay dividends, Facebook and Amazon don't. So the fund will collect the dividend money and then divided it up equally among the shares in the fund. In our example, we imagined that there were 200,000 shares. So let's say for the sake of example, that the fund collects $450,000 annually in dividend payments. It then divides up this amount equally among the shares, and so pays $2.50 of its own dividends to the investors in the fund.

Remember that in the chapter on dividends, we mentioned that the manager of an ETF can decide what to do with the dividends. Of course, the fund manager must pay out the dividends in some way to the investors, but they can choose to pay cash to the investors or buy more shares for the investors in the fund on their behalf. Of course if the investors actually want cash and they are given shares instead, they can sell the shares and then take the profits from the sale as a defacto dividend payment.

This is the basic concept of an exchange-tradedfund. There are ETFs for many different sectors, indexes, and even asset classes. So you can invest in bonds, money market funds, or gold, using ETFs. You can also invest in multiple sectors like energy or healthcare. Some of the most popular ETFs that people invest in are index funds. So you can track any major stock market index including the Dow Jones Industrial Average, S & P 500, or the Russell 3000.

Advantages of ETFs

The first major advantage of investing in ETFs is that they give you instant diversification. Not only that, since these funds can invest in hundreds of companies at once, the level of diversification can be described as basically massive. So you are going to have far more diversified exposure using ETFs than you can possibly get investing in individual stocks. As a small investor who does not have the capacity to invest in dozens or hundreds of stocks, going the ETF route can be a distinct advantage.

The second advantage of ETFs is that you can invest in maybe 10 funds, and have exposure across sectors, large-cap, small-cap, and mid-cap companies, asset classes, and different indexes. You can also use ETFs in order to get exposure to overseas markets. This is a major advantage because doing that on an individual basis can be difficult and even problematic. Using ETFs, you let the fund managers and large Wall Street firms handle the difficulties of say investing in Brazil or China for you, while you can sit back with diversified exposure to these high growth markets, helping you to earn significant returns without having to worry about putting your money directly into foreign markets.

Another advantage of ETFs is that due to their natural diversification, they tend to have very high annual returns. It is not uncommon to see ETFs with annual returns of 10-12% over the lifetime of the fund. So if you are an investor who does not want to do a huge amount of fundamental analysis, but you are looking to earn large annual returns to grow your wealth aggressively, then ETFs might be a better option for you.

Of course, you are going to have to do a bit of fundamental analysis on fund investing as well as with individual stocks, but it's a lot less involved. The annual returns, any dividends paid, and the P/E ratios might be the only things that you have to keep track of. There is no pouring over financial statements and that sort of thing.

Remember that the second tactic used when trying to reach your financial goals is dollar-cost averaging. Since you can use ETFs to essentially have automatic diversification, you can concentrate on using dollar-cost averaging to make sure that you are buying into the funds at the best possible average prices.

Bond Investing

Keep in mind that you can invest in almost any asset class there is, using ETFs. But even so, you are investing in stocks. ETFs are stocks that trade on the stock exchanges, and so you are going to have to do research to find the funds that you want to invest in and learn their tickers so that you can buy shares in the funds.

Now, even though ETFs themselves are stocks, they are not required to invest in stocks. They can invest in virtually anything. So you can, for example, do some bond investing indirectly by buying into ETFs that are themselves buying bonds. You will collect the interest payments from these bonds, so this provides another way to earn income from your investments. Bond funds can also see some decent annual returns, even if they are not going to be the best possible investments for that purpose. That said, they are going to be quite competitive. This provides a way to get into corporate, federal, and municipal bonds. There is also the possibility of using ETFs in order to invest in foreign bonds.

Stocks or ETFs? The ultimate question

When it comes to the stock or ETF question, it is not necessarily something that requires you to choose one or the other. In fact, many investors are going to do a little bit of both. But after studying the issue, you might find out that you want to stick with ETFs. There is really good reason to only invest in ETFs, you get high annual returns, massively diversified exposure, and they trade like stocks and so don't suffer from the drawbacks that mutual funds do. You can find virtually any kind of fund to invest in to meet your overall investment goals because fund managers seem to be sitting around all day dreaming up new ways to create competitive and interesting ETFs. Right now, cryptocurrency is probably the only thing that you can't invest in using ETFs, but that will probably change in the near future.

Some people are just attracted to the idea of investing in individual stocks, however. For those readers who want to pursue that path, that is certainly a valid way to engage in long term investing. Presumably, if you are looking to go down that road, this means that you find finance and the markets to be something that you are interested in and so you are willing to put the work in and probably enjoy the fundamental analysis and so forth.

It's also possible to do a mix. Some people who are interested in investing in several individual companies might use ETFs to build some diversity into their investment portfolio. This way, you don't have to worry as much about being diversified when it comes to your stock picks. So you can pick 3-5 companies that you really want to focus on and that you are interested in from an investment perspective, and use some ETFs to ensure you've got the security of diversification

working for you at the same time.

Are ETFs better than stock? In most cases, they probably are. Of course, there are a small number of stocks like Amazon or Apple that really grow and can build wealth for you over time. But most stocks are not going to grow to the degree that those companies did. So generally speaking ETFs are going to be better for investors. That can include the fact that they tend to earn very high returns in many cases. They also require very little analysis, and it’s easy to move in and out of different funds when you see that your goals are not being met.

In the end, however, it is a personal decision. Each investor is going to have their own tastes and opinions. So you will have to pick which way of investing works best for you and go from there.

Chapter 10: Employee Stock Options and IPOS – What the Stock Trader Won't Tell You

In this chapter, we are going to take a look at some other things you need to know about employee stock options, and also take a look at initial public offerings, or IPOs. IPOs can be important for those with employee stock options if they have stock options at a company that is going to go public at some point. You might also want to learn a bit about IPOs if you are simply looking for investment opportunities.

Types of Employee Stock Options

A company can issue two different types of employee stock options. The first is called an NQs or NSO. This is a non-qualified stock option. If an employee stock option is non-qualified, when you exercise the options, taxes will be withheld at that time. You will have to pay ordinary income tax on the difference in pricing for the shares. What we mean by this is that you are going to have to pay income tax on the difference between the market price of the shares and the grant price of the shares.

Another type of stock option is called an incentive stock option, or ISO. If you can get this type of employee stock option, you are better off. The reason is that rather than paying the ordinary income tax rates, with an ISO you will get to pay the capital gains tax rates. If these are long term capital gains tax rates, then you are going to be in a favorable position tax-wise, paying much lower rates.

IPOs

In many cases, a company that you have employee stock options with may go public, or have an "initial public offering" or IPO. It is important to understand a little bit about IPOs if you are in this situation.

The first thing to understand about IPOs is how the share pricing is set. This is done by auction. A Dutch auction is one where investors place bids to indicate the highest price they are willing to pay for the stock. Then the highest bid is taken after all bids have been placed and used to price the stock. However, there is a different way to conduct a Dutch auction. In this alternative method, the price of the stock is set and then lowered until someone accepts the bid for a sale.

An IPO can also be conducted using what is called traditional allocation. In this case, the minimum price for the stock is determined. Investors who bid the minimum price are then granted shares. This method is considered better for inside holders of stock because the shares are instantly allocated.

When thinking about an IPO, you also need to know about the underwriter. The underwriter is a type of middleman. The underwriter will be an investment bank like Goldman Sachs. They play the role of selling the stock to the initial round of investors, and so they play the role of middleman between the company and the investors.

Chapter 11: Notes on Tax Treatments

As a new investor, it is important that you get some general idea of how investments in the stock market are taxed. This can depend on what you are doing and how long you are investing in. The length of time that you hold an asset can be an important consideration when it comes to the treatment given for taxes. In this chapter, we are going to take a brief look at some of the most important considerations.

Selling Stock

The first situation that we are going to look at is the case of buying the stock at a low price, relatively speaking, and then selling it later for a higher price so that you earn profits. The way that this is treated for tax purposes is as a capital gain. However, the length of time that the shares are held before selling them determines how they are going to be taxed.

If you hold the stock for less than one year, then the profits are taxed as short term capital gains. That means that in short, you are going to be paying ordinary income tax on the gains made from selling the stock while holding it for less than a year. If your income tax rate is 37.3%, then that is what you are going to pay on any profits made from short term stock sales. If your income tax rate is 20%, that is what you will pay.

The bottom line for swing traders is that you are going to pay ordinary income tax rates on all of the profits that you earn as a swing trader.

Long term investors are probably going to pay long term capital gains tax rates. To qualify for long term tax rates, you need to hold an asset for one year or longer. So those who follow the Warren Buffett strategy are going to hold their stocks for many years or decades, before selling them off to earn cash. Then you will pay the long term capital gains taxes on your profits. Under present law, these tax rates are very favorable compared to ordinary income tax rates.

Individual Retirement Accounts (IRAs)

Now let’s consider the tax situation with IRAs. If you invest in a traditional IRA, you get the tax benefit now. That means you are able to deduct the money that you invest in the IRA from your current year's taxes. However, when you withdraw the money later, you are going to have to pay ordinary income taxes on your withdrawals. Of course, nobody knows the future, so it's not possible to know if the tax rates today are going to be better or the tax rates in the future are going to be better.

If you have a Roth IRA, then you are going to pay taxes on the investments now. However, when you pull money out of the IRA in the future, the money is going to be tax-free at that point. Again, we don’t know what the tax rates are going to be in ten, twenty, or thirty years, so it’s really not possible to say that one method is better than the other with any certainty. However, to use a Roth IRA there are limits to the amount of ordinary income that you earn each year, so not everyone is going to be able to use a Roth IRA.

Dividends from REITs, MLPs, and BDCs

Investments in REITs, MLPs, and BDCs pay dividends. These dividends are treated as ordinary income from these companies. However, in the case of a master limited partnership, they are going to pass on their depreciation costs to you. These costs can be quite large, and so generate

massive tax savings. You are able to deduct the depreciation costs from your own taxes, and so you will end up paying a very low effective tax rate.

Dividends from Corporations

Dividend payments from ordinary corporations traded on the stock exchanges are treated as qualified dividends if you have held the stock at least 60 days before the payment of the dividends. In that case, they are treated as long term capital gains, and so get the favorable capital gains tax rates. If you held the asset less than 60 days, they are treated as ordinary income.

Chapter 12: Metrics for Value Investors

In this chapter, we are going to review some more metrics that can be used by value investors. You need to understand what all the different metrics are in order to do a fair analysis of the company and determine whether or not it is a good investment for you. We have already discussed doing financial analysis and looking at price to earnings ratio. In this chapter, we will briefly consider some of the more important metrics including price to book ratio, debt ratio, and current ratio.

Price to Book Ratio

The price to book ratio can be an important metric when analyzing the financial health of a company and its long term prospects. The price to book ratio can, like the price to earnings ratio, be something that you can use in order to compare a company to other similar companies in its sector, and also to market averages. This can then help you determine whether or not the company is a value stock or whether it's actually an overpriced stock.

So what is the price to book ratio, and how can we use it to make our investment decisions? Let us have a look.

The price to book ratio is often displayed using the symbol P/B. Here, P is the same value used in the price to earnings ratio. It is simply the current market price of a stock. B is the book value per share. Book value is an accounting term, certain to give many readers headaches. So we won't go into it too deeply, we will only explain that this is a measure of a company's assets less depreciation. This is also called the "carrying value." Or in plain English, it is the net asset value of the company. So they take all of their assets and then subtract liabilities.

If a company has a healthy book value, this is a good sign for the company, but for investors, we are interested in making a comparison of the stock price to the book value. A high value is an indication that the stock may be overpriced.

However, as was the case for the price to earnings ratio, this is not going to be something that you can simply take at face value. You can begin by comparing to stock market averages, and if the company is in an index like the S & P 500, you can also make a comparison to the average value for that index. That said, the really important value that you want to use is making a comparison with other similar companies. So you need to find out what the P/B ratio is for companies that are the closest competitors. Then you want to look at the P/B ratio for the entire sector. If the P/B ratio is low when making these comparisons, then you know that the stock is a value stock, and probably a good buy. But of course, you do not want to do this calculation in isolation. Only a novice investor would buy stock based only on one metric. You should also check the P/E ratio to determine if the company is a value stock or not. The P/B ratio helps you determine the value of the company in terms of its net assets. This is different than P/E, which helps you determine the value of the stock in terms of company earnings. Both are important, but frankly, the P/E ratio is probably more important when trying to determine if we are talking about a value stock or not.

Debt and Current Ratios

The debt and current ratios are two more metrics that we can use in order to evaluate the financial state of a company. When doing value investing, you are going to be looking for

companies that are in good financial health, and so what you want to see is these companies are not taking on too much debt.

The debt ratio takes the total debt and divides it by the total value of the assets of the company. This is a red flag if the debt ratio is greater than 1.0. What the debt ratio tells you is how much ability the company has to pay off its debts. Obviously, a company is not going to have a fire sale and get rid of all its assets in order to pay the debt, but you want to have some measure of how much the debt really impacts the company. A company may have a lot of debt in absolute terms, but if it has even more assets, then that debt is not necessarily a dangerous or bad thing for the company. The debt ratio gives you an idea of how able the company is to pay off its long term debt obligations or put another way its total debt.

We are also interested in how able the company is to pay off its short term debt obligations that are due in less than one year. This information comes from the current ratio. This found from the balance sheet, you want to get current debt/liabilities and compare that to assets. Again, the lower the ratio the better when it comes to debts. If the company has a lot going for it, taking on debt is not necessarily a bad thing. For example, a company may be developing important and exciting products for the future that may bring in lots of revenues.

Conclusion

Thank you for taking the time to read this book.

I hope that the information presented in this book has opened new doors for you, showing you the many possibilities that exist to build your own wealth doing self-directed investing. It is far easier than most people think, and you can build up your own portfolio of stocks to generate wealth now and in the future.

We also hoped to impress upon the reader the importance of not bypassing the opportunities that stock options from an employer can offer. Many people would prefer to take cash, but stock options offer the opportunity to grow wealth over time, which is more important over the long run. We also covered some of the details of employee stock options, so that you can better know how to handle them and whether that is the right thing for your situation.

We've also learned about the opportunities that exchange-traded fund investing provides, and how this compares and contrasts with investing in individual stocks. You should do what is best for your own situation, but most readers will probably benefit from doing a mix of the two investment styles.

Most of all, we have learned the promise of value investing that is promoted by successful investors like Warren Buffett. By following a clear and disciplined investment strategy, anyone can build massive amounts of wealth. It does take time, so there is no time like now to get started!

We also covered many of the important characteristics of a stock that investors should be looking at. These include the many metrics that will tell you at a glance what the health of a given company is so that you can determine whether or not investing in that company is going to be

something that you want to do in order to secure your own financial future.
Next, we discussed the opportunities that are presented by IPOs and what to look for when considering this as a possible move for your portfolio. This may not be something you are looking at right now, but in the future you may find this to be an opportunity to further grow your wealth.

Finally, we discussed the tax implications of investing in the stock market.

Thank you again for making it all the way through my book, and please leave an Amazon review with your thoughts.

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Stock Option Trading Strategies

The Best Step-by-Step Guide to Learn How to Trade Stocks for Beginners and Discover How TOP Traders Invest. The Best Strategies to Create Your Financial Freedom

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Conclusion**+Disclaimer**

Introduction

Options trading is one of the most exciting ways to earn money from the stock market, and it's also one of the most accessible. Any trader can buy and sell options with only a few hundred dollars. However, options trading can be very tricky if you don't know what you are doing. You don't want to rush in and trade options without understanding how they work and what the strategies are.

In this book, we will explain what the options trading strategies are and why you will want to apply them. As you will see there are different strategies for different situations. What strategy you apply will in part depend on what you think the stock is going to do. Also, you will apply different strategies depending on what your goals are.

We will begin talking about the why of options trading strategies, and then we will investigate the most basic strategies that are used for generating income, covered calls, and protected puts. We will also discuss using LEAPS to generate income and make money from trading.

Then we will talk about the possibility of the stock making big moves, and how you can use straddles and strangles to earn money from these situations. We will also talk about when you should consider applying these strategies.

After this, we will talk about spreads. Our focus in this chapter will be on the bull and bear debit spreads.

Next, we will cover iron condors and iron butterflies. The iron condor is an interesting strategy used when a stock is ranging, and it is actually something that you sell on the marketplace.

Then we will wrap up the book with two chapters that will cover earning income using options. In the first chapter, we will talk about the risk mitigated strategy of selling credit spreads. Then we'll wrap up the book talking about selling naked, which supposedly means that you are selling lone puts and calls but without any backing. We will see that isn't entirely true, and show you how to avoid being assigned the stock.

Options trading offers many different opportunities, but you can't go into it with your eyes closed. We hope that this book will help you get into options trading and do it right by following the best strategy that meets your goals.

Chapter 1: Why Use Options Trading Strategies?

Let me begin by asking you a question. What is your goal when it comes to trading options? Many beginning options traders haven't even thought about this. If you answered "to make money," then you might be someone who is coming to the world of options trading without giving serious thought to why they are doing it. But you have to start there.

So the first thing you should do before jumping on board and starting to trade options is to figure out what your end goal is. Every trader should have a plan and stick to that plan, even when it seems like it is stalling. If you don't have a plan then you are just going to be haphazardly trading all over the place with no rhyme or reason. And even worse – you are going to be letting emotion get in the way of your trading.

Trust me, when it comes to options emotions get involved. Depending on what the market is doing, you might see your options melting right before your eyes. When that happens, emotions are going to come up in a big way and that can lead to bad decisions.

Of course, before that happens you need to mitigate your risks as much as possible. But it's not possible to account for everything, and sometimes things are just going to go south. The first thing you need to do is have a clear understanding of how options work. If you don't understand expiration dates, the Greeks, the differences between calls and puts, you need to go study those things right now. You need to know them before you jump off into different options strategies.

Speculating vs. Income

In my view, there are two basic ways that we can classify options trading. It's either speculating or income investing. Let's talk about speculating first. Basically, this is nothing more than guessing which way the stock is going to move and then buying options to profit from the guess. So if you think the stock is going to go up, then you buy a call. If you think the stock is going to go down, you buy a put option.

There are more complicated ways to do it, and there are some strategies too. We are going to be investigating some of them in this book. But you need to be clear about what you are doing if this is what you want to get into. A speculator basically hopes to trade with a trend in the stock market. Options can make money fast, but they can also lose money fast. Most professional options traders avoid playing the game using straight-up puts and calls. Doing that is probably the highest risk you can take while trading options.

That isn't to say that you can't win and win big just buying calls. Sometimes you can, and some traders are really good at it. But winning using that as a strategy takes a lot of time to study and frankly, most people aren't good enough at it in order to consistently make money.

Now let's turn our attention to the other possibility, which is using options in order to generate income. This is a more conservative way to get into the options world, but it has it's risks too. But if you play it right, you can sell options for income and build a pretty lucrative career.

So this is the first step. You need to decide if you are interested in trading options for speculation or for income. I've done both, but I would never recommend that other people do both and nowadays I stick strictly to the income side. But you have to do what you are most interested in.

This is the first step to building an effective options trading plan.

Set Your Income Goals

The next step is to set your income goals. This is really to get you focused on a month to month basis, but you can also have a grand end goal in mind. I am sure that many readers of this book are hoping to ditch their day job and move on to trading options full-time. That is fine, but how much money do you need to make per year in order to get that done? Make sure that you've written this down and that you have a clear understanding of how much per month you need to make. Others might have a lofty number in mind, like becoming a millionaire.

You can become a millionaire trading options, but this is not something most people are able to do, and you are probably not going to be able to accomplish this overnight. If you want to become a millionaire in five years, you are going to have to make enough to live on, and then make $200k + on top of that. I put a plus there because guess what – if you are making that kind of bank then you are going to have to pay a lot of taxes too. This is something doable, but you are going to have to be very serious about it and be cautious about your trading.

Also, you can't start out thinking you are going to make something like $250k your first year. I encourage new traders to start out with reasonable goals that they can reach. Then each time you reach one of your goals, you set a new one and shoot for that.

So start small. You might start off with a goal of making a $500 profit your first month. You are going to be surprised but some people are going to find this very hard to do. But if you are able to do it, congrats – you can then make a new goal, like making $1,000 profit. Building up in this way you can eventually get where you want to be, and then reach your ultimate goal. What then? Options trading is fun, so most of you are probably going to be addicted to it and you will probably keep going. Don't get stupid about it and blow all your money if you manage to reach your goals. Keep playing conservative.

Learn the Strategies

Options trading is very risky. The reason is that options magnify small changes in stock price. I know many people are going to say, yeah but I can buy an option for a hundred bucks. If I lose it, what's the big deal?

There is some truth to that, but after you start trading regularly, you are probably going to be trading more than a single option. So this can get serious real fast, and some people, lots of people, have lost their shirts just trading options carelessly. You don't want to be one of those people, which is one of the reasons that you are reading this book.

To trade successfully, you should study all of the options trading strategies that are available, and then become an expert in one or two of them. Yeah, you heard me right. You don't want to be spreading yourself thin hoping to do and try everything. So you should pick the ones that are the most interesting do you and then move forward, with the hope of building a business out of it.

The next thing you should do is pick your five favorite stocks or ETFs that you want to trade. Just like strategies, you don't want to spread yourself too thin by trading any stock that strikes your fancy. Pick five to focus on at least for the next upcoming quarter, and better yet for a year. At the end of the period of time that you pick, you can evaluate the situation, and move one or

more stocks out and replace them with different securities.

Why there are options strategies

To reiterate, there are options strategies because options trading is risky, and so smart people who study this stuff all the time have come up with ways to mitigate the risk. There are downsides to this. Let’s look at a call option as an example.

With a call option, you have a limited risk unlimited reward financial asset. In practice, it’s not really unlimited reward, but however much the stock might go up, you are going to make that much money x 100, roughly speaking. You might lose money, there is a good chance it could expire worthlessly. If that happens, you will be out $100 or whatever you paid for it. Of course, as I mentioned, when people really get into trading you are not going to be trading a single option. How else are you going to be making money? So if it expires worthless, you might be out $1,000, because you bought a lot of ten options.

So what options trading strategies do in most cases, is they trade away some of that upside to minimize risk. Using a trading strategy, you might have a higher probability of a win, and lower levels of risk, but in most cases, the amount that you can profit will be fixed. That might even sound boring to some people – but let me ask how boring that is compared to buying straight calls and losing $1,000?

Options Trading Levels

If you aren’t aware of it, there are different options trading levels. So if you want to implement various strategies, you have to know what level you are, and how you get to a higher level. The lowest level, a level 1 trader, is pretty limited as far as what they can do. The most they can do is sell what is called a covered call. We will talk about what that is in the next chapter. A level 1 trader can also sell a protected put. Beyond that, they cannot trade options.

A level 2 trader is able to sell covered calls and protected puts, but they can also buy to open calls and puts. That means they can trade options back and forth, or as I called it at the beginning of this chapter, they can speculate. As I said, this can be profitable but it's pretty risky, and to be honest, for most people it’s not going to be consistently profitable.

To do most of the strategies in this book, those outlined in chapters 4-7, you need to be a level 3 trader. In order to get this status, you will have to do an interview process with the broker. It’s really not that complicated and most brokers are actually pretty lenient about letting people become level 3 traders.

In order to sell naked options, you have to be a level 4 trader. That is a little more difficult to obtain, and you have to open a margin account to do it. There are even a few brokers that don’t allow people to do level 4 options trading, but that is kind of overkill if it’s done carefully it's not really all that dangerous.

Margin Accounts

Since we mentioned it, we might as well tell you a little about it now. In order to sell “naked” options, which means they aren’t backed by anything, you have to open a margin account. A margin account is just an account that lets you borrow from a broker. You must deposit a minimum of $2,000 in a margin account in order to open one.

The margin is the amount of cash in your account. You can then use leverage to trade 2x as much as you could using just your cash alone, so you basically borrow the rest from the broker. If you don't pay it back right away, then you will have to pay interest on it and repay the loan. The hope, of course, is that your trades don't go bad, and so you won't have to pay it back other than simply taking the money you won from the trade and paying a portion of that to the broker to close out the loan.

Of course, a smart trader isn't going to blow their entire account on a single trade.

Some other things you need to be aware of our buying power and margin calls. Even if you don't have a margin account, you are going to notice you have a certain level of buying power associated with your account, if you are doing things like selling credit spreads. Your buying power is just what it says it is, it's either the amount you have available to buy options, or it's the amount you have available to put up as collateral for specific kinds of trades.
A margin call is something that could happen if you lose more money on a trade than what the margin account can cover. A margin call is sometimes described as a demand from the broker to put more cash in your account. If you can't do it they are going to close all of your positions and send you a bill. So if you decide to open a margin account, you are going to have to use it carefully. Don't get yourself in a situation where a margin call might happen. If your trades are at risk, get out of them before you get into trouble. There is no sense of holding on using "hope" as a strategy. If a stock is declining, and it's ruining your options trade, don't sit there hoping that it's going to turn around. That is something that is not going to work and it's something that can wipe out a lot of new traders.

Don't get caught by time decay

Something that many new traders are aware of, and yet they continually ignore, is time decay. You need to be keenly aware of time decay. If you are buying options, time decay is your enemy, and it can be quite potent. As options get closer to their expiration dates, you are going to find that time decay becomes ever more important. So pay attention to it, and don't hold an option that isn't going well too long. If you do that, you can find yourself in a position where time decay eats you alive, and pretty soon you have a worthless option on your hands.

What's Next

Now that you have some basic knowledge under your belt, you should start setting up your options trading plan. Start with your goals and where you want to be a year from now. Also, make sure that you are recording every single options trade that you make inside a notebook. It's important to be completely honest with yourself about your trades. Don't just remember the wins and forget the losses. For the year, you want to have a running total that records either your profits or your losses. That is going to be a very important number to always have in mind so that you know where you stand and how far or close you are to your goals.
In the next chapter, we are going to start with level 1 trading, so we are going to learn about covered calls and protected puts. You can only do a covered call if you actually own 100 shares of the stock. So if you don't own stock, you aren't going to be able to make the trade. It's kind of ironic but the lowest level of trading is the one that has the highest bar to cross for many people.

Chapter 2: Covered Calls and Protected Puts

In this chapter, we are going to start by covering the simplest trading methods that there are, which are open to level 1 options traders. Basically, anyone is a level 1 options trader. To become a level 1 options trader, all you have to do is open a brokerage account. These are level 1 trading methods because they are low risk, in that the potential loss is completely accounted for by something that you own. In the case of a covered call that is going to be the stock that you already own. For a protected put, you have to put enough cash into your account in order to cover the potential losses.

Review: What is a call option?

Let's start by reminding ourselves what a call option is. A call option is a contract that gives the buyer the option to buy 100 shares of stock before the contract expires. The contract has the share price that the buyer would pay, should they choose to exercise the option. This price is called the strike price. In order for the option to be worth something, the market price of the stock has to be higher than the strike price. But more than that, there is a fee that the buyer has to pay to own the option. That fee is called the premium. So the option is not going to be worth exercising unless the market price goes above the strike price plus the premium that was paid to buy it.

Most people that buy call options have no interest in buying the stock, they just want to trade it back and forth, hoping to make a quick profit. These are the speculators, who are just hoping that the stock price will go up, making the option worth a lot more money. You can find out how much more by looking at the Greek quantity delta, which gives you the fraction that the price of the option will change by - per share – when the price of the stock goes up. But remember it also tells you how much it will go down too if that is what happens.

So if the share price goes up to $1, and the delta is 0.80, that means that the price of the option will go up to eighty cents per share or $80 in total. So the share price rise of $1 is magnified to $80 because the option controls 100 shares of stock. This is what makes options so appealing, but people forget that you can just as easily lose that $80 too.

The buyer of a call option is betting that the stock price is going to go up. Most of the time they are hoping to ride a trend, so they want to see the stock go up by a large amount. The trick is to get out of the option at the right moment when there are still people hoping that the stock is going to keep rising, even if it's starting to peter out. That may or may not happen, but it can happen.

Other times you might just be hoping to trade a ranging stock when it's going into its upswing. In that case, the possible profits on the stock might not be as great, but you are still able to earn some money. It can also be a quick in and out transaction, so you might find yourself making a day trade.

Now that we have reminded ourselves what call options are for, let's talk about selling one.

What is a covered call

In order to buy calls, someone has to originate the contract, or "sell to open." In this case, someone sells a call option, and they are agreeing to sell 100 shares of stock at the strike price if

someone who bought the option decides to exercise the option. It doesn't matter how many times the option changes hands as it gets traded. Whoever owns the option can exercise it at any time, if the price moves in a way so that doing this would be profitable to them. So if you sell a call option, you might be in a position where you have to sell 100 shares of stock.

In the case of a covered call, you must on the shares of stock before you can sell the call. This is why a covered call is considered to be a low-risk trading strategy. A high-risk trading strategy using the example of a call would be selling the call but not having the stock in your possession or perhaps even having the money to be able to cover the deal. Although there are real risks that are involved, at least in the case of a covered call you already have the shares and so if someone exercises the option it won't be a problem going forward with the transaction.

So the first thing to consider is why would someone put their shares at risk in this way? The reason is that you can earn a regular income from the shares of stock that you own. The trick to doing it right is picking the best strike price so that there is a balance between the potential to make income and the risk of having to sell the shares. A big concept that you need to get into your mind if you're going to be selling covered calls is the break-even price. In fact, no matter what you're doing with options, the breakeven price is an important concept that always has to be looked at.

So let's summarize what a covered call is and how it works. We start with the assumption that you own at least 100 shares of some stock. Perhaps you own a lot more than this and you would be willing to risk several hundred shares or even thousands, in order to get the cash income. But for the sake of our discussion, we will just assume that you own 100 shares.
he way that this works it Is you can't just sell any old price that comes to mind and you can't make something up. You have to go on the market and see what call options are actually available for the stock that you own. We may as well take a specific example to get an idea of how this actually works.

For the example let us suppose that you own shares in the exchange traded fund QQQ by power shares. Looking up the options that are available in one months time we see that there are several strike prices in increments of $.50. So the way that you start out did you have to look up the options that are on the market and then pick up the strike price that you want to use in order to sell your option. The first thing you want to look at is the share price or market price that is the most recent one available. In our case, the share price is $186.95.

In the money, options sell for much higher prices as compared with out of the money options. However, selling and in in the money option is a risk. How much of a risk is going to depend on a couple of factors? The first factor is what the break-even price would be and the second factor is the volatility of the stock.

Can You Get Assigned?

The first thing you might ask is what is the real risk of assignment. For readers who aren't completely familiar with the jargon, assignment means that whoever bought the option is going to exercise their rights. In this case that would mean that they buy the shares from you.

Unfortunately, on the Internet, there is a lot of misinformation with regard to the possibility of assignment. You are frequently going to see the claim made that 85% or something like that of

options expire without being exercised. Or sometimes you might read that 85% of options expire worthlessly. The details really don't matter, what we want to focus on is what might happen if you actually sell on an options contract. And what is frequently left out of this discussion is the question of whether or not the option is in the money or out of the money.

So let's cut to the chase. If you have an option that you have sold and it is in the money, when it expires, it is going to be exercised. So that means that you're going to have to sell your shares in the event that you let the option expire. So lesson number one for someone who wants to sell covered calls is that if they sell an option either in the money from the beginning, or it's in the money as the expiration date approaches, that means that you need to get out of this contract.

If you're planning to sell options, you should highlight the following statement. If you sell an option and it's in the money when the expiration date is approaching, you must buy back the option unless you are comfortable with it being exercised.
At first glance, it might strike you that's crazy to take an action like that. Some readers who are not very familiar with options might be saying to themselves that how are you going to make money? However, if that thought entered your mind, you are ignoring the friend you have as an option seller.

That friend is called time decay. You sell an option a month out, and what happens is the value is going to be decreasing as time goes on. Remember that an option has a value that comes from the underlying stock, but it also has a value from the time left until the options contract expires.
That means that more than likely the option is going to be cheaper by a large margin at the time that you buy it back then it was when you sold it in the first place. So we can sell options and then we can buy them back and we are going to make the maximum profit, but we might be making something like 85% of the possible profit that could be made. And even better we've made money while keeping our shares.

Don't forget that if the contract we are talking about is American style, which is going to be the vast majority of the contracts that you are involved in, the option could be exercised at any time between the date that it's issued, and the expiration date. However, although you can't predict with certainty what anyone buyer is going to do with it, statistics show it's unlikely to be exercised early. Don't let that give you too much comfort however, you have to be aware that it could happen at any time. That said, what we do know is it's unlikely and you also have the break-even price working in your favor, so what you really have to worry about is the situation where the option expired when it was in the money.

Let's take a look at a specific example to understand how this works. So we will go back to QQQ which is an exchange traded fund that tracks the NASDAQ 100. The share price is $186.95. Looking at the first in the money call the strike price is $186.50. That might seem a little bit close for comfort. But whether or not it really depends on the breakeven price and the volatility. For analysis focus on the breakeven price. It's $190.66. So how could that be? Well, that's because someone has to pay $4.16 in order to buy this option. So the fact that the option is a little bit expensive gives you a fair amount of breathing room before there would be any risk of assignment. But we could also look at selling out of the money options which is what most people do. So we could sell a $187.50 call option for $3.55. The breakeven price for that one is $191.05. So we gained about $.50 in breathing room. We could go even further out, one of the things that people look at when selling options is the chance of profit. Your broker should be

giving you this information. Personally, I like to go with a chance of profit of 75%. So we can sell out of the money call option on QQQ with the strike price of $191. In that case, the breakeven price is $192.76. So it's more than $2 higher than the first one we looked at. That means it's far less likely to expire in the money.

If you are comfortably out of the money you can just go ahead and let the option expire. On the other hand, as we said with the strategy you can always buy it back a couple of days before the expiration date so that you don't have to worry about being assigned. But it's important to emphasize again that if you let an option that is in the money expire you will be assigned. The broker in most cases is actually going to go ahead and do the exercising of the option.

Let's look at how the strategy would work. Now let's imagine that the underlying stock price is $188 a share. If we had a strike price of $186, would 30 days left to expiration the option would be worth $538. Now let's consider 20 days left to expiration. At the point, the call has dropped in price to $460 if we keep every other characteristic constant. Now let's consider 10 days to expiration. At this point, the call has dropped to $361 in value. So by now, you should be figuring out that the time value which is lost every day is working strongly in favor of the seller of the call option.

But let's carry it all the way to two days before expiration. We are still imagining that the option is in the money by $2. Now the call is priced at $238. So if we had sold the option would 30 days left to expiration, we would have sold it for $538. So with two days left to expiration, we can buy it back for $238, and we've made a $300 profit. And by purchasing the option back, we have avoided the problem that would arise by letting it expire and then we would probably be assigned and have to sell the shares.

That is how the strategy works. So yes, we didn't make the entire $538 that we could've made had the option expired worthless. However, we still made a substantial profit. So let example was one that considered an option that was actually in the money. But what you should be doing is selling options that are out of the money so that you substantially reduce the risk of being assigned.

Income Strategy

The main strategy involves here is to utilize the shares of stock that you own in order to make some monthly income. If you own 10,000 shares, you could use 5000 of those shares and sell 50 options contracts every month. So if we made $300 from every contract, that would be a $15,000 a month income. But maybe we are getting a little bit ahead of ourselves because you might not own that many shares. Let's say you only own 500 shares. You can still earn $1500 if you sold five options contracts on those shares. That's a pretty good passive income and five options contracts is a lot easier to manage than 50.

The main goal that is used in this strategy is to be able to do this month after month. So you want to have that practice of avoiding being assigned either by showing out of the money for buying the option back so that you can keep your shares and repeat the process the following month.

Selling the Shares

That said, you should also be prepared for the possibility of having to sell the shares. So one thing that might be considered is you should work out a price that you would find acceptable as

far as selling the shares and facing the prospect of losing them. It’s fair to assume that you would not be doing this if you had paid a higher price for the shares than what you are using for your strike price. Of course, it would be a possibility but in most cases, people are going to be selling call options against shares that they had purchased in the past. So it won’t be too painful in that kind of situation to go ahead and let your shares go.

In this case, we can look at the worst-case scenario. That would be you sell the shares but you get paid cash so you are not exactly in a losing situation. Not only do you get the cash from selling the shares, but if the option is exercised you also get to keep the entire premium paid. Just to get an idea of how this would work let’s go back to our previous example. We have set up a call option with the strike price of $186. In our fictitious scenario, the share price on the market was $188. However, nobody would buy it at that price. Don’t forget that the buyer of the option paid $5.38 per share. So they wouldn’t exercise the option unless the price went to $191.38. And even then, do you think they would actually buy the shares using the options contract? The answer to that question is probably not. In order to be worth it, the share price actually has to move above the breakeven price. Once it does that, how much it has to go above the breakeven price is something that is subjective. It might be worth it to someone to buy the shares and make it $.50 cent profit per share. Somebody else, might not find that worth bothering with and instead of doing that they might try selling the option to somebody else. The reason that may be possible is that the price of the option might have increased.
And in fact, if we go to 10 days before expiration setting the share price to $192, the call option would be priced at $658. So in that situation, you are not going to buy it back. However, since most options traders are simply looking to profit by buying and selling the contracts rather than exercising the option they would probably sell it for $658 and take the profit that they made. This leaves you protected because whoever bought it for $658 is now facing their own breakeven price. The share price has to rise past the strike price plus the break-even price in order to make it worth it. So as you can see from this example it still wouldn’t be worth exercising even though the option is in the money.
Now if the option was very deep in the money it might be worth exercising had the buyer purchased it hi there when it was barely in the money or if they were really lucky it was out of the money at the time.

Summary: Covered Calls

So the bottom line with covered calls is that if you wisely choose the strike price used, it’s a pretty good strategy that can be used in order to earn some money off of the shares of stock that you already own. Unless you recklessly choose a strike price, the reality is in most situations that you are going to face you are not going to get an assigned and you will be able to keep your shares and play the same game the following month. Even in the event that you have to sell the shares, you would be lucky enough to get cash for the shares that you sold as well as pocketing the premium that you were paid for the option. So this is not a totally losing situation and you would be able to use the money to buy shares of stock in another company and then go back to using the same strategy. Level one traders are able to sell covered calls in the event that they own the shares of stock. So just to be clear, if you don’t own shares of stock you are not able to sell covered calls. But as we will see later, you will be able to sell calls anyway.

Protected Puts

Now let’s turn our attention to the other possibility that can be used by level, one trader. This is

called a protected put. You can think of this as the opposite situation to a covered call. Well, actually it's not really the opposite situation so we might just say it's an analog in the case of puts. Just as we did in the previous example let's quickly review what a put option is all about for readers who are not completely clear about this notion.

A put option is equivalent to shorting the stock. So if you buy a put option, you are betting that the price of the stock is going to drop. Put options have the same characteristics otherwise than call options do. So they have a strike price which sets the boundary as to whether or not the option is worth anything. In this case, you want the market price of the stock to drop below the strike price. That has implications for the breakeven price. The same laws about money that we discussed in relation to the breakeven price for the call options apply here. However, the difference is you subtract the breakeven price from the strike price to get the first price at which there would be any risk of assignment.

So let's turn our attention to what happens if the option is exercised in this case. In case you don't remember if you are the buyer of the put option you have the option of selling 100 shares of the stock to the other party of the contract. Turning things around that means that if you sell to open a put option, in this case, you would have to buy 100 shares of stock at the strike price. Let's say that the stock was trading at $140 a share. To buy 100 shares you would need to cough up $14,000.

So what does it mean to say that a put is protected? That means that if you sell to open the put, you have the cash in your account that could be used in order to buy the shares of stock. This may not be the best strategy around, but I suppose that it could be better than putting your money in the bank given that interest rates are so low. So the way things work in this case is that you have some money rather than shares of stock that would be tied up each month and you would sell put options against it to generate income.

So in this case having to tie up $14,000, if we earn $538 selling a put option you could think of this as earning 3.84% within a single month on that $14,000. When you look at it this way, that is actually a pretty good use of cash. Of course, it's a high-risk adventure because there is a chance that you would be assigned. In this case, what that means is that you would have to buy the shares of stock. And we are assuming that the price of the shares has dropped so you are going to be taking a loss in some sense. However, it's not like you're being kicked out onto the street. Although you did lose the $14,000, you now own 100 shares of some stock.
People who sell protected puts are going to choose stocks that they wouldn't mind owning at the strike price. So maybe just for an example, you sold a put on IBM at $132 a share. Maybe for some reason, IBM drops below that and the option is exercised so you have to buy the shares. Over time, that probably is not going to be a bad deal. It would be likely that the market price of IBM is probably going to climb back above the $132 price. And another thing to consider is maybe you just want to keep the shares. You could also be selling call options against the shares while you waited for the price to rise.

When it comes to selling put options, the same strategies should be used. So one of those strategies would be that rather than simply waiting for the option to expire and having to buy the shares, a smart options trader would buy the options back before expiration. Second, you would probably want to choose a strike price wisely so that you wouldn't be put in a position of having to buy the shares. But the point of the previous discussion was that in the event that you are

assigned and you have the cash in your account to buy the shares, is not exactly a catastrophic situation.

Although protected puts are one way that you can make income, in the grand scheme of things you probably wouldn't want to be doing this. As we will see later on in the book there are better ways to make money while having to put down far less capital. We can even do this selling put options as we will see in chapters seven and eight.

LEAPS

The next topic we are going to consider in this chapter is a specialized type of options contract called a LEAP. To be honest there's actually not really anything that is specialized about these options. This is simply a term used to refer to options that have expiration dates one to two years into the future. The fact that they expire so far into the future does offer some interesting possibilities because they really aren't affected buy time decay the way that options that are closer to expiration are.

One thing that you can do with these is simply to buy them when you're confident that the stock price is going to move in a particular direction. These options have pretty high prices because they expire so far in the future. So, for example, you could buy a call option and then wait for the price of the stock to rise. The advantage of these options that expire so far into the future is that you have a really long time where you could wait for the price of the underlying stock to move in a direction that would make the option significantly profitable for you. The real downside to this strategy is that these are more expensive buy a pretty large margin as compared to options that expire within a month or a week. But if you are able to spend the money to purchase them it would offer a possibility of learning some profit in this way.

There could be another downside, however. One of the things that you have to worry about whether you are trading stocks or selling options is the liquidity of the underlying security. So when you are buying leaps one of the things you want to check is the open interest. Make sure that the open interest is at least 100. If it's above 100 that's even better. Open interest for those who don't recall is the number of contracts that are on the market. It gives you an indication of how many buyers there might be when you need to sell it. So for example going back to the QQQ NASDAQ Exchange traded fund, looking two years out, we find hey $186 call which is $18.52 per share, making the total price of the option $1852. So it's almost 5 times as expensive as the same strike price that expires within a month. The open interest is 406. So this would actually be a good one to invest in if you thought the price of QQQ was going to rise in the future. Of course, the expiration date is so far away you definitely have lots of time to wait for this to happen.

Selling Calls Against LEAPS

So if you recall an option gives you control of 100 shares of stock. It turns out that you can use a call option that is a LEAP for an interesting strategy that is known as the poor man's covered call. Using this method you can actually sell short-term call options against the LEAP. This is possible and it saves you a lot of money. That is as far as having to invest in the stock. So we saw that the option would cost us $1852. But the share price is almost $187 so to buy 100 shares it would cost us $18,700. In other words, we'd have to spend 10 times as much money. So this method is something that you can use in order to sell covered calls without buying the stock.

Summary

So let’s review what we have learned in this chapter. What we’ve covered here are the possibilities that anyone who has a brokerage account can use as a strategy to sell options. The strategies in this chapter require some type of asset to back up the contract. They cover call requires 100 shares of stock that you own in order to sell options against it. This can be used to generate a monthly income. Another way to generate a monthly income is to use cash instead of shares of stock and then earned money by selling put options. Finally, we talked about the poor man’s covered call which utilizes LEAPS to sell call options. This is a money saver as far as an investment because investing in LEAPS costs a lot less money than actually buying 100 shares of stock.

Chapter 3: Trading With the Trend

In this chapter, we are going to move on to considering basic options trading. This is probably what most people think about when they are thinking about options. Although the concept involved in this chapter is simple, it is considered a higher risk activity than the strategies outlined in the previous chapter. Of course, most people only trade one or two contracts at a time and so they aren't risking all that much money. But doing this right is actually pretty tricky. What we are talking about in this chapter is simply buying to open an options contract and just buying individual calls or puts. So we are not talking about using any complicated strategies of the kind that we are going to talk about in the later chapters.

Buying Calls

So let's get started by considering the most basic strategy of all, and that is buying a call option because you believe that the price of the stock is going to increase in the near future. Our consideration in this chapter does not involve buying or selling a stock, we are only going to be talking about trading options. Therefore the goal was buying a call option would be to purchase it at the right moment and then hope that the stock will go up so much that we are able to sell the option for a profit. This all sounds simple enough almost like something that you could never miss. Unfortunately, in practice, it's actually a lot more challenging than it sounds on paper.

The first consideration is going to be whether or not you purchase an option that is in the money or out of the money. If this strategy works maybe that is not really an important consideration provided that it's not too far out of the money. The reason that people decide to purchase out of the money options is that they are cheaper as compared to in the money options. It's also a fact that if the stock is moving in the right direction out of the money options will gain at price as well.

So if someone tells you that you can't make profits from out of the money options they are not being completely honest with you. In fact, you can make profits but it's always going to depend on how the stock is moving and the distance between your strike price and the share price.

The best strategy to use when going with out of the money options is to purchase them slightly out of the money by a dollar or two. What this does is it ensures the price of the option is going to be significantly impacted by changes in the stock price. Second, you wouldn't be purchasing a call unless there was a good chance that the share price would be moving up. So if you are close in price to the market price, and there is a reasonable amount of time until expiration, there would be a good chance that the share price would actually rise above your strike price. If that happens it could mean significant profits for you.

Of course, you can always take the risk of putting it a little bit more money upfront and investing in a call option that is already in the money. If the stock price rises, that is only going to solidify your position. You also have a little bit of insurance there. That comes from the fact that if you choose a decent strike price there is a solid chance it will stay in the money and so even if it doesn't gain much value you will be able to sell it and either not lose that much, or still make a profit.

So what are we hoping for with this strategy? The main hope would be that there is a large trend

that takes off so that we can write the trend and earn a healthy profit. Since options are so sensitive to the price of the stock if such a trend occurs it's pretty easy to make decent money. The key, of course, is getting in the trend at the right time and knowing when to get out of the position.

Market Awareness

The first thing to keep in mind is what I call market awareness. This involves being aware of everything that could possibly impact the price of the underlying stock. This can mean not only paying attention to the chart of the stock, but you also need to be paying attention to the news and not just financial news. So let's take a recent example by looking at Facebook. In recent months Facebook has been constantly in the news. Some of the news has been good such as a decent earnings report. On the other hand, Facebook has been receiving some pushback from governments around the world. One of the issues that have been raised is privacy concerns. Facebook is also catching a lot of flak over its plan to create a cryptocurrency.

So here is the point. Every time one of these news items comes out, it's a potential for a trend. But there are a couple of problems with this. In many cases, you simply don't know when dramatic news is going to come out. So you have to be paying attention at all times and have your money ready to go. The best-case scenario is purchasing an option for the day before some large event. People are often reacting strongly in the markets when there is a good or bad jobs report or the GDP number is about to come out. So what you would want to do in that case is first of all pay attention to the news and see what the expectations are of all the market watchers that everyone pays attention to. Of course, they are often off the mark but it gives you some kind of idea where things might be heading. If a good jobs report is expected, then you might want to invest in an index fund such as DIA which is for the Dow Jones industrial average. One thing you know is that a good jobs report is going to send the Dow and the S&P 500 up by large amounts. So the key is to be prepared by purchasing your options the day before. But on the other hand you might be wrong with your guess, which could be costly.

You could wait until the news actually comes out. But I have to say from my experience trading this is a difficult proposition. The reason is you would be surprised how quickly the price rises when dramatic news comes out either way. So when one sense is a safer way to approach things but the price might be rising so fast that you find it nearly impossible to actually purchase the options. That you can execute a trade the trend might even be over. But if you're there in the middle of the action you might as well try and then you can ride it out and probably make pretty good profits.

Some people like to sit around and study stock market charts. During the course of everyday trading when there hasn't been any dramatic news announcement or something like that which will massively impact the price of the underlying stock, looking at candlesticks charts along with moving averages can give you a good idea of went to enter or exit trades. However, it's fair to say that there is a little bit of hype surrounding these tools. The fact is they don't always work because they are easily misled or maybe it's the human mind that is misled by short term changes that go against the main trend but is temporary. So you can make the mistake while following candlesticks and moving averages of seeing evidence of the sudden downtrend and then selling your position, only to find out that the downtrend wasn't real and it was only a temporary setback soon followed by a resumption of the main trend. So that is something to be

careful about.

Setting Profit Goals

If you were going to trade this way probably the best thing to do is to set a specific level of modest profit to use as a goal. One that I use is $50 per options contract. Some people may be more conservative so you could set a goal of $30 profit. Some people might be more risk-oriented. I would honestly discourage that kind of thinking because sitting there hoping for $100 dollars profit per contract, while it is possible, you may also find yourself in a situation more often than not where you lose money. What might happen is you have to sit around waiting too long to hit that magic number and it never materializes. Options can quickly turn from winners into losers because they magnify the changes in the underlying stock price by 100. So it's very easy to lose money quickly.

In my experience, the $50 price level is pretty good. The only time that this value has hurt me is when I see the $50 profit hit and I failed to sell my positions because I got greedy watching the upward trend and hoped for even more money. So that is something you should avoid it's better to stick to your law, whatever you happen to pick, and then always implemented no matter what the situation is. Remember that there is always another day to trade. You're trading career never depends on a single trade or a single days trading. The bottom line is that it's better to take a small profit her option contract and per trade and then go back and trade some more, then it is to hope for large profits that may never materialize. Also, you can always magnify small profits by trading multiple options at once. So if you trade 10 options and you're only going to accept a $30 profit on the trade, that means in total you could make $300. It doesn't really matter what specific number you pick, but you should pick a value and stick to it. If I have a regret from trading the only regret is that I didn't stick to the rules that I have set for myself.

Day Trading?

For those who are not aware, if you are labeled a patterned day trader, you need to have $25,000 in your account, and you need to open a margin account. So for most individual traders with small accounts, the last thing you want is to be labeled as a day trader. However, since options lose a lot of value from time decay, and many trends are short-lived, you may find yourself in situations where you have to enter a day trade. But if you are doing this make sure that you only do three per five day trading period. That way you will avoid getting the designation and all the problems that might come about with it. In this case, if you buy a lot of several options that have the same strike price and the same expiration date, those are going to count as the same security. That may result in problems if you need to unload them all on the same day. One way to get around this is to purchase call options with slightly different strike prices instead of getting a bunch with all the same strike price. Of course, if you were going to hold your positions overnight and risk the loss from time decay having to do that may not be something to worry about.

Trading Puts

Trading puts using these techniques is going to be basically the same, with the only difference being that you would be looking for downward trends. This is actually a little bit different because people are accustomed to thinking in terms of rising stock prices means profits. So it might be hard to wrap your mind around the idea of profiting from stock market declines. But you should never ignore the possibility of making money with puts. A successful options trader is going to be versatile. So you should be able to move in between calls and puts pretty easily

depending on market conditions. So when bad news comes out this is a huge opportunity to make money buying put options and then selling them for more money as the price drops. It doesn't matter if the bad news is political, economic, financial, or are related to a specific company. If the bad news is general in nature then purchase an option for an exchange traded fund that tracks the entire market. Or a great one to use is SPY for the S&P 500. You can use that one for good or bad news of a general nature. So if it was announced that there was a really good jobs report, buying a call option on SPY, is what you would want to do. On the other hand, if there is some news like China announcing retaliatory tariffs, you would probably want to buy a put option instead.

Range Trading

Some people think that they have to wait for a big stock move in order to make profits. But that's simply isn't the case. You can also look for stocks that are engaged in a pattern that is called ranging. This is a situation where the stock is moving up and down within a range but it's not breaking out either up or down. This requires a little bit of patience because you have to watch the stock for a while in order to determine what the range is. The lowest price that is reached is called the support level price. You want to see the price Drop down and touch this level two times. When a stock is ranging it's going to touch that support level price, and then rise up to a peak value that represents what is called the resistance. So obviously the best time to buy a call option would be when the market price goes down to the support level. Then all you do is whole onto the option until the market price rises back up to the resistance level.

If we were trading put options on a ranging stock, we would do the same technique but in the opposite manner. So, in this case, we want to purchase the options when the stock is at the top value. Then you just wait for it to drop back down to the support level price and you can sell your put option for a profit at that time.

Swing Trading

You can basically swing trade using options. The only difference that has to be taken into account is the fact that time decay may inhibit your ability to hold the position long enough in order to profit. So swing trading would involve looking for our price swing. It's going to have to be something that occurs over a day or two at the most. Otherwise, the price might not move high enough in order to fight against the time decay. So if you're doing this with call options you are going to look for the stock hitting the low price that it's probably going to hit all other things being equal. Then you would buy your call option at that time. From here on out you just sit and wait until the price rises back to the resistance level. You want to be disciplined about it and don't start hoping that there is going to be a breakout and price. Just take your profits while you can get them and then you can enter more trades later.

Chapter 4: Earning Money No Matter How the Stock Moves

One of the difficulties went straight up trading using call and put options is that you can always be sure the stock price is going to move but you may not be sure which direction. For example, if we are buying options before hey jobs report, it's virtually impossible to tell ahead of time how the market is going to react unless the jobs report is particularly dramatic. One of the situations that really drives this point home is earnings season. People are always lining up to trade options at earnings season because the underlying stocks typically make huge moves. It's a rare occasion when a company exactly meets the expectations of the analysts.

The problem is before the earnings of the company are reported you don't know which way the stock is going to go. Wouldn't it be nice if you could make profits anyway the stock moved? Well, it turns out that you can. And that's what we are going to investigate in this chapter. The method that is used is to buy a strangle or astraddle. We are going to explain how they work in this chapter.

The Two Strategies: Straddle and Strangle

The primary goal here is to set up a strategy to earn profits when there is a large price movement of a stock. Furthermore, we are looking for strategies that will earn provides if the stock moves either up or down at price.

There are two strategies that you can use to make profits no matter what direction the stock moves. These are called straddle and strangle. With these strategies, we will be purchasing a put and a call at the same time. It will cost more to enter the trade than just buying a call or a put on their own, but as we'll see the probability of having a winning trade is increased.

A straddle has a put and a call with the same strike price and expiration date. A strangle has a put and a call with different strike prices but the same expiration date. Either way, the position is going to have a range over which you lose money, that will be in the middle of two break-even prices. There will be a higher break-even price and a lower break-even price. If the stock ends up in between these two prices, you will lose money but the loss is limited. If the stock moves above the higher break-even price or goes below the lower breakeven price, this is when you will make profits.

When to use these Strategies

You use these strategies when the stock is expected to make a big move, but the direction of the movement is uncertain. The classic example of when to use a strangle or a straddle is when there is an upcoming earnings call. The trader will buy the options a few weeks before the earnings call, or at least one week before the earnings call, in order to take advantage of volatility. Implied volatility can make the prices of options rise, and as an earnings call approaches, especially for a hot stock like Amazon or Netflix, implied volatility is going to increase by a significant amount. By purchasing the options early, the trader ensures that they have bought them at the best possible price. However, since the stock is likely to move by fairly significant amounts, you can still enter a strangle or straddle the day before an earnings call, but it will be more expensive. The movement of the stock the following day after the earnings call will probably more than makeup for it.

Another time to use this type of strategy is when a company is going to have a product

announcement or a big news conference. Take Apple as an example. They have events throughout the year where they demonstrate their new devices or their developer's conference. The same kind of phenomenon will take place because investors will be closely watching the new iPhone, for example. If their reaction is excitement, the stock will go up a lot. If the , is a disappointment, the stock will drop. The point here is that before Apple actually shows the new iPhone, nobody knows how the market is going to react, but it's going to react one way or the other. A snazzy new iPhone that will sell well is going to mean a lot of future earnings, so the stock is going to go up in that case.

You can also buy strangles and straddles on index funds. You can do this when major announcements on the economy are expected. The types of announcements to look for where you would apply this strategy include the federal reserve meetings where interest rate changes are coming, jobs reports, or GDP growth announcements. Funds to use in these cases include SPY, QQQ, and DIA, which track the S & P 500, NASDAQ, and Dow Jones Industrial Average, respectively. You could also use other indexes like the Russell 3000.

These Are Risk Limiting Strategies

The purpose of using a strangle or straddle is to adopt a risk-limiting strategy. The risk limitation in these cases works two ways. First, with this setup, you don't care which direction the stock moves. When you buy a call, if the stock moves down you lose money. When you buy a put, if the stock goes up you lose money. With the strategies discussed in this chapter, you will make money either way as long as the move is big enough to overcome the breakeven prices.

The second way that the risk is limited is potential losses are capped. Unlike some of the other strategies, we will discuss in the book, these strategies are not limited reward, however. The reward is lessened as compared to a call or a put alone because you have to account for the one-loss you have. In other words, if the stock price moves high, the put you purchased expires worthless. So you would have to eat that loss, but compared to the gains you are likely to see, it will still put you in a position where you earn profits. Conversely, if the stock price drops, you will have some loss from the call expiring worthless.

Straddle

First, let's talk about straddles. The goal of a straddle is to earn a profit when the stock makes a large price move. The price can move in either direction, up or down. To set up a straddle, you buy a call and a put with the same expiration dates and the same strike prices. This is entered into a single trade.

To set one of these up you pick a strike price that should be reason enough for the market price to cross on dramatic news. Often, after an earnings report, the stock of a company can move up or down by $20, or more. But unless you have insider information, you probably don't know which way the stock is going to head. That is why a straddle is so useful. The way that you set one up is you pick a strike price, and when you buy a call option, and you also buy a put option that has the same strike price and expiration date. What this does is it creates a narrowband that lies about the strike price which defines the range over which your option is not profitable. In order to earn a profit, you need to have a breakout price on the market. That is the price of the stock would break out of this band that determines losses for your position.

The maximum risk is capped to the cost required to buy both options. You would incur the maximum loss if you keep the strategy to the expiration date and both options expire worthlessly. This would happen if the stock price did not move with a magnitude as large as anticipated. Keep

in mind that you don’t even have to hold a position until the options expire worthlessly. If it is a stock or index fund that is heavily traded, it’s usually possible to find a buyer under any circumstances. Why someone would buy this position if it wasn’t working out and the expiration date is approaching is anyone’s guess, but we don’t care about that. If the position is not working out for us we need to get out of it and minimize our losses. Letting the options expire worthlessly would be a silly mistake that will cost you money.

This brings to mind the expiration date. If the earnings call is on Wednesday, August 1, then don’t buy a straddle that expires on Friday, August 3. You should leave sometime in the contract so that it will give it some extra value and you have a bit of time to get out of the position if you need to before it really loses value from time decay. So in that situation, you would be better off entering a position that expired Friday August 10 instead, even though the upfront cost will be higher. You are also more likely to find a buyer in that situation if you need to get out of the position because there would be time left for it to turn a profit.

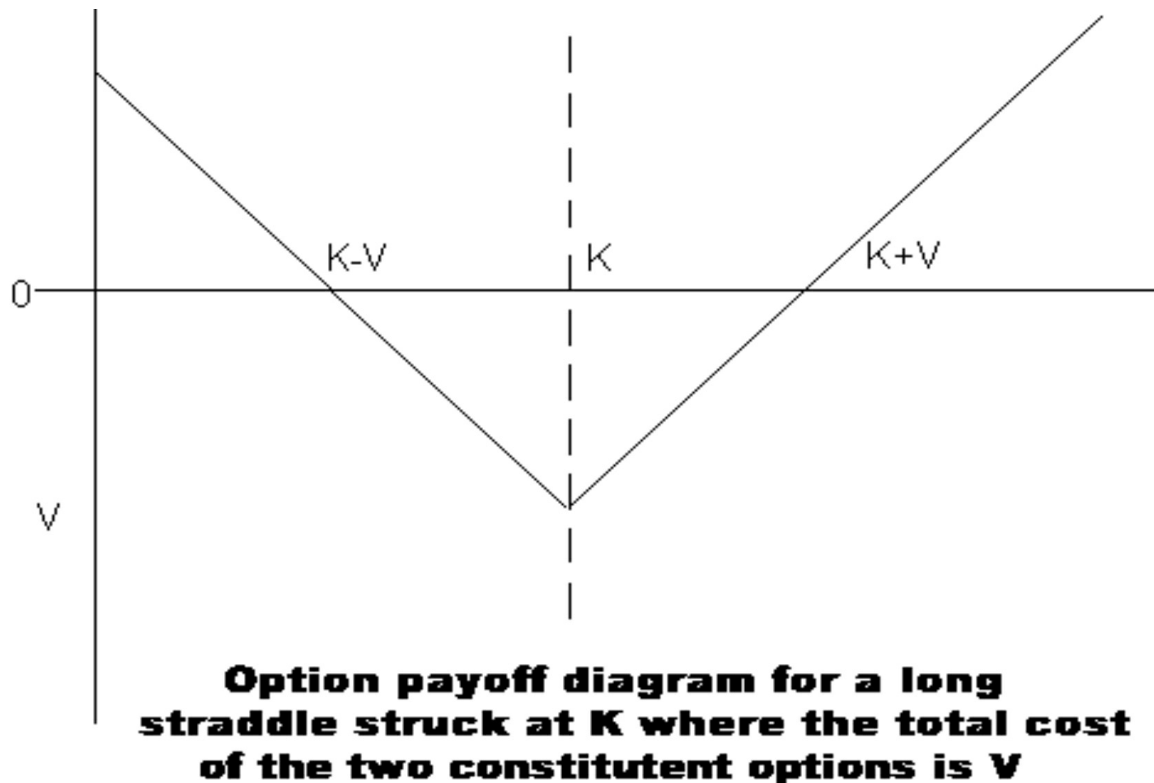
A straddle can make money if the stock price goes up by a significant amount or if the stock price goes down by a significant amount. On the downside, the theoretical maximum profit would be the price of the stock less the cost of the call option and the cost of the put option. What would happen if the stock dropped all the way down to zero? Of course, that is extremely unlikely to happen, but it gives you an idea of the maximum boundary for profits for a declining stock price. This is actually the same as buying a put option, except now we have the added cost of having bought a call option as well. But it has the advantage that we didn’t know the direction that the stock would move, and still can make a profit. After earnings calls, price movements can be extreme and so they will more than account for the cost of buying two options. Consider that this past month, Netflix dropped more than $40 a share after hours, the night of the earnings call.

If the stock price rises as a result of the event we are trying to tap into such as an earnings call, in theory, the gains are unlimited. And of course that is also theoretical, a stock might rise $5 a share, $10 a share, or even $40 a share, but it's not going to increase without limit. No matter what it does, however, it is likely that it’s going to raise enough to overcome the cost of entering the position and earn profits.

To maximize the chance that you are going to see gains, you should enter positions like this with hot stocks that draw a lot of attention at earnings season. They don’t have to all be tech stocks, others to consider could be stocks like Disney, for example.

Calculating breakeven points

Before you enter a straddle you need to know what the breakeven points are. In the graph below, K is the strike price used for both the call and the put purchased to enter the position. We have defined V as the total cost of purchasing both options.



The break-even points are symmetrical. To the upside, the breakeven price is the strike price + V. On the downside, the breakeven price is the strike price – V. Before entering a straddle, you need to know what these values are, and they have to be selected to have a reasonable chance of success. The more narrow you can make the gap, the more likely it is that you will earn profits.

When you buy the options to enter a straddle, they say that you have entered a long straddle. Remember that earnings calls are likely to cause a major movement in the stock price, but this is not guaranteed. So don't go into these positions thinking that you are guaranteed to earn money. One of the reasons that you want to enter into a straddle early, and not wait until the night before the earnings call, is that a rise in implied volatility is going to spread out the breakeven prices. A week or two weeks before the earnings call, implied volatility will be lower, and it will be more favorable for you to enter the position. That is because it is going to cost you a lot less to enter the position than it is as the earnings date approaches. If you wait until the night before, the spread of the straddle, that is the price range over which you will have losses, will be wider due to the increase in implied volatility that always happens as it gets closer to the date of the earnings call. So you would need a larger price movement in order to earn a profit, and your profits will be smaller as compared to what they would be entering the position early.

Earnings dates are announced in advance, so if you are planning to use this type of strategy that is something you need to keep track of. Then you should enter your positions early and have the patience to wait for the earnings call to proceed. You can enter the position as soon as the date of the earnings call is known for the company.

How pricing changes for straddles

If the price of the stock hardly moves at all, the straddle price won't change very much either. So

we are imagining a situation where the stock price stays about where it was when you entered the position. However, if the stock price rises or falls by a significant amount, then you are going to see a lot of price movement for the straddle. If the price rises, the call option is going to rise in price faster than the put option declines in price. Conversely, when the stock price falls, the put option is going to rise in value faster than the call option is going to lose value.

When to Exit the Position

If you are using this strategy to time to a major event like an earnings call, you should probably sell the position about midday, the day after the earnings call. At the very least you should sell by the end of the day. While it's possible that price movements can still continue the following day, and even a few days after, most of the price movement is going to be captured on the day after the earnings call. Moreover, if there is a big price movement, the shock to the market begins wearing off. So even if a company has a bad earnings call and the stock price drops by a huge amount the day after the earnings call, the following days are likely to see some recovery even if the stock doesn't get anywhere near where it was before the call.

So you shouldn't hold the position hoping to gain more profits as time goes on. More than likely, you are seeing the maximum results that you are going to see the day after and you should be happy with this and take your profits.

In the event you are in a losing position, that is if the stock didn't move enough so that the position was able to at least breakeven, you could consider holding it longer to take the chance that there will be some price movement to minimize your losses. However, remember that time decay is always at work leading to lower options prices with each passing day. And in this type of position, you are long on two options. So both of them are going to be hit with time decay, and if things are not moving in your favor your position might end up worse with each passing day rather than recovering.

The best strategy over the long term for your trading is to get out of positions that didn't work as anticipated as quickly as possible. If the earnings call did not generate the price movement that you were hoping for, then exit the position and accept your losses. Getting out of it quickly will minimize your loss because you won't suffer from any more time decay, and it will free up the capital to move on to your next trade. Losses are a part of the business and you just have to accept them when they occur and pick yourself up and move on to a new trade.

Strangle

The purpose of a strangle is the same as the purpose of a straddle. That is we are entering into a position that will earn money from a large price movement of the underlying stock. The direction of the price movement is not relevant. If the movement is large, the position will earn a profit if the price increases, or if the price decreases. So it is similar in strategy to a straddle but has some differences.

To enter a long strangle, you will buy a call and a put option. They will have the same expiration dates but different strike prices. The total cost of the position is the premiums paid to buy the call and the put option. This is also going to be the maximum loss that you will incur should the position not work out.

The discussion in the previous section with regard to the way of the position and the nuances of

implied volatility and when to enter the position are the same here. So you would use a straddle or strangle strategy for the exact same reasons.

Since the options are going to have different strike prices, this will set where the breakeven prices are. This allows you to weight the two breakeven prices. That is, if you think it is more likely that the stock is going to break one direction or another, you can set up the strangle to be more favorable in that direction by choosing your strike prices accordingly.

Many textbook examples show symmetrical choices for strike prices. So if the stock price was currently trading at $100, they might show you an example with a put at $95 and a call at $105. But if you thought it was more likely that the stock would decline in value by a large amount, you could buy a put at $98 and a call at $105.
A graph of a strangle is shown below. In this case, the mid-region between the two options strike prices has the maximum loss, with a linearly increasing curve up to the break-even points on both sides.

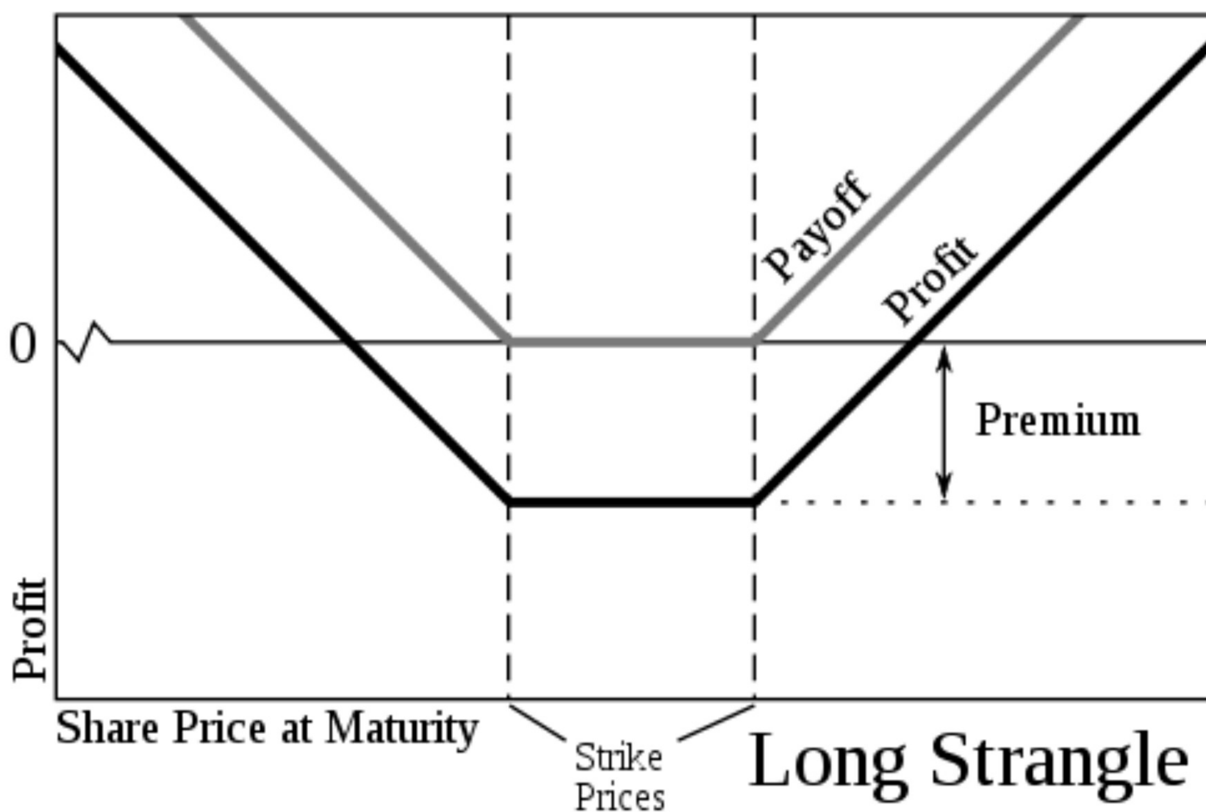


Image from Wikipedia Gxti [CC BY 3.0 (https://creativecommons.org/licenses/by/3.0)]
As was the case with a straddle, a strangle is going to be heavily influenced by implied volatility as the date of an event like an earnings call approaches. As soon as you are aware of the date of the upcoming earnings call, you should enter the position so that you can get the best possible prices for the options. Implied volatility is going to cause options prices to increase by large amounts by the time the day of the earnings calls arrives.
Likewise, you should use the same strategies after the earnings call. Earnings calls happen after market close so you should be ready to act the following day. The market reaction after hours is going to give you a good idea of what is going to happen the next day. If the reaction is dramatic,

you should be ready to quickly exit your position and take profits. Most of the price action for the day is going to happen within the first half-hour of the trading day. It will then stabilize somewhat but price movements are still possible either way. Sometimes the shock of the earnings call wears off relatively quickly, so you might consider selling to exit your position about two hours after market open.

Summary

When there is a strong trend in the market, buying a call or a put alone is a good strategy. However, there are going to be many times when it is known beforehand that there is going to be a large price movement of major stock, but nobody knows which direction the stock is going to move. This will happen with earnings calls (4 times a year), major product announcements, or a report detailing the findings of an investigation. Or if a company is announcing a major change in management, this can also be a time when a big price movement is coming, but nobody is sure how the market will react. In these situations, a straddle or a strangle is a good strategy to use. Be prepared to enter the position as soon as the date of the event in question is announced, and be prepared to sell to exit the position after the price movement has occurred. Don’t hold on to the position after there has been a large price movement and then the stock starts to stabilize, holding on in the hopes of increased profits is usually something that ends up cutting into your returns instead.

Chapter 5: Introduction to Spreads

In this chapter, we are going to return to the case of looking at strategies that can be used when you are anticipating a unidirectional price movement in the stock. So these are strategies that will be employed when you expect the stock to either move up, or to move down. The purpose of the strategies in this chapter is to mitigate possible losses.

The strategies described in this chapter are more advanced because they will involve selling options as well as buying options. This means that you're going to have to have a higher trading level in order to utilize these strategies. Most brokers are going to require level III status in order to trade spreads.

There are two ways that spreads can be used. These are called debit and credit spreads. With a debit spread, you have to pay in order to enter the position. A credit spread is a different type of trade. With a credit spread, you are actually using the strategy in order to earn income. Since the main goals used in the strategies are really quite different we are going to consider them in different chapters. It is a simpler transition in thought process to continue thinking about playing the market to take advantage of either an upward trend in stock price or a drop in stock price in order to make profits. It's also easier to think in terms of buying something to enter the position before considering the possibility of selling something in the marketplace that you don't own. So for that reason, we are going to talk about debit spreads first.

There are two types of debit spreads. The first type is used in anticipation of an increase in the stock price. This is called a call debit spread. It is also known as a Bull debit spread. You can consider the latter term to be slang because most brokers are going to refer to it as a call debit spread. For that reason, we are going to use that terminology.

Likewise, there is a set up they can be used in anticipation of a declining stock price. This is called a put debit spread. Using slang terms, it could also be known as a bear debit spread. But again, when you are entering these positions you aren't going to be doing it on the trading floor you are going to be doing it through your broker. And most brokers use the term put debit spread. So we will also use that term to refer to the strategy in this chapter.

Risk of Assignment

The big difference between the strategy and the ones we've considered so far is that previously we have only considered buying options. These strategies also involve selling options. So there is some risk of assignment when you are selling options. But the risk is mitigated due to the fact that you are not only selling an option you are also buying an option. We will talk about this in more detail when we talk about selling credit spreads because that's more of an issue there than it is here. But let's get a couple of things clear before we move on.

First, let's consider a call option. If you buy a call option, that gives you the option to purchase 100 shares of stock at the strike price. If you sell a call option, you have the obligation to sell 100 shares of stock at the strike price in the event that a buyer of the option decides to exercise it. If that happens we say that you have been assigned. If an options trader is assigned, the broker will alert them to this fact aftermarket clothes on the day that assignment occurred. As we discussed earlier, it's really not very likely although it is possible, to get assigned before the expiration date. It's most likely to happen when an option expires in the money.

For a put option, if you buy it, that gives you the right to sell 100 shares of stock at the strike price. If you sell a put option, you are under obligation to buy 100 shares of stock at the strike price.

The issue with all the strategies going forward is that unlike covered calls and protected puts when you are using the strategies, the options that you're selling are not backed by anything. That's not really true because in the case of a debit spread you have to pay money to enter the position and that is going to define the maximum possible loss. Credit spreads also have to be back to a certain extent. However when we are dealing with calls that we are selling using these strategies we do not have to own any stock in order to execute the strategy. Likewise, any puts that we're selling as part of the strategies are not going to require us to have enough cash on hand to purchase 100 shares of stock. So you really don't have to worry, but we will explain a little bit more when discussing credit spreads.

These are Vertical Spreads

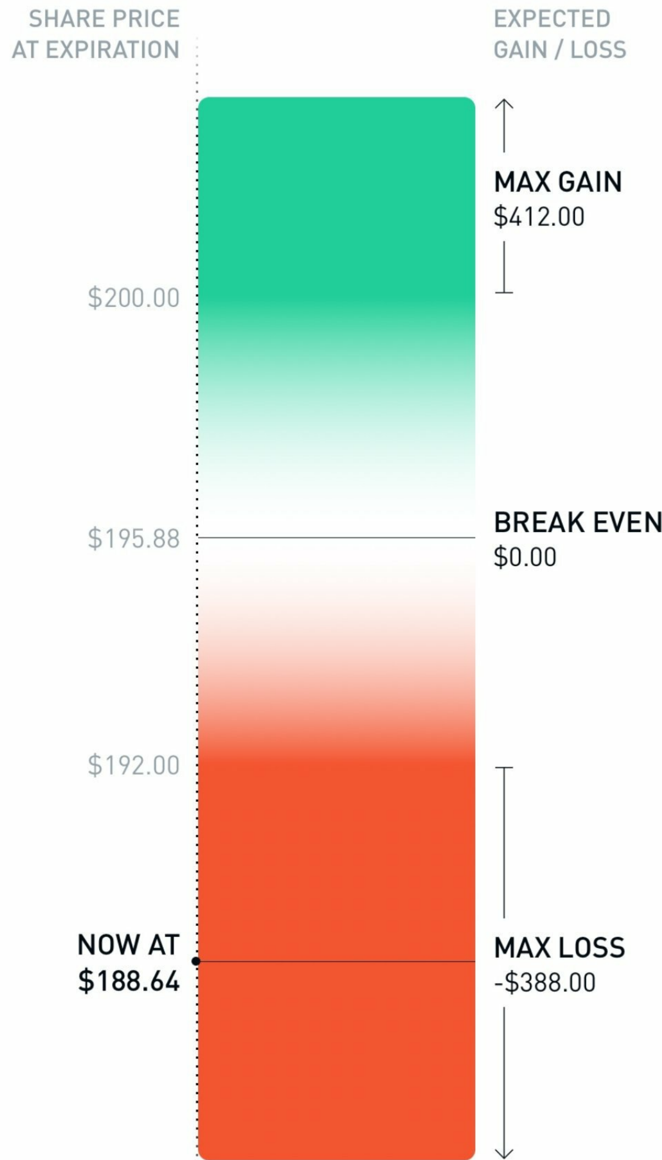
When you read up about options you might hear people talking about vertical or horizontal spreads. In the cases that we are going to talk about in this chapter, they would be considered to be vertical spreads. That is because the two options are going to have the same expiration date but they are going to have different strike prices. The vertical in the spread comes from the different strike prices which are spread higher and lower.

Call Credit Spread

The first strategy that we are going to consider in this chapter is a call credit spread. Remember that if you're reading about this online some people may refer to it like a bull call spread or a bull credit spread. The purpose of this strategy is to follow the same type of strategy that you would use buying a call option on its own. So with this strategy, you would enter the position with the assumption that the stock price is going to rise. So we could say that you are bullish on the stock.

The difference between the two strategies is that this strategy is going to limit your losses. Of course with a regular call option, your losses are limited to the premium paid. What this strategy is going to do is it will cut the amount of lost down further. However, although the theoretical gain from a call option is unlimited, a call credit spread caps potential profit.

For that reason, this type of strategy is called a limited risk and limited rewards strategy. In fact, the potential gain using this strategy is not just limited it's basically fixed. To illustrate this you can see the figure below. This is a call debit spread for QQQ, the NASDAQ Exchange traded fund, with strike prices of $200 and $192. The loss that can occur is fixed for most of the range of possible share prices. However, the gain is also fixed for most of the range of possible share prices. The losses for this strategy occur to the downside. So that is the same as with a call option. Likewise, the gain occurs to the upside.



Although you are trading some possible gain to the upside you really are losing all that much. First of all, you need to consider that in the vast majority of situations the stock price is not going to move more than one standard deviation over the kind of time periods that we are talking about for most trades. Most options traders are focused on one week to one-month time frames. Certainly, over one week unless there is a dramatic event of some kind, it's extremely unlikely to see a price movement outside of one standard deviation. That is even true over a month time frame most of the time. So the reality is that although it seems like you're giving up a lot of potential upsides, you really aren't doing so. You are also significantly managing the possible losses that could occur. The example above is for a longer-term trade. So that would mean the cost of buying a call option on alone would be pretty expensive. In fact if we just bought a call option alone, we could be looking at losses of about $780.

Most Professional Traders Don’t Buy Calls

When you look at it that way you should be noticing that this trade has a lot of advantages as compared to buying a call option by itself. Sure, there is a bit of a downside in that your profits are limited. But if the probability of getting higher profits is not really that good, that should make it clear to most readers that a debit spread is a better trade. It also benefits from the capped losses, that are going to be smaller in magnitude as compared to buying a call option alone.

The implications of this are clear. Professional traders are going to use this strategy instead of simply buying call options. Amateurs are more likely to buy call options by themselves. And of course, the same logic is going to apply to the case of put options. It is simply a fact that new traders who are naïve are the ones that only by call and put options in isolation. The probability of racking up a profitable streak of winning trades buying call and put options in isolation is low. Many times new traders are going to enter into a position and have a big win buying either a call option or put option in isolation. This will fool them into thinking that is an easy way to make money. But if you try doing this on a day-to-day basis doing multiple trades, what you will find is in most cases it’s very hard to make profitable business or to make living trading that way.

So what a strategy like this does, is that although you are trading away some of the potential gains, by limiting the losses it makes it easier to generate a profitable streak of trades over a long time period. So just as a simple example, we could imagine executing the trade shown in the graph over and over again and sometimes it’s going to work but other times it won’t work. Each time it doesn’t work assuming that we get maximum loss, you would lose $388. But as we noted earlier the equivalent call option would have a cost of $780, so each time you had a loss you would be losing nearly $400 more. Solve your losses with the call option in isolation, are significantly magnified in comparison. So that makes it just very difficult to generate a profitable streak as compared to using a debit spread. Remember that if you want to earn living trading, some of your trades are going to be losses and some of your trades are going to win. And what you need to have happened is that by the end of the month the money you earn from wins is going to outpace the money that you lost. It’s just common sense business.

Something else to consider is that although a call option in isolation has the potential to earn a lot more money when you do the analysis of a lot of these cases, the stock price would have to rise quite a bit more to earn the same amount of money. Because of the strategy used with the debit spread, we will have some advantages in the choice of our strike prices. So when the two examples that I considered, to make $488 dollars in profit the debit spread would require the share price to rise to $200. The call option and in contrast would require the share price to rise to $208. Of course if the share price goes above that the call option and isolation would earn far more profits. But the probability of that happening small.

But keep in mind that that is not the reason that you enter into a call debit spread. The reason to do so is to mitigate your loss on the downside.

Call Debit Spread Setup

The set up of a call debit spread is actually quite simple. It involves two call options. You are going to buy one call option, and you are going to sell one call option. While you could do this separately since it involves selling a call option, doing it separately would require level 4 trading status if you were not able to sell a covered call. But chances are people using this strategy are

going to be people that don’t own the stock. And if you are not a level 4 trader, you can’t sell naked calls.

Therefore you are going to be entering this position simultaneously buying and selling the call. All brokers allow you to do this in a single order.

With a call debit spread, you buy a call option with a low strike price. That is going to make it more expensive. Then you sell a call option with a higher strike price, and the price of that option is going to be lower since call options with higher strike prices are cheaper. You are hoping to make a profit from the option that you buy in this case. By selling the higher-priced call option, you lower the cost of entering the transaction. Both call options are going to have the same expiration date. The call option that you buy is known as the long call, and the call option that you sell is known as the short call.

This type of position works as a call option in that it will earn a profit if the stock price rises.

Call Debit Spread Risk

The maximum risk that occurs with the call debit spread is going to come from the cost of entering into that position. When you sell an option, you get paid. So you will receive a credit to your account. So to calculate the cost of a call debit spread, you take the cost of the lower strike price option that you buy, and then subtract the credit you receive for selling the higher strike price option.

This value is also your maximum risk on the trade.

Call Debit Spread Profits

Now let’s see how we would calculate the maximum gain that we can get buying a call debit spread. This is calculated as follows. The profit that you can earn with a call debit spread is the difference between the strike prices minus the net cost of entering the trade. So let’s use a real example so that you can understand how this works.

Consider a call debit spread for the ETF QQQ. We will buy a call option with a strike price of $188. The cost is $3.81 (remember that is a per share quote, so the actual price is $381 for 100 shares). Now we will sell a call option with a strike price of $192. This will give us a credit of $1.68 per share.

The cost of entering the call debit spread would be the cost of the lower strike price option minus the credit received. So this is:

$3.81 - $1.68 = $2.13

That also represents our maximum risk or loss for the trade. Had we bought the $188 call option by itself, the maximum loss would have been $381. So you see that by using a call debit spread instead, we have lowered the maximum possible loss to $213.

However, we’ve limited the maximum gains as well, decided to cap our possible gain in exchange for limiting the loss. As we said earlier, this is the smart thing to do, because it’s not likely that under normal circumstances the share price is going to rise by a massive amount. It takes earth-shattering news for that to happen. Of course, it can and does happen, but most of the

time it’s not likely. So this is the smarter trade.

Now we calculate the difference in share prices. This is:

$192 - $188 = $4

Then we subtract the cost of entering the trade:

$4 - $2.13 = $1.87

Multiplying by 100 shares, the profit we can earn on this trade is $187.

When Does a Call Debit Spread Earn Profit

The question now is what is the condition under which this trade will earn a profit? The maximum profit will occur if the stock price rises to the strike price of the call option that you sold. If the stock price is at or above the strike price of the short call you get maximum profits. The profits are fixed, so if this happens you should close the position and take your profits. If it is close to expiration you could hold on and hope that it expires in this condition, but there would be a possibility the stock price could drop again and lower your profits.

You will still earn profits if the stock price is lower than the strike price of the short call, but above the break-even price. However, they will be smaller in magnitude.

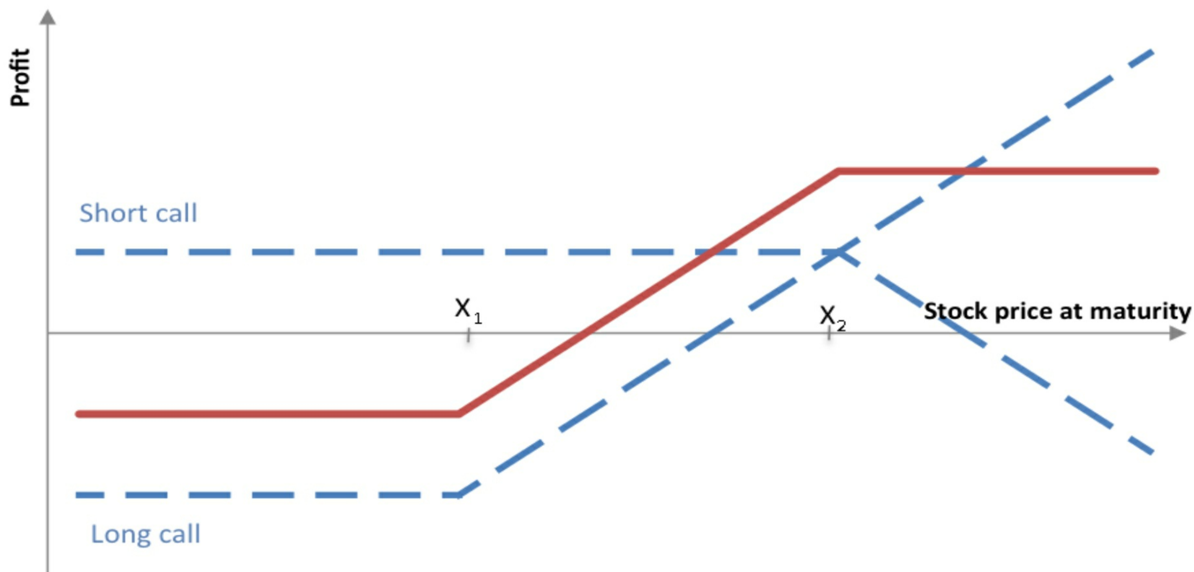
The breakeven price for this strategy is given by:

The strike price of long call + Net Cost to Buy Debit Spread

In the previous example, the net cost was $2.13, and the long strike price was $188. So the break-even point would be:

Breakeven price = $188 + $2.13 = $190.13

The diagram showing profits and loss with the breakeven price is shown below. Image created by Suicup for Wikipedia. The dashed blue lines show the curves for each option alone, while the red line shows the curve for the call debit spread. Notice that the break-even price for the spread (when the curve crosses the x-axis) is lower than the break-even price for the call option by itself. In our example, the breakeven price for the $188 call is $191.12. So it is a dollar higher than the breakeven price of the call debit spread, showing that it’s more likely to earn profits using a debit spread since a smaller movement of the stock is required to breakeven.



Put Debit Spread

Now we will consider the case of a declining share price. If you think the stock prices going to drop they put debit spread is a risk-limiting strategy that we can use rather than buying a put option in isolation. The benefits of doing so are the same benefits that we saw was a call debit spread. The only difference that is fundamental is that we are anticipating the stock price will decline in this case.

This strategy involves buying a put option and selling a put option simultaneously. So we will have a long put option that is going to have a higher strike price. Then we will have a short put option for the same stock and the same expiration date, with a lower strike price. The net cost of entering this position is going to be the price you pay for the long put option with the higher strike price minus the price received for selling the option with the lower strike price. With put, options remember that the lower the strike price the cheaper the option.

When you enter this position it is going to work similarly to a put option but we are going to have caps on the losses and gains that are possible. This is similar to the previous case of examined. So the maximum profit is going to be fixed rather than having the potential to increase continuously as the stock drops to zero. But we can use the same logic that we applied previously in that under normal circumstances it is definitely unlikely that the stock price is going to drop more than one standard deviation. There is a 68% chance that it will stay within one standard deviation of the current stock price.

In addition, by selling a put option with a lower strike price, we are going to reduce the cost and therefore reduce the possible maximum loss from taking the position. The same effect will also occur with the breakeven price that we saw in the case of the bull spread. That is the breakeven price will be easier to attain using the bear spread approach in comparison to going long on a put

option by itself.

Maximum Loss for Put Debit Spread

The maximum total loss that you can incur with a put debit spread is the cost of purchasing the put option with the higher strike price minus the premium you receive for selling the put option with the lower strike price.

Maximum Profit for Put Debit Spread

The maximum profit that you can earn would they put debits spread is going to be given by the difference between the strike prices minus the maximum loss. So let's look at a real example to see how this might work out. This time we will consider they put different spread that expires in one month for Facebook. At the time I am writing this book the share price is $184. So let's look at a slightly in the money put option and choose that for our long put. The $185 put is priced at $5.35. For reference note that the break-even price is $179.65.

Now let's sell the $180 put. Doing so gives us a credit of $3.40.

The total cost of entering the transaction is going to be the price paid for the one $185 put option, minus the credit received for the $180 put option. So that would be $5.35 minus $3.40 for a total cost of one dollar ninety-five. Of course, you have to multiply that by 100 to get the actual cost which would be $195.
Now let's calculate the maximum profit. The difference between the strike prices is five dollars. So to get the maximum profit we subtract the total cost of entering the position from the difference in strike prices. So that would be five dollars minus $1.95. So the maximum profit in this trade is $3.05. Multiplying that by 100 shares, our potential gain is $305.

Break-Even For Put Debit Spread

In the case of a put debit spread, the breakeven price is going to be given by the strike price of the long put(the higher strike price of the two) minus the price paid to enter the position. For our example, our higher-priced strike price for the long put was $185. The total cost answer the position was $1.95. The difference between the two is $183.05. Remember that the breakeven price for the $185 put by itself is $179.65. So not only do we limit losses entering this trade, as compared to the put option by itself, we've also moved the breakeven point closer buy $3.40. So the probability of this trade being profitable is much higher.

Chapter 6: Iron Condors and Iron Butterflies

Often the market is “choppy,” meaning that a stock is not trending one way or the other. Of course, stocks don’t remain static, so what you will see in these circumstances is that the stock will move up and down by small amounts. This is called ranging. Some traders will attempt to earn money off the small price movements, buying when it hits the low price for the range (called the support) and selling when it his the high price of the range (called the resistance).

However, we don’t have to trade that way, we can use a conservative strategy called an iron condor. It makes money when the stock stays within a range of prices and doesn’t move very much.

Iron Condor

An iron condor seems complicated, and the reason is it involves four options contracts simultaneously. To trade with iron condors, you have to be a level 3 options trader. An iron condor is a type of spread strategy, but in this case, the idea is to confine the pricing to a range over which the stock stays inside. In a sense, an iron condor is a little bit opposite to a strangle, in that the trader who buys a strangle is hoping that the stock price is going to go outside the range so that they can earn profits. With an iron condor, we are hoping that the price of the stock stays inside the range in order to make profits. However, a strangle is setup only using two options that you buy. An iron condor is a setup using two options you buy and two options you sell.

The upper band of the iron condor

The iron condor is going to have an upper range or band that is made up of two call options. You are going to sell a call with a lower strike price, and then buy a call with a higher strike price.

The lower band of the iron condor

For the lower band of the iron condor, we are going to use puts. So you will sell a put with a high strike price, that is lower than the lower of the two call strike prices. Then you will buy a put with a strike price lower than the first put.

The goal of the Iron Condor

The goal for the iron condor is that the stock will stay within a narrow range of prices. At times you can use an iron condor on any stock, but it might work better on more mature, slow-moving stocks that are likely to be staying within a range of prices most of the time. Compared to other options strategies, the amount of money earned from one contract is going to be relatively modest. You can let the option expire if you are confident that the stock is going to stay trading in the range until the expiration date. If you are concerned that the stock is going to break out of the range before expiration, you can close the position. There is some confusion as to whether you are selling or buying the iron condor, but selling it is a better way to think about it because you are selling two options of higher value and buying two options of lesser value, and you will receive a fixed credit. Therefore to exit the position you would buy the iron condor back. If the stock stayed within the range until that point, time decay would work in your favor and the options will all have declined in value. That means that you will only give up a small amount of money when you buy back the iron condor.

An iron condor is called a limited risk, limited profit strategy. Risk is limited but potential profits are limited as well. The maximum loss of the iron condor depends on whether the stock breaks out to the top or to the bottom. If it breaks out to the top, take the differences between the two strike prices of the calls and subtract the credit received for selling the iron condor. If the stock breaks out to the bottom, then you do the same, but the distance between the strike prices isn't required to match. So you take the differences between the strike prices of the puts and then subtract the credit received.
The profit earned from the iron condor is the net credits received. This is given by:

(credit received for low strike price call – the price paid for higher strike price call) + (credit received for high strike price put – the price paid for low strike price put)

If you want to earn money from iron condors, you might consider slow-moving high priced stocks. Volatile stocks aren't generally good candidates for iron condors, however sometimes even the most volatile of stocks can be in a ranging market.

To sell an iron condor, you need to have collateral on hand. The amount needed is going to be determined by the greater of the two possible losses that can occur, to the upside or to the downside. If the iron condor is symmetrical then the upside and downside are going to have the same possible maximum loss.
As an example, consider an iron condor on Google using strike prices on the calls of $1207.50 and $1212.50, and strike prices on the puts of $1182.50 and $1177.50. The maximum gain is $335, and the maximum loss is the same on both the upside and the downside since the difference in the strike prices is $5 in both directions.

This contract expires in a week, and since the range is actually fairly wide and there are no earnings calls or anything on the horizon, this iron condor is a good trade to consider even though Google is one of the FAANGs and considered a hot stock. If you did 5 contracts you would be required to deposit collateral of $1188. You could earn around $1675 for the trade.

Iron Butterfly

The next strategy that we are going to look at is called an iron butterfly. An iron butterfly is not that different from an iron condor, but we reverse the way that we buy and sell the options contracts. So to set up an iron butterfly you will buy a put with a high strike price, and sell a put with a lower strike price. You will also buy a call with a low strike price and sell a call with a higher strike price.

While you receive a net credit for selling an iron condor, an iron butterfly strategy requires a debit, so you have to pay in order to enter this position. When everything works out it is really going to be the same since you have to have collateral on hand to sell the iron condor, while an iron butterfly is going to result in a net debit and that is the end of it.

In the case of an iron butterfly, the maximum loss is the price paid to enter the position. An iron butterfly differs from an iron condor in another crucial respect. The options that you buy, the put option and the call option, are going to have the same strike price.

To calculate the profit you can earn from an iron butterfly, you take the greatest of the differences between the outside strike prices and the middle strike price. Then you subtract the

debit paid to enter the position. As an example, we could set up an iron butterfly by purchasing a put and a call option with a $200 strike price. Then you could sell a call option with a strike price of $205, and sell a put option with a strike price of $195. In each case here, the difference is $5. So we would subtract the net debit required to enter the position. Say that was $3, and so the maximum profit would be $2 per share or $200 for the entire contract.

An iron butterfly has a breakeven point to the upside and to the downside. Take the center strike price used and add the debit paid to get the upside breakeven price, and then take the center strike price and subtract the debit price to get the downside breakeven price.
To make a profit for the iron butterfly, you want the price of the stock to stay within the strike prices on the outside. If the stock price falls below the strike price of the lower put, you are going to be assigned, which will lead to a maximum loss on the downside. The put option with the middle strike price can be used to mitigate the loss. On the other hand, if the stock price rises above the higher call price, you would also be assigned, but that would be mitigated by the call with the middle strike price, limiting you to the maximum possible loss.

So to be profitable, the stock price has to stay in between the range set by the two options that you sold to set up the iron butterfly. If the stock price ends up close to or equal to the middle strike price, you get maximum profits.

Summary

Generally speaking, the iron condor is preferred of the two strategies. The iron condor is considered to be an income-generating strategy. It is a relatively conservative strategy that is used when you believe that the stock is going to be ranging over a narrow band of stock prices. We have seen in the example given with the Google iron condor, that you can set up a rather wide range to use with an iron condor and so you can minimize losses while having a nearly 2:1 or more than 2:1 income to loss ratio. So this can be a good earnings method to generate regular income selling iron condors. If you decided to use this trading strategy, it is recommended that you make it your specialty because it is a rather specialized way to trade, and you should become expert in applying it if you want to be earning a regular income from it. You are probably going to have to spend a great deal of time each week doing research in order to find stocks that will be a good candidate for applying the strategy, and you will have to be prepared in this case to vary the stocks that you use quite a bit week to week.

Many traders use the strategy staring 45 days or 30 days out, and it can be a good way to use it. However, keep in mind that the longer the time frame you use before expiration, the more chance there is going to be for the stock to break out of the range, which would give you the maximum loss. Personally, I think selling iron condors a week before expiration is a better strategy because the short time frame is more likely to be a situation where the stock stays ranging.

Iron butterflies aren’t used as much as iron condors, but the principles are basically the same and if you want to go with debits and wait until you sell the position to close it, iron butterflies can be used. Many of the same issues apply in this case. With an iron butterfly, you want to make sure that it is a liquid stock so that you can sell it when you need to.

Chapter 7: Earning Income with Credit Spreads

In this chapter, we are going to change gears and consider using options in order to generate monthly income. This is going to be an entirely different way of looking at options compared to most strategies. So we are going to be looking at options strictly from the position of the seller. For one, it means that time decay and the expiration date are things that work to our advantage rather than being things to worry about. If the strategy is implemented carefully, it is possible to generate a reliable income from week-to-week or monthly. You can use different ways to earn your money depending on how you want to do it.

There is a risk of assignment but it will actually below if you setup your spreads carefully. In addition, we are using spreads to mitigate the risk. As we will see below doing it this way means that we will be able to limit the risk of assignment and if that happens it will all be automatic and our risks and total losses will be limited.

Contrary to public opinion, this is a low-risk strategy if it is done correctly. We are going to explore how to do that in the sections below.

Put Credit Spread Basic Setup

The idea of a put credit spread starts with a similar idea that we saw in the case of a debit spread. That is, we are going to be buying and selling two options simultaneously. They are both going to be the same type (in this case put options) and they are going to have the same expiration date. However, they are going to have different strike prices.
The difference between a credit and a debit spread is that this time we are looking to sell an option that has a higher strike price, and hence more valuable. In the case of a debit spread, the goal is to earn money from the stock price declining. In the case of a put credit spread, we are only hoping that the stock price remains above the higher strike price in our spread. We are not going to earn money from the price movement of the stock, this is an income-generating situation. So we don't really care what the stock does other than hoping that it is going to remain above the higher strike price of the two options. So although some people talk about this as being a "bull" credit spread, or a "bet" that the stock price is going to rise, it really isn't either of those things. If the stock price drops some, but it stays above our strike price, we are still going to make money. In fact, all we really care about is that it stays above the breakeven price.

The risk that is associated with a put credit spread is that the stock will drop by a large amount, that turns out to be big enough so that it drops below the upper strike price in the spread. We will look at the risks involved in detail below.

When NOT to sell a put credit spread

There are certain situations that you want to avoid selling a put credit spread. Under normal conditions, selling put credit spreads is a low-risk activity. However, if you are in a situation where the stock is moving by a large amount, with a lot of selloffs, then it is higher risk.

For that reason, you don't want to sell put credit spreads that are going to be active after an earnings call. As we noted in the chapter on straddles and strangles, an earnings call is one of those times when stock can move by huge amounts. If the stock moves up by a large amount, your put credit spread would be unaffected. If the stock stays about the same or only moves by a small amount, your put credit spread would also be unaffected. But, if the earnings call was

negative earnings call that really disappointed investor, the stock price may fall by large amounts – and put your higher strike price put in the money. With that in mind, you want to be conscious of when the earnings call dates are for the companies that you are investing in. And avoid selling put credit spreads during those weeks. Earnings calls are staggered, so when you are on the sidelines with one stock you can be investing in a different stock by selling put credit spreads.
There are other events that can cause your put credit spread to be at risk. A major downturn in the overall market can certainly do so. When the market starts dropping, most stocks are going with it (otherwise the market would not be dropping), and nobody really knows when the stock is going to bottom out. So if this is an ongoing process it might be better to wait on the sidelines or even switch to selling some call credit spreads, which we will discuss below.

However, even in bad markets selling put credit spreads can work. Many very successful traders earned good money continuing to sell put credit spread s(or naked puts as well) during the 2008 financial crisis. The problem with this is you have to be very smart about what you use for your strike prices. Most people will find it easier to switch to selling call credit spreads during these types of situations, including mere “corrections.”

Often bad news is hard to predict. At the time of writing, there has been a parade of bad news (as far as the markets are concerned) in the form of what can be described as extrinsic events. That is, these are events that are outside the stock market itself. For example, Trump is involved in his trade war with China. That may or may not be a positive thing, but the markets aren’t very happy about it and would like to see a deal worked out. So every time that Trump tweets about raising tariffs, the market goes through a major drop. That could put your positions at risk if you are selling put options. But again, choosing carefully can help avoid too much risk. Also, you can always get out of a position, something that we will be discussing.

The purpose of this trade is to earn income

When you enter into a put credit spread, you get paid for it. The purpose of doing this trade is to earn income. You actually won’t see the money until the position is closed. The position can be closed at expiration, or you can close it early by buying it back. So remember that you enter into a position of a put credit spread by SELLING it.
Let’s look at some real examples. You can sell a put credit spread for Facebook using the strike prices $170/$155 expiring on 3/20/20, and you would get paid $435. The breakeven price is $165.67. The current share price is $183.45, and so unless something major happens between the time you enter the position and the time you close it out, it is unlikely that you are going to have to worry about the break-even price. Of course, a lot of politicians are babbling about breaking up the tech companies lately, so that could cut into your potential profits in the case of Facebook.

The maximum loss for this put credit spread is $1,065. Your broker will require you to put up $1,065 as collateral for this position. They are not going to withdraw the money from your account. Again, this is because you are selling the spread. But your buying power will be reduced by that amount until you close the position.

That one expires a long time from now, but you can setup put credit spreads that expire in a few days. For example, a put credit spread with strike prices of $182 and $180 that expires in 9 days will pay you $82. The maximum loss is $168. In this case, you would have to put up $168 in collateral.

Now, $82 might not sound like much. But consider the fact that you can enter into as many contracts as you like, and with a highly prized stock like Facebook it's going to be easy to sell them. So you could do ten contracts, and that would give you an income for the week of $820. Not bad for a passive income (well, mostly passive, you should be keeping up with your trades).

An Income Strategy

Of course, you also have to put up collateral for all ten contracts, so that would mean you'd need $1,680 in your account to cover the trades. But this is really an amazing return when you think about it. There is simply no other way to earn money like this. You only have to tie up the $1,680 for about 9 days, and then you'll earn $820 – so you could think of this as a 49% return in just 9 days. Of course, we note for the record that these transactions are not without risk.

As an income strategy, what you would want to do is enter into these types of positions every single week. So that would mean using the collateral you have in your account to repeatedly generate income week after week. Of course, this is not automatic or magic, you are going to have to be careful about the positions you enter and be ready to close them early if they look like they are going bad, to mitigate losses. But many people actually use this strategy to make a living as options traders. Some people use 45 days or one-month time frames, others use about a week as described, and others even sell options on the expiration day. Remember that when you are working with a stock or exchange traded fund that is in high demand, there is always going to be a buyer out there somewhere. We don't have to worry about their motivations for taking the contracts off our hands, our only concern is going to be being able to get out of the trades when we need to. If the stock prices are very favorable then you can just let them expire.

You can increase your weekly or monthly income by putting up more collateral. Consider the difference between doing it this way and selling a protected put. If Facebook is trading at $183 a share, for a protected put, we would have to tie up around $18,300 for a put option that expired in 9 days with a $182 strike price, as collateral. If we sold a $180 strike price put, We would only earn $239 for the trouble.

When you compare that to the put credit spread, where we can sell ten contracts and earn $820, but only tie up $1,680 in collateral, you have to ask why would anyone bother selling a protected put? In my view, there isn't any reason to sell protected puts. In fact, if you have $18k that you can sink in the stock market to use as collateral, you should probably be selling naked put options.

The Risk Reduction Setup of a Put Credit Spread

To sell a put credit spread, you must be a level 3 trader. You are also going to be required to have some capital (aka money) to put up to back the trade. The good news is that the amount of money required is a small fraction of the money that you need to have for a protected put option. You don't need to put up enough cash to actually buy 100 shares of stock. This is because you are protected to a certain extent by the put option that you buy as insurance.

Assignment Risk

To understand the risk reduction of a put credit spread, we will take a look at the risk of assignment. Remember that before expiration, while the risk of assignment is always real, you are more likely to face assignment when the option expires. Second, the break-even price works in your favor to give you a little bit of room in case the stock is dropping.

Let’s have another look at Facebook options. We are not concerned with the put option that we buy that has a lower strike price. That one we will exercise on our own if it comes to that because we are playing the role of the buyer in that case. You might be wondering how you are going to exercise the option, especially if you don’t have the tens of thousands required to buy Facebook stock, but we will explain that in a minute.

Let’s say that we sold a $180 put. The Price is $2.39 for this put currently. So for each put contract that we sell, we receive a credit of $239. This tells us the breakeven price, which is the strike price minus the price paid for the option. In order for it to be worth exercising at all, the share price must drop at least down to the breakeven price. In this case the breakeven price is $180 - $2.39 = $177.61.

So even though the strike price is $180, there are zero risks of assignment unless the share price of Facebook drops all the way down to $177.61. And even then, it’s unlikely that you will be assigned. From the buyers perspective, at $177.61, they only break even because they had to pay you $2.39 for the privilege of owning the contract. So while it could happen, an assignment is still unlikely. It’s even going to remain unlikely if the price keeps dropping past the break-even point. Someone who has the money to buy the shares on the market is probably not going to be interested in trading 100 shares in order to make $50 or even $100. Of course everyone has different opinions and motivations, so we are not saying it’s impossible, we are only saying that it’s not likely to happen.

Now let’s set up an actual credit spread so that we can get a real idea of what the risks are and what is going to happen. We are going to set one up that expires in about 2 weeks. To do this we are going to go a bit out of the money – which is the smart way to sell put credit spreads. You are not going to sell an in the money put and risk assignment right away, or certainly risk assignment if the position expires. By moving out of the money, we increase the probability that we are going to earn a profit on the transaction.

The share price is currently $183, so let’s pick a strike price of $175. We can sell it for $1.21 per share, or $121 per contract. The probability of earning a profit on this option is 82%. You have to like something that has an 82% chance of profit. It’s highly unlikely that in the next two weeks the price of the Facebook stock is going to drop $8 a share. Of course, if the Justice Department announced they were going to break Facebook up, or Mark Zuckerberg was arrested, that would cause that kind of drop. It could happen, but it’s not likely to happen.

We want to make a decent amount of money on the transaction, but remember that we can sell many contracts, so we don’t have to earn all that much on an individual contract. The more distant the strike price of the put option you are going to buy, the more money you are going to make. However, that also means you have to put up more collateral. Let’s try two different schemes.

For the first one, we will pick a price close by. So we will sell the $175 put for $1.21, and we will buy the $172.50 put for $0.87 to create the put credit spread. The net credit for this transaction would be $0.34. So per contract, we’re only earning $34. To sell one of these contracts, we need to put up $205 in collateral. To earn some real money, we might sell 20 contracts. That would give us a credit of $680, but we would have to put up $4,309 in collateral.

Now let’s see what happens if we go much lower for the option we sell. We are still going to sell the $175 put for $1.21. Now we will buy the $160 put, which is only $0.18. This gives us a nicer

net credit at $1.03. We could sell 5 contracts and earn $515. The likelihood of this spread going in the money is very low, remember that the chance of profit is 82%. So this is a good deal.

However, we see that we are required to put up more collateral. The amount needed is going to be $6,974.

Whether one trade is better than the other is going to be a personal decision. The point here is to illustrate that putting a larger spread in the strike prices means that we are going to have to put up more collateral. But note that we only have to sell 5 contracts to earn $500, in the other case to earn around $680 we'd have to sell 20 contracts. In the event we need to close the position, it's going to be easier to close 5 contracts than it is to close 20 contracts.

Closer to current stock price

The closer you get to the current stock price, the more money you can make for less required collateral. The risk of losing trade increases. However, a four-year study showed that one standard deviation put spreads had a 94% success rate, while slightly out of the money put spreads had a 79% success rate. That argues in favor of the one standard deviation out of the money spreads, which is probably the way a more conservative trader would proceed.

But that doesn't tell the whole story. When the profits were added up, the slightly out of the money put spreads earned nearly 3x as much profit. So if you trade closer to the stock price, the higher amount that you can earn means that you are going to make more money over the long run even though you are going to lose more trades.

This time we are going to take a look at a more expensive stock. The advantage of this is the more expensive the stock, the fewer contracts we have to sell in order to make good money. So let's try Google, using GOOGL (they have two stocks). The share price is $1,191. We can sell a credit spread for $1.60 per the contract that expires in one week. Five contracts would give us a credit of $800. The collateral needed is only $1,589.

The strike prices are $1,182 for the upper strike price and $1,177 for the lower strike price. There is some risk here that the stock will fall enough to put at least the upper strike price at risk, but the stock still has to drop $9.

The main point of this exercise, however, is to show that we can earn $800 in one week with only $1,589 in collateral. So the closer you go to the current share price, the less collateral you have to put up, but conversely the higher the risk of the spread. But how real is the risk – under normal circumstances in a bull market or a ranging market it's not going to be that significant? The probability of profit for a GOOGL put option $9 out of the money is 69%. That is a bet that I would take, a 70% chance of profit and you only have to put up $1,500.

But one of the best things about this as compared to the other contracts we looked at is the fact that we can earn $800 a week only trading one, single contract. That means if we need to get out of this contract, it's going to be easier to do.

Breakeven

The breakeven price for a put credit spread is the strike price of the short put (the put option that you sell) minus the net premium received. So to calculate it just take the price of the higher strike price option, and subtract the price of the lower strike price option, and that is the net premium

received. Then subtract that from the upper strike price to get the breakeven point

How Assignment works

Let’s take a look at the Google example and we will suppose that in fact, the share price drops by a large amount. The example we will consider has an upper strike price of $1,182.50 and a lower strike price of $1,177.50. The breakeven price is $1,180.90. So we don’t have to be too concerned unless the stock price drops all the way down from $1,191.58 (today's current price) all the way down to $1,180. If there were a bad earnings call, that would be probable. During the hum-drum market activity, it’s extremely unlikely. But let’s say that the share price drops to $1,179. What happens in this case?

We would lose $189.81. How did we get that number? If someone were to exercise the higher strike price option, they would sell it to us at the strike price. That means we’d have to buy 100 shares for $1,182.50 per share, or a total of $118,250. WOAH!

So you are probably thinking, where am I going to get $118,250 to buy the shares? Seems like you will have to declare bankruptcy! However, that isn’t the case. What happens is your broker buys them for you.

Then they immediately sell them on the open market. For our hypothetical we are setting up, we said that the market price of the shares is $1179, so they can sell them on the open market for a total of $117,900. The loss that we incur is the difference:

Total loss = $118,250 - $117,900 = $350.

Well actually, we need to add in the credit we get for selling the contract. That is about $161. So the actual loss is:
Total loss = $118,250 - $117,900 – Credit = $350 - $161 = $189.

Pretty exciting isn’t it? All that money flying around in our account, and we just end up with a $189 loss.

So the assignment isn’t something to fret too much about. That is why you are not required to put up the kind of cash that you have to put up in order to do a protected put where you get stuck with the shares. Of course, in that case, you could sell the shares on your own if you wanted to.

Now let’s look at what happens in the case of the stock price dropping down even further. If the stock price drops below the strike price of the other put, we can exercise that put to sell shares. We would lose more money in that case, so you might be wondering how the lower strike price put offers protection. The case where it offers protection is when the stock drops by large amounts. Let’s say it dropped to $900 a share. If we only had the first put option, we’d be out $28,089. The reason is after being sold the shares at the upper strike price of $1,182.50, we’d be forced to sell them on the market at $900 a share, and in that case, we’d only get back $90,000.

So we’d take a huge loss. This is where the other put protects us. Now, after buying the shares for $118,250, we can exercise the other option that had a strike price of $1,177.50. This brings in $117,750, which is a lot more than $90,000. Now our total loss is:

Total loss = $118,250 - $117,750 - $161 = $339.

So you see how the lower strike price put, which we buy, offers a huge amount of protection in case of a large drop in the stock price.

Pick About 5 Stocks

When implementing a strategy for making an income from put credit spreads, you should stick to about five stocks to use. You don't want to have so many you are interested in that you are not able to keep up with the stocks and the companies. At any given time, you should only be actively trading 2-3 of them. If you want to earn more income, it's better to trade more contracts on one stock than to let things get so big that you are not really able to keep track of all the different stocks. Using this process, you can re-evaluate at the end of the year and change out stocks that are not working for you or if you find something that is more of interest.

Call Credit Spreads

It's also possible to sell call credit spreads. This is a strategy that you would use when you don't expect the stock price to rise high enough to put your spread in the money. A call credit spread has the long and short positions of a call debit spread reversed. That is, you sell a call option with a lower strike price and hence higher option price. Then you buy a call option with a higher strike price. In this situation, the goal is to earn income from selling the option with the lower strike price, and then we mitigate our risk by purchasing the higher-priced option.

In this case, we need to know the break-even point, which his going to be lower strike price plus the net credit received. In order to make maximum profit, the share price is going to have to stay at or below the strike price of the short call.

During a bull market, and often even during bear markets, professional options traders are selling puts. However, a versatile trader will move back and forth between them. If there is a bear market a call credit spread represents a reliable way to earn income. It is really the same strategy as selling a put credit spread but adjusted for different market conditions.

To determine the maximum loss you can incur with a call credit spread, take the differences in the strike prices minus the net credit received for selling the spread. So if you are short a $200 call, long a $210 call, and the net premium received was $5, your maximum loss would be:

($210 - $200 - $5) x 100 = $500

If the stock price rises above the strike price of the lower-priced call option, and the option goes to expiration, you will be assigned. You can also be assigned early although as we've repeatedly said the risk of that happening is low, relatively speaking. So in the case of a call credit spread, you are not going to own the shares, because this is not a covered call. This is going to work something like the put credit spread, the brokerage will step in to make it happen.

So let's say that we have a $200 strike price and the stock price rises to $204, and the option is exercised. So we have to sell 100 shares at $200 per share. The broker will buy the shares on the market at $204, then sell the shares to the buyer at $200 a share on your behalf, and then stick you with the $400 loss.

The higher-priced, long call option that is used as a part of the spread is for our protection if the stock rises by a large amount. Say it rises to $240 a share. The lower strike price option is going to be exercised, which means having to get shares to sell. We get the shares by exercising the

$205 option, so we are able to buy 100 shares for $205 each. Then we sell the shares when assigned for the $200 option, with a net loss of $5 per share, for a total of $500. So our loss has been limited to that amount (less the credit received) even though the share price rose to $240 a share.

Buyback Strategy

Remember that you can always implement the buyback strategy discussed earlier in the chapter about selling covered calls. If there is some chance that the stock could make a sudden movement on expiration day, or you find yourself in a position where the closest strike price is in danger of going in the money, you can close your position by buying back the credit spread. Always buy back the credit spread if there is a danger of assignment and it’s close to expiration. Don’t let it expire.

The Issue of Commissions

In many online treatments regarding options, they are going to note that your expenses include not only losses or premiums paid, but also commissions. These days it's easy to find a zero-commission brokerage. Many beginning options traders can get by using these zero commissions brokerages and do just fine. There is a lot of benefits to using a zero commissions brokerage since you are going to save a lot of money and therefore keep your profits up. One argument against some of these brokers is that they don’t always have the kinds of tools that you need. This is true, in some cases. But you have to ask whether or not you really need all of the tools that are available on some of the websites. Also, it’s possible to get free access to many stock market analysis tools online.

It’s also a simple matter to do all the calculations of breakeven point, maximum profit, and maximum loss just by looking at the formulas which are all simple arithmetic. In my opinion, you really don’t need a computer to be doing all of those calculations for you. But everyone has their preferences, and if you want all that displayed for you on-screen and think that it's going to help you make better trades, you can use platforms like Think or Swim or Tasty Works are probably the two that I would recommend.

If you are looking to earn income from selling put options, one thing to be aware of is that some platforms don’t allow you to sell naked puts or calls. As a result, some traders may find them inadequate because they would rather do those types of trades as opposed to selling credit spreads. Certainly selling a naked put is slightly easier than selling a put credit spread, you only have one option to worry about and don’t have to try and figure out which spread is the best to use. If you prefer trading naked options then it might be worth paying the commissions, which are going to be small relative to the money made from the trade. But remember that every time you make a trade you have to pay the commission and that can add up over time if you are doing lots of trades.

Chapter 8: Selling Naked Options

In this chapter, we are going to talk about selling naked options. In many ways, selling naked options is easier to deal with than selling spreads. However, in order to sell naked options, you need three things.

- You must be a level 4 options trader.
- You need a margin account (which must have a minimum of $2,000 deposited).
- You will need to have cash on hand to cover your trades.

In many online treatments selling a naked put, options are presented as if you sell the options without any backing whatsoever. However, like selling put credit spreads, you have to have some collateral in place in order to do it. That said, the amount of money you need to put in your account is going to be a lot less than needed to sell a protected put option. Most brokerages use what is called the 25% rule which we will discuss right here.

How much money is needed

The amount of money needed to sell a naked put option is called the margin requirement. It depends on the current share price of the stock, the selling price of the option, and if the option is out of the money. There are two formulas that are considered. The greater value of the three formulas is used.

- (Stock’s market price x 25% + Option Selling price – Out of the Money Amount) x 100 shares x # of Contracts
- (stock’s market price x 10% + Option selling price) x 100 shares/contract x # of contracts
- Number of contracts x 500

Most of the time it’s going to be the 25% formula. So let’s see how much we need to sell a Google put option. If we want to make about $1,000 in a week, we can find an option with a per-share price of around $10 that expires in 7 days or so. We can sell a $1,175 put for $12.30. The current share price is $1,191.58. As we said, odds are the broker is going to use the 25% formula, so we calculate 25% of the stocks market price:

0.25 x $1,191.58 = $297.90

The option is out of the money by $1,191.58 - $1,175 = $16.58.

So the formula yields, for one contract:

($297.90 + $12.30 - $16.58) x 100 = $29,322

So selling naked options does take some capital. Of course, to sell a protected put, you would have to have $117,500 in cash in your account, and this is a small fraction of that. But you can see that selling put credit spreads, you could make a similar income without putting up so much cash. Of course, an advantage of this is that you can sell a fairly far out of the money option.

The credit we would receive would be:

$12.30 x 100 = $1,230

Not a bad monthly income. And compared to putting your money in the bank, you would be making a good return. Also, note that with a margin account you can use leverage, so you would only be required to actually put up half of the total amount in cash.

Naked Calls

It is also possible to sell naked calls for income. You can do this at any time, if you feel that the share price is not going to rise above the strike price of the option, and go above the breakeven price. However, remember that you are at risk of assignment in this case. The margin requirement for a naked call is slightly different but similar. Usually, a broker will require 20% of the underlying strike price to sell a naked call.

When selling naked calls, care has to be used. The best time to sell naked calls is during a bear market, and you should sell them one standard deviation above the share price or more. Selling naked calls during a bull market is a risky activity that might not work out well for you.

Normally what traders do, is that during bull market conditions, they are going to sell naked put options. If the market changes course and there is a recession or a bear market, they will switch to selling naked call options. Then when the market recovers again, they return to selling naked put options. Generally speaking, selling naked put options is the more popular activity, and even during stock downturns some traders still sell naked put options, they just go with lower prices, adjusting as the market is adjusting. Of course, this can be a difficult strategy to implement in practice, and there is a high risk of getting yourself into trouble.

There are many short term trends in the market that happen for one reason or another, and the best thing to do in those situations might be to simply wait on the sidelines.

Chapter 9: Trader Mistakes and How to Avoid Them

In this chapter we are going to focus on giving a bit of advice. The purpose of this chapter is going to be to look at the most common mistakes made by novice options traders and how to avoid them. Hopefully most readers who plan actually start trading options will take this advice to heart. Of course, it's one thing to read about these mistakes, and quite another thing to actually be in the midst of trading with real money online, and possibly facing real losses. That said, at least you will have heard about them and maybe when you are in trading difficulty you can look these up and review them as necessary. When you do that, try and relate them to the actual situations that you are involved in when doing your real trades.

Buying calls, without a goal for profits

The first mistake that novice traders tend to make is they start off by trading call options by themselves. This type of trading has a lot of appeal for novice traders because the idea is very simple. All you have to do is bet that the stock is going up and buy a call option and sell it at the right moment to make a profit. As we discussed in the book earlier, this is not a very good strategy, to begin with. Trying to use a crystal ball approach to the markets is simply something that really doesn't work very well. That isn't to say that trying to profit from increases in share price is something that you should avoid altogether, but if you were going to do that what you should do is use one of the more event strategies that mitigate risk while increasing the odds of profit.

That said let's suppose that you are just trading call options. The problem with this is emotion often gets involved. So what happens is a traitor gets lucky one day and they get in on an upward trend of a stock. Then they find themselves getting a little bit giddy and taken over by greed as the potential for income seems to get bigger and bigger. So the trader won't really have an exit plan and they might just sit around waiting to see what happens hoping to make big profits. But what happens most of the time is that suddenly the stock is going to stop rising. The stock market is really a complicated thing over the short term. Over the long-term, the stock market is actually quite predictable. That is why people who were willing to wait 30 years to realize their gains always seem to get their plans to work out. The stock market tends to increase in value over time making that possible.

But over the short-term, the stock market is incredibly chaotic and dominated by all kinds of factors that are interacting simultaneously. These include large institutional traders and hedge funds that have their own motivations which might not lineup with yours. And you also have the mental states of thousands of individual traders interacting simultaneously. You can couple this with the fact that people are often going to panic on the stock market and not make the best decisions.

To avoid getting taken in as a victim of all these factors you have to have a set profit level that you are willing to accept in order to exit a trade. Of course one of the problems is saying you are going to have a set profit level and then actually doing it in practice can end up being trouble. I had this problem myself early on in my trading career. One trade that I remember was I bought a put option after a company had a bad earnings call. It quickly made a lot of money. Within a few minutes, I had made a $75 dollar profit. At the time, I had made a rule for myself that I would sell any option that made a $50 profit. But I got caught up in the heat of the moment and so I

didn't sell when I could've taken that good profit. Inexplicably the stock price suddenly started rising. This is one of those things that happens with the psychology of thousands and maybe tens of thousands of investors. When a bad earnings call comes out there is a lot of panics and desire to sell off shares. But at some point, people are going to calm down and the selloff is going to stop. The objective measures that caused the selloff in the first place are probably going to ensure that at least for the near-term future the stock is not going to recover the value that is lost as a result of the earnings call. However, when people's heads cool down, the stock is either going to stabilize or even rise a bit to a new price level. And if you are paying attention that can catch you off guard especially when it comes to options contracts whereby the price movements of the stock are massively magnified. What happened in my case is the price rose enough over couple of hours, that by the time I accepted defeat in the situation, I had turned that $75 gain into a $50 loss. Of course if you set a pricing level like $50 for-profit even then sometimes you're going to end up losing. But that's better than having a loss that I had. Imagine if I had bought 10 contracts.

If it's possible with your trading platform you should put in a limit order to sell the option automatically if a given profit level is realized. That way your emotions are completely removed from the situation.

Not Taking Time Decay into Account

One of the most fundamental properties of options is that they have an expiration date. Novice investors often seem to forget this fact. The reason that many of them forget this fact is actually related to the previous discussion. There is always the hope that if the trade is not going your direction it will recover later. Of course that's always possible. If we were talking about trading stocks for you could actually hold them indefinitely and wait around for the stock price to recover. But in the case of options trading, they have an expression date and lose value every single day. That works against traders that are buying options to open their positions. So it's important to remember how time decay is impacting the value of any contracts that you are holding. You need to factor this into your calculations as far as what's going to happen or not in your trades. If you haven't held options overnight before what happens is soon after market open the next day you will see the price of your options suddenly drop by a large amount. Let's just say that an option is trading at $100 in total value. The way to learn the amount that you are going to lose is to look up the value that is called theta. Theta is given as a negative number and a typical value might be -0.11. That means the price of the option is going to drop by 11% the following day. So if at the close of trading power option is priced at $100, the next morning it will immediately drop to $89. This fact makes recovery of a trait that is not going in our direction a lot more difficult. And if we have to wait two or three days for recovery that can be really painful. You can do the calculation to see how it's going to be dropping every single day yourself.

Not having a stop loss

Day traders and swing traders that are not amateurs but professionals, don't enter into trades without using a stop-loss order. A stop-loss order is a type of limit order that will automatically sell the shares that they have purchased if the stock drops to a certain value. You need to have a similar procedure in place for your options trading. So every time that you enter a trade, set a maximum loss for yourself that you are willing to accept. Then if the option price drops by that amount just sell it and move on. This can be difficult to do because people will always be

wondering what is going to happen if they just held on. And in some cases cutting out early you are going to miss opportunities for profits that could have occurred later on. But most of the time, you are going to save yourself from loss and pain. You can't worry about hypothetical situations and worry about would have or should have scenarios. You also can't worry too much about one single trade that you might've missed out on. When trading options you have to worry about the averages of all your trades over a long time period. And since most of the time, when a stock is dropping by large amount you are not going to recover, it is better to cut your losses and move the money into a better trade. When everything is averaged out, that is going to result in better results.

Buying Out of the Money Options

Another mistake made by amateurs is to buy options that are significantly out of the money because they are cheap. When you're training options you should not be looking for bargains. Let's say that a stock is trading at $290 dollars a share. If you were to look at options with a strike price above $300, you could probably find some bargains. In fact, you could probably buy a $303 strike price call for $.10 a share. So you get to own the thing for $10. That might seem like a good deal, but the truth is it's a complete waste of time. Over the lifetime of most options the price is simply not going to move by that amount before the option expires. And so what if you gain 10%. That only means that you earn a dollar. The only time that you should consider investing in options that are far out of the money is with leaps that expire in a year or two. So in this case with the stock trading at $290 a share it would be possible for it to reach $303 in a year or two from now. So that might make sense although they're probably better ways for you to be trading options, it certainly doesn't make sense if you're looking at an option expires in a month or less.

Not trading liquid options

The next mistake to consider is whether or not an option is liquid. We talked about that a little bit earlier in the book. Liquidity for any financial asset means that the financial asset is readily converted into cash. In the case of options trading what it means is you will quickly find a buyer when you put the option up for sale. Options trading can move very fast since they're so sensitive to small changes in the stock price. So if you are trading and option and the trade goes wrong you need to get out of it as quickly as possible. If it takes a long time to find a buyer for your option you may end up holding it until you take huge losses. This is true especially if you're trading multiple contracts at once. If you had 10 contracts on SPY or Facebook or Apple, it would be very easy to sell them off in a matter of seconds. That's because the volume of trading for these stocks is very high. But if you had 10 contracts or even one contract on a stock that very few people are interested in, it might take you a whole day to find someone to buy the option of you. You might even be in a situation where the market maker buys it from you but of course you won't know whether that's the case. But the point is if you are trading you certainly don't want to get a situation where it's an illiquid option. If that happens you might even be stuck with it. Now if we are talking about put credit spreads or naked puts, this is less of an issue but you are still better off sticking to options where is not too hard to find a buyer or seller. Remember the advice we gave her earlier which was that you should stick to options that have an open interest of at least 100. If you check some of the high-volume stocks you're going to find that the open interest is well above that.

Failing to keep up with news

Another mistake made by novice traders his they just enter a trade and then wait to see what

happens. You need to be keeping track of your trades very closely and one of the things you need to watch out for is news that suddenly breaks. If the news is bad you need to cut your losses and get out of the trade,that is unless you were investing input options. But you also need to be careful about this as well. You don’t want to make the mistake of getting out of an options contract prematurely. So if you see a news item that has negative implications for option that you may be invested in, you want to see if that news item is getting repeated across all of financial networks. If it’s not a widespread news item that might indicate that investors don’t think it’s that important. But if you start seeing it flashing all over the place, that is a good time to consider getting out of the trade. This also relates to the basic point that you need to factor in future events that may impact the price of your option. So mistake that you could make would be selling a put credit spread right before an earnings call. If the earnings call turned out to be a bad one, that could quickly wipe out your put credit spread. So you need to have some environmental awareness and using that example if a company you were interested in selling put credit spreads on has an upcoming’s earnings call, wait until after the earnings call and at least one day of stock price movement before you start selling put credit spreads on that company.

Ignoring Index Funds

Novice traders often don’t trade index funds and this can be a missed opportunity. Several index funds are good for using straddles and strangles and even for using iron condors. Also, keep in mind that when there is great or bad news index funds offer an opportunity to jump on a rising or falling trend. So any time there is some big news that impacts the entire market consider looking at trend trading with index funds or if you’re uncertain try a straddle or strangle strategy.

Taking Positions that are too large

Is it better to trade 10 options contracts that are the same or enter multiple contracts on different stocks? The latter is actually a better strategy. You don’t want to be in a large contract, that is trading large lots if you want to call it that. When a thing doesn’t work out, that is going to magnify your losses. Try trading three different stocks with multiple contracts if you are hoping to make a certain level of income within a given time period rather than rolling the dice with 10 or 20 contracts for one single option.

Conclusion

Thank you for taking the time to read this book. I hope that you have found it very informative and educational.

Trading options can be a very exciting thing to do. When you have won on your trades, you can become ecstatic. Of course the losses bite, but traders are an optimistic bunch, always hoping for the next opportunity to earn big profits that might be right around the corner.

If you trade without following a strategy, you are not likely to see enough profits to make trading worth doing. Traders that trade without a strategy are going to be wandering around aimlessly, and have a few wins here and there and lots of losses, unsure of what their goals are and where they are going in terms of their end goals.

That is why it’s important to develop a specific style of trading focused on trading strategies that work. A long time ago, professional options traders, including those trading very large amounts of money, figured out the many ways that you can structure options trades to meet different goals while mitigating total risks. If applied correctly, these different methods can result in more consistent profits.

The first step is to set a specific goal that you have for your trading. You need to decide if you are going to speculate for short term profits or if you want to set up a system that can generate reliable income. To be completely blunt, it is the rare trader that could do both simultaneously. Some traders do both and manage to be successful, but the vast majority of traders are going to have to stick to one method or the other. So your first step as a budding options trader is to decide which method appeals to you more.

Once you settle on a method, then you should learn the strategies that are best suited for that method. Then you should set an end goal in mind, with stepping stones along the way as well. Don’t just dive in saying you plan to have a million dollars at the end of the year. First of all, you should start off by setting a realistic goal. So instead you might say that you want to have a million dollars within three years. Then you need to create milestones along the way that are going to be realistic and attainable, with each milestone helping you get closer to the ultimate goal.

Once you have your plan mapped out, you need to learn the different strategies for your style inside and out. If you are going to be a speculator, betting on the directional moves of stocks, then you will need to learn how to trade calls and puts, how to trade strangles and straddles, and how to trade debit spreads. This will include knowing the break-even and maximum loss for each type of trade, along with knowing the profit you can make with each trade. You should also protect yourself by having acceptable profit levels, and then exiting your positions when you get those profits. You should also have a maximum loss that you are willing to accept in any trade and then get out of the trade if you reach that point, unfortunate as it may be.

Others may find speculation too risky. Earning income from options is a relatively low-risk activity. You are kind of like the dividend investor of the options world. Of course, compared to investing in dividend stocks selling options for income is high-risk activity, but at the same time it requires a tiny fraction of the money. As we saw with many of the examples, with a few

thousand dollars you can make $52,000 a year. The thing is, you probably only have to put in money now and then and can continually reuse your collateral to generate income off of relatively small amounts of money. If you put in $3,500 or so, you can even make a six-figure income. Compare that do dividend stocks, where you would probably have to invest a million dollars to earn just $40,000 a year. Yes, it's a much safer way to earn money from the stock market in the sense of chances of losing money. However look at the massive amount of capital that you would have to come up with in order to earn a small amount of income! Options are a much better way to earn money than investing in dividend stocks if you look at it from the perspective of how much money you are required to invest in the first place. Many people, in fact most people, are not going to be able to come up with a million dollars to put in the stock market all at once. But lots of us can come up with $3,500 to invest in order to generate regular income, and we'll make more than twice as much money.

For those that want to open margin accounts, selling naked options is a time tested strategy for earning income. It will require you to be careful, disciplined, and savvy about your trades. It is also going to require you to have good judgment about when you need to buy back an option to get out of a trade. Before trying to sell naked options, you should get some experience with other types of trading so that you have a solid handle on the process. Selling credit spreads is the best preparation for selling naked options. If possible, you should sign up with a broker that has a simulated or demo trading platform. That is another way that you can practice different trading strategies to gain more experience without having to put capital at risk. Some people criticize the practice of using demo accounts because it takes the emotion that is normally associated with trading out of the equation. That is a valid argument, but it's still better to spend some time trading with a demo account to experience how things work even if the emotion is not involved. Studies show that traders that practice with demo accounts come out ahead of traders that just start trading with no experience. But the good thing about options trading is that you can start small to get experience. Therefore, you can just trade one contract at a time, risking maybe a couple of hundred bucks, before you start moving on to big trades.

If a given trading style isn't working out for you, then you can always switch. But you should give it six months to a year before you decide to try something else. Just on an odds perspective, it's more likely that people are going to have more success and be profitable if they are following a selling strategy. No matter which strategy that you decide to follow, you need to become as expert as possible with all the available strategies so that you know exactly what you are doing. So this book should function as an introductory education to the world of options strategies. Please be sure to continue your education elsewhere before trading.

No matter which strategy you decide to adopt, be sure that you learn all the ways to mitigate risk. Remember that if a trade is not going well for you, holding it until expiration is a really bad mistake. That is only going to ensure that you come out of the trade with maximum losses. Any time that you are uncomfortable with a trade you should just get out of the trade. It is better to minimize losses and preserve as much capital as possible so that you can get into new, and possibly better trades.

Thank you again for reading this book, and I hope that you have found it educational and useful. If you enjoyed the book please leave a review for the book on Amazon.

Disclaimer

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Options Trading Crash Course

The Best Beginner’s Guide with All the Essential Information an Investor Needs on How the Option Trading Market Works and How to Start Trading Options

Gimm Livmor

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Introduction

Congratulations on purchasing *Options Trading Crash Course* and thank you for doing so.

For most individual investors, options are a new way to make money through the stock market. Although they've been around for a long time, most people don't really understand what options are all about. In this book we will explain options for beginners in a way that will help you understand what options are, how they are traded, and how you can make profits from options.

Options are different than traditional investing. But the good thing about options is that they can help you earn profits without having to invest a lot of money. However, options are tricky if you have not educated yourself about how they work. That is one reason why reading this book is so essential. We will help you get started on the right foot so that you can trade options simply and easily without falling prey to the problems that options trading can create.

First we will begin with an introduction to stock options, explaining what they are and how they work. We will discuss the types of options and help you get acquainted with the jargon used in the options trading industry. We will explain how options compare with stock investing, and why options might be preferable for you when it comes to investing.

You'll learn why options provide massive leverage and how they actually save you money. As we learn about options, we'll demystify the "Greeks" and explain how to use them to make effective and winning options trades.

Finally we will cover different options trading strategies that can help to increase your odds of earning a profit while capping possible losses.

There are plenty of books on this subject on the market, thanks again for choosing this one! Every effort was made to ensure it is full of as much useful information as possible, please enjoy!

Chapter 1: What are Stock Options?

In this chapter we are going to introduce the basic concept of stock options. You will learn what options are, the two general classes of options, and the characteristics that any option has. We will also cover the language used to describe options in the industry.

Options: The Basic Concept

An option is a contract on some financial asset that involves buying or selling the asset at an arranged price. The benefit of this type of contract is that for a set time period it fixes the price of the asset over a given time period. The prototypical example used to illustrate this is a real estate contract. This is a bit hypothetical to illustrate how options work on the stock market, so bear with me and don't sweat the details as they related to the sale of a home.

Suppose that you have a house for sale, and someone is interested in the house but they are still uncertain about the purchase. Maybe the buyer will be moving to your town provided that they get a job at a particular place of employment. If they move to your town, they are certain to buy the house, but they don't want to commit to buying the house unless and until the job is finalized.

You could setup an option contract for 30 days on the house. The agreement might work as follows. It would give the buyer the option to buy the house for $250,000 within 30 days. This is an optional purchase for the buyer, they are not required to buy the house in 30 days. If they fail to buy the house in 30 days, the contract just expires and they lose their option to buy at that price.

For the seller of the option contract, it's not an option, it's an obligation. So if you enter into this contract, for that 30 days you can't take a different offer on the house, even if its for a higher price. If home prices in your area spike over the time period the contract is in force such that your house is now valued at $300,000, you still can't sell the house for that amount or for any price, unless and until the contract expires without the other party exercising their rights under the contract.

The buyer of the contract could transfer it to another party. If home prices are rising, other people might be interested in the contract, and since they could save a great deal of money on it with a home, they might be willing to buy the contract for a significant sum. So if the buyer finds out they are not going to get the job, they could let the contract expire worthless, or they could sell it to a third party for say $1,500. If home prices had risen making your home worth $275,000, even though they paid $1,500 for the contract, the ability to buy the house for $250,000 makes it worth it.

That is the options contract in a nutshell. For house all we have to do is substitute 100 shares of stock. So an options contract on the stock market has an underlying asset, which is 100 shares of stock and the basic options contract gives the buyer the right to buy 100 shares of stock on or before the expiration date at a fixed price.

The fixed price is called the strike price. The expiration date is very important, and there are various expiration dates for options on the stock market. A month is a typical length of time but there are also *weeklys*, which expire in a week, and there are LEAPS which expire in 1-2 years.

You are going to find that there are options constantly expiring and available for investment at any time – so you will be able to find options to invest in that expire in a few days, in a week, in two weeks, in three weeks, a month, or whatever time frame you are interested in.

Two Classes of Options: Calls and Puts

There are two major classes or types of options contracts on the stock market. The type that we described in the last section is a *call option*. I introduced this type first because it is the easiest type to understand. To reiterate, a call options gives the buyer the option to buy 100 shares of stock at a fixed price on or before the expiration date.

But there is a second type of option, which is called a *put*. A put option gives the buyer the right to *sell* 100 shares of stock at a fixed price on or before the expiration date. Aside from being designated a call or a put, the language used to describe the characteristics of each option are the same, so the fixed price of sale is called the strike price for a put option as well.

When understanding these two different types of options, the main point to focus on is when and why you would want to use a specific type of option. We will consider call options first, because this is the most straightforward and common sense way to understand options and why they are useful.

I'm calling it common sense because a call option is beneficial when the stock price rises. If you buy a call option, you're hoping for the stock price to rise, and if the price does rise, the value of a call option on the marketplace increases. The more the stock rises in price, the more the value of the option increases. So prices of call options move with stock prices.

The reason that call options increase in value when the stock price increases is pretty straightforward. You've got an agreement that lets you buy shares of stock at a fixed price – the strike price. As the share price rises, the strike price becomes more attractive. If the share price goes above the strike price, then the option becomes very attractive – because now you can buy shares of stock at a discount.

Whether you are actually going to buy the shares isn't relevant. Someone is going to want to buy the shares, and so the value of the option will increase. If you are not interested in buying the shares of stock, it doesn't matter because you can sell the option to someone else, and earn a profit.

Now let's consider put options. The idea of having a contract that lets you sell 100 shares of stock at a fixed price seems mysterious at first, but put options are beneficial in a market of declining prices. So if the stock price is dropping, an investor can have some protection by using put contracts. That enables them to sell shares of stock at a fixed price that would be higher than the market price of the shares. For this reason, many investors buy put options to act as a kind of insurance on their stock holdings if there is reason to believe the stock may drop significantly in price.

Put options also let people *short the market*. This is a phrase used to describe a situation where a trader makes a profit from declining stock prices. This can be done by actually trading the stock in question, or by simply trading put options.

Let's look at the first situation. If a trader has reason to believe that the price of a certain stock is

going to drop significantly, they can buy a put option that has a strike price near the current share price. In comparison to buying 100 shares of stock, a put option is going to be a small investment. If you are talking about a stock trading at $200 a share, buying 100 shares means a $20,000 investment, while you might be able to buy a put option for $100-$400.
This is an important thing to note, if you consider the way stock traders short the market. Traditional shorting of the market is actually a pretty high risk activity, because normally the way it's done is the trader will borrow the shares from the broker, and sell them on the market. If the price were to rise, the trader could lose a significant amount of money – because they have to return the shares to the broker.

There is a hoped for outcome. The trader borrows the shares from the broker, and then sells them on the market at the current stock price. Then the stock price drops, the trader buys them back at the reduced price, and then they return the shares to the broker. They pocket the difference that they got by selling the shares at the high price and then buying them back at a discount.

In order to participate in this type of trade, you need to have a large margin account with your broker so that you can borrow the shares. To borrow 100 shares trading at $200 a share you are talking about borrowing $20,000.

Put options allow you to do something similar for a few hundred dollars. Rather than borrowing from the broker, you invest a couple hundred bucks in the put option which secures your position should the stock price drop.

If the stock price were to drop, then you would buy them on the market, and then you can sell them to the originator of the put option at the strike price. Then your profit is the strike price x 100 – the lower market price – the cost of the put option.

We could put some specific numbers on this to help readers understand the concept. Disney stock is currently trading at $132 a share. A put option with a strike price of $130 a share sells for $198.

So rather than buying 100 shares of Disney at $132 a share for a total of $13,200, or borrowing the shares, we spend just $198 to buy the put option. Of course, you are not going to do this randomly, for our thought experiment we are imagining that there is some reason to believe that the share price is going to drop significantly over the lifetime of the option contract, which expires in 30 days.

For the sake of example, suppose the stock dropped to $110 a share. That is a drop of $22 a share. You could buy the stock at $110 a share, for a total investment of $11,000 + $198 for the put option, setting you back $11,198. But since you own the put option, you could sell the shares at the strike price of $130 a share. That brings in $13,000. So your net profit would be:

Proceeds exercising the option – cost of buying the shares – cost of the option =

$13,000 - $11,000 - $198 = $1,802

A put option gives you the same power that shorting the stock does, but you are risking only a couple hundred dollars in the event things don't play out the way you are hoping.

And of course – there is a second path you can take. Rather than buying or selling shares, you can simply trade the option. Options prices are governed by certain mathematical formulas. You don't have to know what they are, but we can actually get a pretty accurate estimate of the price of a Disney put option should the stock price drop to $110. For our example we will suppose that this happens over a two week period. With two weeks left on the option contract, the price of a put option would rise to $1,998.

So we could simply sell the option, and ignore the shares of stock. This would give us:

$1,998 - $198 = $1,800

In this case we basically make the same profit that we would going through the exercise of buying and selling the stock. That isn't always going to be the case, but the example illustrates that you can profit from selling options *themselves* and not worrying about trading the stock at all.

This is why many people are options traders. An option allows you to control the stock and leverage its price movements without actually owning the stock at all. Notice that the $20 drop in share price is *magnified* in the price of the option. Later, when we learn about the "Greeks" we will get a precise notion of how options prices change with stock prices.

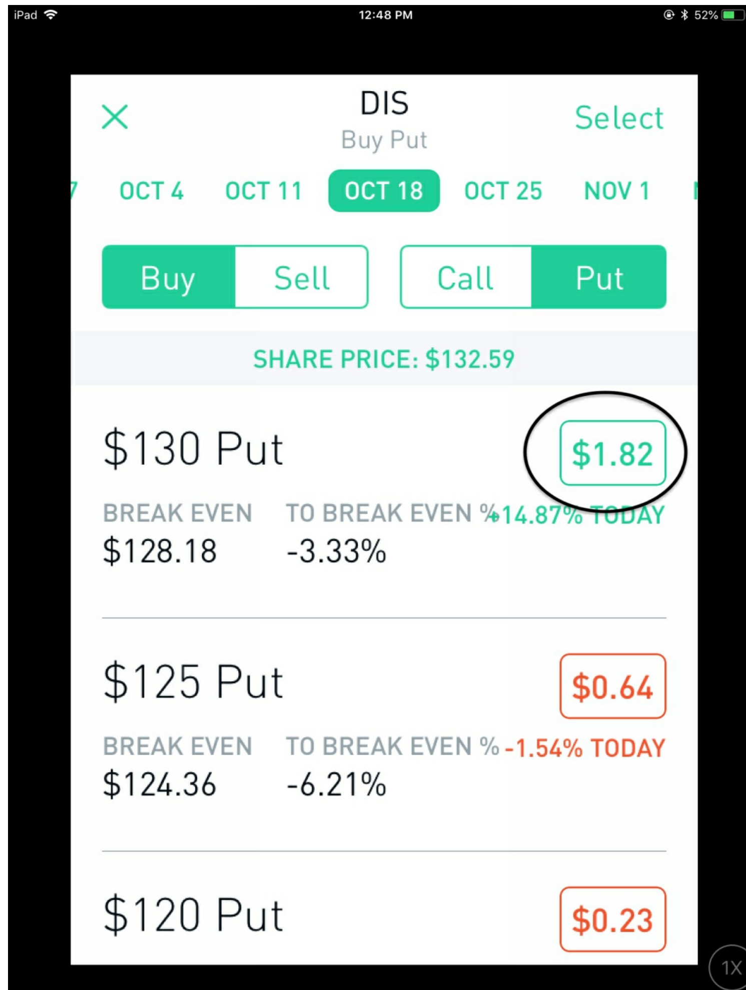
Learning About Options Prices on the Market

Now you understand the basic types of options that are available. We know that each options contract comes with a strike price and an expiration date. In this section we are going to learn about options pricing so that you understand the costs involved when you are looking to actually buy and sell them on the market.

The first thing to note about options pricing is that prices are quoted with three major factors taken into account. The first is the expiration date of the option. Options are grouped together by expiration date. So the first step in buying an option after picking the stock, is to find an expiration date of interest. Then you are going to see the options listed by strike price. So what you'll want to do after picking the stock and the expiration date, is find the desired strike price.

The price of the option that is the current market price is then listed on a price per share basis. So if you see an option priced for $1.50, you need to multiply that price by 100 to get the actual price that you have to pay in order to buy the option. In this case that would be 100 x $1.50 = $150.

The following image is taken from a trading app called Robinhood. The price of the option is circled on the right (incidentally, in the time that I wrote this the price dropped from $1.98 per share to $1.82).



You might also see options prices quoted in a traditional format. Each option contract has its own ticker. Below, we have an example of a Disney option from Yahoo Finance, presented in this fashion.

DIS190920C00133000	2019-09-17 2:39PM EDT	133.00	3.30	3.35	3.60	0.00	-	24	0	134.57%

The ticker is:

DIS190920C00133000

The first three letters of an options ticker is the ticker for the stock that underlies the option. Following this the next 2 digits are the year, and then you have the month and day that the option expires. So the expiration date for this option is 9/20/19, or September 20th of 2019.
After the date, you will see a C or a P, indicating whether the option is a call or a put option, and in this example we have a C for call option. The information following this is the strike price information. Three decimal places are used, so this option has a strike price of $133. If it were $133.50, the ticker would read:

DIS190920C00133500

If it were a put option expiring on September 27th with a strike price of $125.50, it would be:

DIS190927P00125500

The price of the option is not reflected in the ticker, but if your broker displays tickers you will be able to find the price information alongside of it. These days most brokers display options pricing information in a more readable format the way that we saw above with the Robinhood app.

Commissions

Many brokerages charge commissions for entering into trades, and so this is an expense you may have to account for in your trading activity. Commission fees are typically pretty small relative to the size of trades, so they might be on the order of $5-$7. There are some brokers that might charge even lower commissions.

However, many brokers offer commission free trades. There are going to be many factors involved in choosing a broker, so whether it's worth it going for commission free trades is something you are going to have to evaluate as a part of a larger picture. If you are trading frequently having the ability to do commission free trades can be beneficial, but you might find paying a commission is worth it if you get a lot of additional benefits.

Chapter Summary

In this chapter we learned what an option contract is. Then we learned about the two types of stock options, calls and puts. We learned what the strike price is, and the importance of the expiration date and why you might want to sell put options. We also learned about options tickers and pricing. In the next chapter we are going to learn more about options expiration and some jargon about options that is commonly used in the field of options trading.

Chapter 2: Navigating the World of Options Trading

In this chapter we will cover basic options trading. For now, we will not cover selling options, a more advanced topic. In this chapter we will discuss simple examples of call and put options trading and some of the jargon used in the industry.

Call Options: In the Money

The terms “in the money” and “out of the money” are slang used by options traders to indicate whether an option is really worth something or not. It turns out that even out of the money options are worth something, but before we get to that let’s learn what these terms mean and how different call options fit in with the definitions.

The first definition you need to know about is “in the money”. A call option is in the money when the strike price of the call option is lower than the current share price. In other words a call option is in the money when you can buy the shares at a discount price relative to the market price.

To really be worth it, however, you need to understand how the breakeven price fits in. If the stock is trading at $101 a share, technically speaking a call option with a strike price of $100 a share is in the money. However, if you paid $2 per share for that option, then it is not really in the money, because you’d lose $1 a share exercising the option.

So from a practical standpoint, an option has to be positioned such that the market share price has risen enough to account not only for the strike price, but also the price paid to buy the call option. So you need to pay more attention to the breakeven price rather than the in the money price – if you are interested in buying the shares of stock.

Call Options: Out of the Money

So to summarize, a call option is in the money if the share price rises above the strike price. On the other hand, if the strike price is above the share price for a call option, then that option is said to be “out of the money”. Out of the money options are less desirable than in the money options, and so they are priced at lower levels. The more in the money a call option, the more the option is worth. However, you should not neglect out of the money options. If an option is a little bit out of the money, but the pricing trend is in its direction, the value of the option can still rise. So you can make profits from out of the money options, although it’s a little bit trickier. Holding them overnight can also cause problems because options lose value due to time decay.

The key thing to remember about out of the money options is that they expire worthless. That is, if you hold an out of the money option through expiration, once the option expires it has zero value. That means your investment in the option is completely lost.

If you are going to trade out of the money options, then you should be sure to get rid of them as soon as possible. This is a good reason to be trading liquid options.

When is an option liquid?

Liquidity is one of the most important concepts in finance and trading. Simply put, liquidity is a measure (vague, but real) of how quickly you can convert something into cash.

A cashier’s check is very liquid. Cash is 100% liquid. A bar of gold is pretty liquid because you

can take it to a gold or coin dealer and sell it immediately for cash. Stocks are liquid, but less liquid than these items because you can't immediately access the cash you get from selling stocks (most brokers will make you wait a few days).

You can compare liquidity between different types of assets and within assets. To explain what we mean, let's focus only on options. Some options are going to be more liquid than others. No matter what, your broker is going to have rules on being able to get the cash out, but that isn't our concern when talking about the liquidity of options. Those rules are going to apply to all options.

Our concern here is how easy it is to buy and sell a particular option.

Options trading can move fast. In my own experience, I have seen options that I've purchased lose and gain $100 or more over a matter of 30-90 minutes. The rapid price movements of options coupled with the fact that they lose value through time decay every single day that passes means that when the time is right to get in and out of an options contract, you want to be able to do it right away.

So the concept of liquidity when it comes to trading options comes down to being able to buy and sell an option instantly. The market provides two important pieces of information that you can use in order to determine how liquid an option is.

Open Interest

Open interest is the number of contracts that are in existence for a given stock ticker, strike price, and expiration date. If you find that option A has an open interest of 1,250 for a strike price of $120 and an expiration date of October 1st, that means that there are 1,250 options contracts on the market for these values. If option B for a different stock only has an open interest of 85, that means there are hardly any traders interested in option B.

The higher the open interest, the easier the option is to trade and the faster your orders will get filled. Some stock tickers have very high levels of open interest, and so you can execute your trades instantly. Examples include the high tech companies or popular index funds like SPY. These may have some options with an open interest in the thousands.

While more is better, the minimum that is considered by professional traders is 100. So make a note to yourself as a rule that you will always check the open interest before entering a trade, and that you will only trade options with an open interest of 100 or greater.

Obviously an option with an open interest of 100 is going to take a lot longer to trade than one with an open interest of 2,400, but professional traders take 100 as large enough to ensure that you will be able to find a buyer or seller before there are large price movements that could wipe out your position.

Longer term options (LEAPS) might have smaller open interest but be worth buying anyway, because you can hold onto them longer. Remember that time decay becomes a huge issue for options that are approaching the end of their lifetime and it's not going to be as much of a factor for a longer term contract.

Volume

Volume is the number of times the option was traded. If the markets are open, volume tells you how many times its traded so far on that day. If the markets are closed, volume is the trading volume the previous business day. So if the open interest is 200 and volume is 500, it means there are 200 options contracts and they were traded 500 times on the last trading day.

More volume means that the option is more active, and it also means that it's going to be easier for you to get in and out of your positions when you need to.

Consider two examples. SPY is an index fund that tracks the S & P 500, which is an index consisting of the 500 largest companies on the stock market in the United States. Many traders like to trade SPY options because it's a high demand fund that provides a solid opportunity for traders. Looking at an example, an option that expires in two weeks that is in the money by $3 has an open interest of 5,920 and a trading volume of 1,310. With an open interest that high, you would have no problem trading this option – and you could probably sell it instantly.

The closer you get to the expiration date, you might find that the open interest begins decreasing, sometimes by large amounts. This is because sellers are closing out their contracts to avoid assignment (we will discuss what this specifically means in a later chapter).

Lower Open Interest Doesn't Mean Don't Trade

While there are no hard and fast rules, the 100 open interest level is generally followed by most professional traders, and it's a good rule for you to follow. That said, don't think that options with smaller levels of open interest are not worth trading as compared to options with open interest in the thousands. While you might have to wait a little longer to execute a trade, they are often well worth trading. So just use 100 as a minimum cutoff and don't worry beyond that. If a stock with an option that has an open interest of 120 is trending strongly upward, you're going to be better off with that than you will with a different stock with an open interest of 2,500 that is stagnant.

Call Option Examples

The best time to trade call options is when a stock starts trending. A good example is SPY. If good GDP numbers come out, then you can make a good profit off call options on SPY. The key is getting in at the right point, which is why higher levels of open interest are good.

Sometimes an option will trend for a long time period. But remember with options you have time decay working against you. Let's illustrate with a few examples so that you can understand how this works. We will use a hypothetical stock with a share price of $200. First let's consider an in the money option with a strike price of $195, and say we buy it 14 days to expiration.

A call option would cost $6.10 per share under this scenario. That means that each option contract, covering 100 shares, would cost $610. If the share price rose to $203 on the same day, the option price for a call would jump to $810. So you can make significant profits on a single day.

But let's say that soon after you buy the option, the share price actually drops to $198. The option price would plummet to $487. So you'd lost a significant amount of money right out of the gate. But do you have the stomach to be a trader? The price might reverse, either the same day or a few days down the road.

If we hold out and wait a few days, and the price goes back up to $202 a share, the option price would now be $749. So we could sell it at a profit.

But let's look instead at holding it until 2 days before expiration. Suppose that at 11 days, it remains lower than $200 a share, so that we are still in a money losing situation. If we hold it all the way to 2 days, and it goes back up to $201 a share, the option price is now $602. So we can exit the position at a slight loss.

When you get close to expiration, the option is worth the difference between the share price and the strike price. That is related to the actual cash that would be generated by exercising the option. That would mean buying the shares at the strike price and then selling them at the market price.

If you don't intend to either keep the shares of stock or sell them after purchasing them, then you probably want to get rid of the option before it expires.
Now let's consider a different scenario. Five days to expiration, you buy an out of the money option. Once again we will start with a share price of $200. This time we will setup an out of the money call option. Remember that an out of the money call option has a strike price that is higher than the share price.

If the strike price is:

- $201: The option is worth $133.
- $202: The option is worth $96.
- $205: The option is worth $30.

Wow! So at a strike price of $205, we can get in on an option for cheap! Can we make profits? Let's look at each case.

First consider the $205 strike price. Suppose the same day, the stock rises from $200 a share to $203. That $30 option will rise in price to $99. Of course a $3 move is fairly large, but that certainly happens with stocks priced on the order of $200 a share.

So at least in theory, you could buy 10 options and make $690 in profit. But there might be day trading limitations. If you let it roll over another day and the price of the stock stays the same, the option price will drop to $81.

In that case, however, if the stock price rose to $203.25, the option price would jump to $90.

Options prices are governed by specific mathematical formulas, so these numbers are actually fairly accurate (but not exactly). They are hypothetical but they have been chosen to show that you can in fact trade out of the money options and earn profits on them. Academic articles on the internet give you bad advice – they say don't trade out of the money options.
The question really should be when to trade out of the money options. The time to trade out of the money options is to trade them when you expect or see a rising share price. Buying out of the money options at the beginning of a trend can save you a great deal of money, and you can still earn substantial profits.

Now let's consider the case of the $202 strike. In this situation if it goes through the same

scenario, when the stock moves to $203.25 this option is in the money – and its price goes to $235. So you could sell it for a substantial profit.

The only situation to avoid when it comes to out of the money options is to not go out very far. If the option was $210, there would be little chance that the stock price would come anywhere near it. At 14 days to expiration with a share price of $200, you could buy it for $34, but at 4 days to expiration the option would be worth just $9, even with the share price rising to $203.25. So you'll want to pick strike prices that are reasonably close to the market price if you hope to earn profits trading out of the money options.

At the Money

An option can also be "at the money". This means that the stock price is exactly the same as the strike price. While this can and does happen, it doesn't happen that often, truthfully. At the money options are more responsive than out of the money options, with a delta of 0.50 or very close thereto. Later we will see that delta gives you the amount of movement you can expect in an options price for a given change in the share price. Options that are in the money are more strongly influenced by changes in share prices.

Losing Money on Call Options

Let's say for the sake of an example we buy a $200 strike price option that expires in 10 days on a stock trading at $200. A call option would cost $252. You would buy this option hoping that the share price is going to rise above the strike price.

Let's say that instead the share price languishes, moving between $199.50 and $200. Since it hasn't dropped much, we hold onto the option hoping things will move in our favor.

If instead the share price were to drop to $197 with 5 days left to expiration, the option price would plummet to $65. We would be out $187. Even if the share price only dropped to $198.75, the option would be priced at $122, still leaving you with a substantial loss.

It's important to realize that these kinds of losses can and do occur. It's important to do a thorough analysis of the situation before entering into a trade, and even with your best analysis you might still end up with heavy losses. Options trading is not magic, even though a lot of gurus are heavily marketing their "system" online claiming you can make constant profits. If someone sounds too good to be true, they probably are. A drop of $1.25 in share price for a stock priced at $200 is not very much – and it happens on a regular basis.
The key to successful options trading is not trading on a whim, carefully planning your trades, and knowing when to get out. The goal is to have more wins than losses over time that average out to profits. So you should not get too down if you have a loss or even a few losses in a row, they can be followed by several trading wins if you are planning your trades carefully and not just buying options to see what happens.

When to Trade Call Options

Hopefully these examples have illustrated how call options can work, both the good and the bad. The question is when is the best time to trade call options.
The first thing to look for is the start of a trend, especially if it's accompanied by some positive news about the company, or an overall upward trend in the stock market. This means that you should be devoting some amount of time to the financial news, and carefully following the stock charts of companies you are interested in trading with regard to options. That means looking at

the stock itself, and not options prices. When you see signals of an uptrend forming in the stock, then that is the time to move in purchasing your options.

Options trading can be quickly. We illustrated a case where the value of an option could cause you substantial losses. But the thing is a stock priced at $198.75 could easily move to $202 that afternoon or the next day, and you could recover from your losses.

I have personally lost $100 in the course of an hour, only to move into a situation of $100+ profit a few hours later.

It can be difficult knowing for sure when the best times are to bail or to hold on. It’s really impossible to know unless there are external factors that can be influencing the stock price. So if you are in a situation of losing money, but good news hits the airwaves about the company, then it is probably a situation that indicates you should hold on to at least recoup your losses and possibly move into a situation of profit.

But later we are going to lay down some trading rules that you should follow. In most cases, trying to figure out what is going to happen using a crystal ball is not the best way to approach trading. You should have rules that guard against losses, and that means having a maximum loss per option that you are willing to accept. Bailing out when these losses occur does mean that sometimes you are going to miss out on some recoveries. However, most of the time it’s going to minimize your losses. It’s better to minimize your losses and then live for another day. There are always new trades to get into.

Trading Put Options

Stocks are always going up and down, and while most stocks are trending with the market, even when they are going one way there are going to be outliers that are going in the opposite direction. And sometimes the market overall is tanking. But the beauty of options is that you can easily profit either way. Put options allow you to profit from market downturns.

Let’s return to our example of a stock that is priced at $200 a share, and we are going to look at put options this time around. In this situation we would be doing so because there is reason to believe that the stock is going to decline.

At 14 days to expiration, a $200 put option which is at the money (the strike price is equal to the share price) would cost $296. Let’s say that in 7 days there is an earnings call, and there are expectations that the earnings call is not going to be a good one. This is an opportunity to invest in put options, but do keep in mind that there is some risk involved here. If the earnings call turns out better than expected, the share price may not drop.

At 7 days left to expiration, let’s say the earnings call turns out to be worse than expected. In situations like this – which do happen frequently – the stock can drop a large amount. A drop of $20, or even $40 a share overnight is not unheard of. So for our example let’s say the share price drops $33. This could send the price of the put option all the way up to $3,229!

So a situation like that can bring you substantial profits from your bet against the company. Of course betting right is risky business, so don’t expect things to move your way that dramatically all the time or even very often.

Sometimes the market might not react much. If the stock only dropped $5 a share, the put option at 7 days to expiration would be worth $546. Of course since we bought the option for $296, this is still a good profit.

Put options can be useful in many circumstances. Sometimes people are just getting out of a given stock. You can study technical analysis and learn when stock is overbought. This usually means that share prices are going to drop as investors start getting out of the stock. This can be a good time to buy put options and earn some money.

The key factor here, of course, is paying attention. You have to know what is going on with trading and also with the financial news. That can include not only company news but also political news and anything that can impact the markets overall movements, like job reports and so on. That is one reason that many traders like to focus on trading options against index funds. In order to make educated guesses about price movements, you only have to follow political and macroeconomic news. General moods can move SPY leading to profits in either direction.

This requires some flexibility in your thinking processes. We are conditioned to think in terms of earning profits from increasing prices. As an options trader, you need to be flexible so that you are able to earn profits no matter which direction the market moves. I always encourage brand new options traders to get in the habit of buying some put options to get a feel for how it works in real time, so that they can learn how to earn profits no matter which way things are going. Ridding yourself of the bias toward increasing stock prices is something you need to do as an options trader.

Put Option: In the Money

Put options work in the opposite way as compared to call options, and so the notions of “in the money” and “out of the money” are reversed. In the case of a put option, we say that it is in the money if the share price is *below* the strike price.

So if you have a put option with a strike price of $220 but the share price is $200, that put option is in the money. The reason is you could buy shares of stock at $200 and then exercise the put option and sell them for a profit of $20 a share (not considering the cost to buy the option). In contrast, with a share price of $200, a call option with a strike price of $220 would be far out of the money.

If there were 30 days left until the option expired, and the share price was $200 with a strike price of $220, the call option would only be worth $4! However, the put option in this case would be worth $2,013!

A put option that has a strike price below the share price is out of the money. Now say that instead, the share price is $220 and the strike price is $200. This time the call is going to be priced at $2,032, and the put option is going to be virtually worthless at $18. But if the stock price were to drop to $208, the put option would gain in value, moving up to $152.

If the options are at the money, they are going to be priced about the same. With 30 days left until expiration, and $200 strike prices when the share price is $200, the put option and the call option are both going to be priced at about $432. That makes sense because the stock could move either way, and so both are going to be worth the same in the marketplace.

When to Invest in Put Options

You can invest in put options any time the market is declining for a specific stock (or generally, if you are trading options against index funds). This can be done as things are going – so you can jump into a downward trend as it's happening. Or if you have information about upcoming events that leads you to believe that stock prices are going to be dropping in the near future, you can buy put options to short the stock.

How to Trade

Trading straight put and call options is very easy. You simply find the stock that you are interested in, and then pick an expiration date and strike price that you feel are good values to use. Generally speaking longer time frames until the expiration of the option are better, for two reasons. The first reason is that longer time frames mean that the option has more time value left. This gives you more time to have things move in your favor before exiting the trade. Second, in most circumstances it's better to sell options that have more time remaining on the contract, because a longer expiration date is going to be more interesting to buyers, since they will feel they have time to have the stock move in such a way that they can make profits.

That doesn't mean that you can't make money trading options that only have a short time left. I've done it and many traders even trade on the last day or two to earn profits. If the stock price is moving, any option can gain value (or lose it as well). The thing to watch out for in this case is making sure that the open interest and volume are high so that when you need to exit the position you can sell the option. Unless you are planning to buy the stock and the option is in the money, you don't want to be holding onto options too close to expiration.

Trading involves simply buying the call or put options you feel are a good trade, and then holding them until the price moves in such a way that you have earned the kind of profit that you are hoping to make on the trade. It's really that simple – but trading options is harder and trickier than this sounds. For this reason most professional options traders don't just buy calls and hope to make profits from increasing share prices.

Instead, they use advanced strategies. Let's just think about the fact that we can buy call and put options. You could start buying them in different combinations in order to ensure that you are going to earn profits. For example, if you were betting that the stock price was going to rise, you could buy an in the money or close to at the money call option, but you could also buy an out of the money put option as a little bit of insurance in case your bet was wrong. So the put option could focus as a hedge.

That could even lead to making profits on both ends. Just for an example, suppose that the share price is $200. You could buy an at the money put option (strike price = $200) for $437. You could also buy an in the money call option with a strike price of $197.50 for $571. In the event that the share price goes up to say $202, then the call option would rise to $699, while the put option would drop to $342. So you gained $128 on the call option but lost $95 on the put. You could sell both options and take a modest profit.

This example illustrates that you can hedge with options, but at the expense of profit. That is we made less profit than we would have just buying the call option by itself. Is that a tradeoff worth making? Sometimes it might be, but as we will see in later chapters, there are specific strategies that have been developed that will help you make set profits and minimize losses. These

strategies are known as limited risk and limited reward strategies. Professional options traders use strategies of that time in order to build an income that they can rely on over time, by increasing the probability that their trades are winning trades.

This recognizes the fact that even an experienced trader is going to have problems consistently picking winning call or put options on their own.

Let’s return to the scenario above. Of course this approach carries a lot of risk, but when the stock price went up you could sell the call option and then hold onto the put option. The idea behind this would be that you might be able to profit from both options. We are not really talking about stock pricing moves that are all that dramatic, and the reality is that the stock market is always going up and down a lot over short time periods. So what you could try to do is sell the call option when the stock is nearing a peak in pricing, but hold the put option on the bet that the stock is going to drop back down, at least a bit, and increase the value of the put option.

Once again let’s say that the stock price rose to $202. Then the following day, suppose it drops to $201.25. The put option would be priced at $367 – so we recovered some of the loss that we incurred earlier. If the stock continued dropping, say to $200.80, then the put option would rise to $387. At either point, we could have sold the put option and recovered some of the previous losses, increasing our overall net profit.

Now suppose the next day it drops to $199. In that case, the put option would rise in value to $468.

The point of these scenarios is to get you thinking about the possibilities of entering into more complicated trades. There are a lot of gurus going around the internet claiming that they pick winning call options all the time, but the chaotic nature of the stock market makes this unlikely. But by entering into more complicated trades, you can increase your odds of making money, and sometimes you can make substantial profits.

Here is a scenario similar to one I actually engaged in myself. Suppose that the stock is trading at $186 a share, and we buy a call option with a strike price of $188 and a put option a strike price of $184. There are five days left to expiration.

The call option will cost $85, and the put option will cost $83. So we are about even on both sides of the market price. Now suppose the stock drops to $184 a share. The put option increases to $163. So we can sell it and take a $80 profit. At this point the call option is $37, having lost a significant amount of money. But we have reason to believe that the share price is going to turn around and go up – and probably exceed the strike price of the call. So we hold onto it.

Over the course of a couple of hours, the share price rises to $187, $188, and then to $190. Now the call is worth $287. Then it goes to $190.50, and we sell the call option for $322.
Our profit on the call option is $322-$85 = $237, and we also earned a profit of $80 on the put option, for a total profit of $317. Not bad for a days work! Of course finding trades that work in this manner is not something that you are going to be able to do all the time, but it does happen and it shows how you can make money quickly from the chaotic price moves that happen all the time on the markets.

Day Trading Options

In order to take advantage of the large price moves that happen throughout the day, you may want to day trade options at least some of the time. The reason is simple. Day trading options allows you to take advantage of the price swings that happen on the markets daily without holding options overnight and losing value to time decay. Remember that with each passing day, the option will lose some value on that basis alone, although other factors are in play that might rise above time decay causing the options to gain in value on the following day.

But let's imagine that share prices are remaining constant. We'll also assume for the sake of illustration that everything else including implied volatility (more on this later if you have not heard of the concept before) are remaining constant. Suppose a stock is trading at $300 a share. We'll use an at the money option with a strike price of $300. The price of a call option will move as follows, simply due to time decay.

- 30 Days: $655
- 20 Days: $535
- 10 Days: $378
- 5 Days: $267
- 3 Days: $207

Time value works against options traders. If the option is out of the money, it takes on an outsized role in causing value to drop as the days pass.
The problem with day trading, however, is that you can only do so many day trades over any five day period (that being five business days). So unless you want to open a day trading account, you have to be careful about using day trades and only use them sparingly. Four day trades in any five day period, where the period is five consecutive trading days (so weekends don't help) result in a day trader designation.

A day trader has to open a margin account, with a deposit of $25,000 according to the regulations in the United States. A margin account is one that allows you to borrow money in order to do trades.

For some people, this may not be an obstacle. Are you willing to sink $25,000 into your account in order to day trade options? For some people, this might be worth doing. It is certainly a plausible scenario, and once you open a day trading account, as long as you maintain the account in good standing, you can day trade as much as you like under those circumstances.

In my view this is worth at least setting up, so that when you need to day trade options in order to make profits you will have that ability. Keep in mind everyone has the ability, but only up to 3 day trades per 5 business days. If you open a day trading account then you will be able to unlimited numbers of day trades.

So what is a day trade? That is simply buying a security and then selling it before market close on the same day.

Keep in mind that trading two different options doesn't amount to a day trade. So if you buy an option on Apple with a strike price of $199 and then later that same day buy another option on Apple with a strike price of $198, and then sell the option with the strike price of $199, you have only made one day trade.

So for a day trade each option is a unique security, so that means the same strike price and the same expiration date. If you buy 10 options with the same strike price and expiration date you might not be able to sell all of them on the same day, depending on the brokerage rules.

Day trading options can be very lucrative, but this is a full-time activity and it can be very high pressure. In order to have success with this style of trading, you will have to be paying close attention to the markets all day long until you close out all of your trades. Some people will enjoy this, but other simply won't be able to because of other commitments they have in their life such as a full-time job. You might also not be able to put $25,000 into your trading account, or enjoy the pressure of having to make quick trading decisions. But this is something fun and exciting for some people.

Swing Trading Options

Swing trading is a style of trading financial assets that relies on large price movements or "swings" that occur over time. With stocks, swing trading is a popular strategy. It is not as high pressure as day trading and you can do it without a margin account or any deposit requirements. The basic idea is to buy at a relative low point in prices, and wait for the stock price to "swing" to a high pricing level where you can sell and take your profits. It can also be used to short the market, so you would enter a position at a pricing peak and then exit the position when the price swings back down to a low price.

Swing traders hold their positions overnight, and then trade over the course of days or even weeks.

It could be a natural fit to options trading of straight calls and puts. The basic process of trading only calls, for example, is not that different from swing trading because you are simply looking to buy low and sell high. Conversely, with put options you are shorting the market, as a swing trader could do when the market is at a high and then "swinging" down to a low price.

The only difference is swing traders don't have to worry about expiration dates and time decay, but options traders have to. That doesn't mean that you can't effectively swing trade using options, you can. But you have to account for time decay in your trades. You might consider swing trading using LEAPS since they are less susceptible to time decay over the time periods of interest, but they could also move substantially with large price swings of the underlying stock. LEAPS will not move in the same magnitude as options close to expiration when stock prices change, but they do still move a large amount. You can look for a 65 cent per share change on a LEAP for every dollar change in the stock, for example. But the important thing about LEAPS is that the time decay is very small, so unlikely to have much impact if any on the price.

That means that if you are really going to approach options trading from a swing trading perspective, trading LEAPS can be a way to do that. They can also save you a large amount of money while providing a much higher return on investment as compared to trading stocks. As an example, you could buy in the money calls on Apple at $3700. Sounds like a lot until you consider that the 100 shares underlying those call options would cost more than $20,000 at the time of writing.

Do what works for you

There are no rules for trading. So you should pick a style and goals that work best for you and your personality style, as well as with your ability to make financial commitments to trading without putting yourself at too much risk.

Pros and Cons of Trading Call Options

Trading call options is the common sense way to trade, and they are easy to understand. When the stock price goes up the value of the call option goes up. So it's a straightforward way to get involved in options trading. It's also a good way to get started and get a feel for the options market before getting involved in more sophisticated strategies. In the beginning you can start by just trading small priced options. Go for some options for well-known but lower priced stock, such as AMD. The stock trades for around $30 a share or so, and you can get in the money call options for around $125.

After you get comfortable doing a few trades on stocks like AMD, you can move up to higher priced and faster moving stocks like Facebook, Apple, and SPY. With more active stocks the prices are going to be moving faster, and there are going to be more opportunities for profits.

The cons of trading call options by themselves are mainly focused on two areas. Prices can suddenly go against you. If you are trading something like Facebook, and you wait too long, a small price shift, going down 75 cents or a dollar, can put you in a situation where you lose a lot of money quickly. The trick to avoiding this is getting out of the trade at the right time by selling your options when you are making a profit, or if they start heading in the other way getting out before things get too bad.

Another con of trading call options by themselves is time decay. If you don't plan things right time decay can cost you a lot of money as well and make it harder to recover from losses. Dealing with time decay simply involves having awareness of it and planning head.

Pros and Cons of Trading Put Options

On the pro side, put options give you more flexibility for earning money from stock price movements. They make it easy to short the market, and they are relatively straightforward to understand. That said, some new traders will find them a little bit confusing. Just like with call options, I recommend that you start with a few small trades with put options so that you can understand how they work, getting a feel for it in real time, but without putting much money on the line.

The cons of put options is that it's a little counter-intuitive for most people to be thinking of making money when the stock market is declining. This can lead to trading mistakes. However, that is something you can deal with by practicing. You can even start getting acquainted with put options by following market movements for different stocks without actually entering into any trades. That way you can start learning how to recognize opportunities to profit from stock market declines, and train yourself to think in terms of shorting the market. Of course it isn't a requirement that you trade by shorting the market, but doing so will help you gain a bit of flexibility.

Chapter 3: About Options Markets

In this chapter we are going to introduce you to the options markets. In your trading, some of the concepts involved in this chapter are background material that won't impact your actual day-to-day trading. We will also talk about brokers and commissions as well, which is going to be more impactful. But the lessons of this chapter will be understanding the structure of the options market and who is involved.

Options are Derivatives Contracts

Options are a type of derivative contract. You may have first heard about "derivatives" during the 2008 housing market crash. But don't let the term scare you. *Derivative* simply means that the value of a financial security is derived from an underlying asset. In the case of options, the value of the option is derived from the underlying shares of stock.

Options Exchanges

Just like stocks, options are traded on exchanges. There are many options exchanges. The largest options market is owned by NASDAQ, which as you probably know is a stock market that is mainly made up of technology stocks. NASDAQ actually owns six different options exchanges. These include the Nasdaq Options Market, PHLX, BZX, Gemini, Mercury, and ISE. Together, the six options exchanges owned by NASDAQ make up about a third of total options trading. Another major options exchange is CBOE/BATS.

CBOE stands for the Chicago Board Options Exchange. Chicago is generally seen as the center of options trading, but there are also options exchanges in Boston and New York. ISE stands for the international securities exchange. It was developed in the late 1990s as a fully electronic exchange.

As a trader, the options exchanges are totally hidden from you. Trading options, like trading stocks, will be presented to you in an electronic format that is completely unified, and the actual exchange where the option is bought or sold is invisible. Your broker creates the interface between you and the options exchanges. So while it may be good to at least know about the options exchanges, this is not something you have to become an expert on in order to trade options or to make a profit trading options. You won't even be aware of the exchanges themselves as you go about your business.

Options Clearing Corporation

The options clearing corporation or OCC is an organization that issues and guarantees options contracts. The OCC is regulated by the U.S. Securities and Exchange Commission or SEC. The OCC manages transactions involving call and put options. They are also involved with futures contracts. The main function of the options clearing corporation is to ensure that the obligations outlined in options contracts are fulfilled by working with brokers. The organization also helps provide regulatory oversight of the options markets to help manage risk.

Market Maker

Options market makers are under contract with options exchanges to help provide liquidity in the options markets. These are professional traders that are paid by the exchanges to fulfill this role. They can be large institutional traders or even individuals. The main purpose of market makers is to ensure that retail traders are able to trade options. Market makers will often take the other side of your trades. They maintain a large inventory of financial assets of their own, and often use

actual stock trades to hedge their risk in taking options trades that have a certain probability of being a losing trade. Market makers are viewing the markets in a completely different way than individual traders such as yourself view the market. This is because they are not focused on individual trades. They are focused on the aggregate of large numbers of trades and overall probabilities. When you are trading, you aren't going to know who takes the other side of the trade and it's not really relevant. It might be another retail trader, it could be an institution or it might be the market maker. Your only focus when trading is on the performance of the stock, and entering and exiting trades in a way that works for your personal situation. Market makers have huge portfolios of options contracts that are known as "inventory". If you are trading a low volume option, the market maker can help keep the market liquid by taking the other side of the trade.

The Options Industry Council

The Options Industry Council or OIC is an educational organization. It is sponsored by many options exchanges, and it's main purpose is to educate the public about options trading. The organization maintains a website for this purpose located at optionseducation.org where you can find courses on options trading as well as data associated with options trading. They also have an online store where you can buy videos, books, and software. This site is highly recommended for use to further your education in options trading. You should use these reliable and official course materials rather than relying on online gurus who have other, sometimes, ulterior motives.

Virtual Trading Platforms

If you are a true beginner, you might consider signing up with a broker that offers a demo trading platform. This will allow you to engage in demo options trades so that you can gain experience without risking any money. For all intents and purposes, the demo trades operate as real trades with the exception of real money being on the line, so you can go through trades and learn how things work with no real risk. Since options trading can be quite tricky and different from stock trading, using this procedure is highly recommended, at least for a short time period. Many people are impatient and want to dig into real trading right away, but if you prepare yourself by spending a few weeks or a month using a demo trading platform, you are going to be better off than someone who starts out the gate risking their own funds. Do some research online to find a broker that has a practice trading platform. Some examples include think or swim which is operated by the famous stock broker TD Ameritrade, and another one you can use is run by a company called Tasty Works.

The Broker

Just like you need a broker to trade stocks as an individual investor, you need a broker to trade options. Since options are closely associated with the stock market, the same brokers that are used to trade stocks are involved in options trading.

What is a broker? A broker is simply a middleman. As we mentioned at the start of this chapter, there are many different options exchanges. As an individual trader, you are not going to go through the work of finding where a specific option is traded and then go trade on the exchange. Instead, everything is hidden from you by the broker who does the actual legwork. Of course these days everything is managed electronically, and so the broker will present you with the options exchanges as if it were one single, unified market. They play the role of acting between you as the individual trader and the exchange and whomever takes the opposite side of the trade.

With today’s computational power and fully electronic trading, everything runs seamless. Behind the scenes, you place an order with your broker, and the broker actually carries out the trade on your behalf. Since the broker is doing work for you, they will often charge a fee for placing each trade that is called a commission. Not all options brokers charge commissions, and they make money in other ways.

The broker will provide a software interface that you can use for options trading. Some brokers provide a basic interface that will allow you to look up options and place your trades, while others will also include the ability to do in-depth analysis. These days most brokers make their interface available through the internet on desktop computers, or as mobile applications for tablets and mobile phones.

Finding a good balance between features offered by the broker and fees like commissions is important. If you are using a broker that does charge commissions, this is going to be something that you have to figure into all of your trades when calculating profits and losses.

Tasty Works is one of the most popular options trading platforms. It was started by pit traders from the Chicago exchanges, and so it’s run by people that really know the business. They also have an associated educational network called tasty trades, that helps educate people and keep them informed, often including interviews with successful options traders. Tasty works charges small commissions, on the order of $1 per option contract. Later we will learn about more complicated options strategies that involve multiple options in a single trade. Each option is known as a “leg”. So if you have 2 options in a single trade, that is a 2-leg trade, while a trade involving 4 options has four legs. When selecting a broker you are also going to want to know about any charges associated with legs. Tasty works will charge a maximum of $10 per leg. Single leg trades are $1 each, but as of 2018 the company allows you to open 100 calls or puts for just $10. As of 2018 they also lowered their prices for 100 vertical 2 leg options to $20, and 100 4 leg trades were capped at $40. So the price of $10 per leg is for 100 options contracts. They also only charge commissions on opening an options trade and there is zero commission charged on closing options trades.

Robinhood has become a very popular trading platform. While you can access it through a desktop computer, it’s mainly designed to run as a mobile app. Robinhood is very popular because it has a clean, simple trading interface and it also charges zero commissions. They make their money through other ways, such as offering a “gold” membership for a monthly fee that has more features.
Many experienced traders don’t like Robinhood because it has some downsides. The most important downside for most traders is that it has limited information available as far as tools used for analysis. However, you can get that type of information elsewhere, so you might look at it as a tradeoff that you are willing to accept in order to get commission free trades.

Traditional stock brokers offer options trading as well. These include Charles Schwab, E*Trade, and TD Ameritrade.

Ultimately the broker you choose is a personal decision, so you should evaluate each broker you may be interested in and find the one you prefer, rather than doing what others tell you to do.

Once you find your broker, you can fund your account. This is done by linking a bank account to

the account maintained by your broker and depositing some funds into the account. You can trade options contracts one at a time, so you only need to fund an account with a couple hundred dollars in order to get started. I advise that beginners start slowly and small, don't jump in and buy 20 call options right away. Do one contract at a time so that you can learn how to trade options before putting significant money at risk.

Options vs. Stocks

The main advantage of options over stocks is that options provide leverage and massively higher return on investment. We touched on this earlier. You can invest a much smaller amount of money and earn profits that are similar in magnitude to what you would earn actually trading 100 shares of stock, but without having to put thousands of dollars at risk. For those who don't have thousands of dollars to put at risk trading, options offer a way for them to take advantage of price swings in the market.

Consider a stock trading at $200 a share. If you were to buy 100 shares of stock, that would require an investment of $20,000. Now suppose that the stock rises by $2 a share. That would give you a total of $200 in profit, not accounting for commissions. So you could sell the 100 shares and take your profits. Of course $200 profit from one trade is a good take.

If you were to buy an option, it would cost $437 to buy an at the money option ($200 strike price) with 30 days to expiration. A $2 rise in the stock price over 2 days would mean the option would rise to $525, so you could sell it for an $88 profit.

The ROI on the stock trade would be:

ROI (for stock trade) = ($20,200 - $20,000)/$20,000 x 100 = 1%

The ROI for the options trade would be:

ROI (for options trade = ($525-$437)/$437 x 100 = 20%

That shows the power of leverage that options provide. Of course you need to keep in mind that losses as well as gains are magnified by options, but this shows the power to make profits on smaller investments. In fact if we traded 3 options contracts, we'd have a profit of $264, larger than that from buying the stock. To do that we'd only need to invest $1,311, a fraction compared to the $20,000 we'd have to invest to make that kind of profit using a stock trade.

For those who have the funds available, trading stocks might be preferred because it can be more straightforward and familiar. But if you would rather make the same levels of profits while risking less money, or you don't have the funds required to make large stock trades like that, options offer an advantage.

The cons of options trading as compared to stock trading are mainly centered around the fact that options can move quickly in price and the trading can be tricky. Stocks also have the advantage of not coming with an expiration date. If the stock was languishing, you could hold onto 100 shares of stock as long as you need to in order to make a profit. With options trading it's something that you have to get in and out of quickly, and you have to be aware of the expiration date.

We can summarize the pros of options vs. trading stocks in the following:

- There is far less capital required to trade options as compared to stocks to make equivalent profits.
- Options provide a much better return on investment as compared to stocks.
- Options are fixed loss investments. The total loss you can incur is the price of the option. Losses on stocks can be much larger.
- Options offer flexible ways of trading, and it’s easier to profit from price declines as opposed to shorting stock.
- As we will see in later chapters, it’s possible to enter trades with options that do things that are not possible trading stocks.
- Options require less startup capital.
- Options have less risk from “gap openings”, which are fast price changes that can wipe out a day trading account at market opening, if the trader had held a position overnight.
- Options offer flexibility, since you can trade over different time frames.

Chapter 4: Tips and Avoiding Mistakes

In this chapter we are going to look at some general tips to help you to become a successful options trader. We will also look at some common mistakes to avoid. Following this advice and putting it into practice is going to be strictly up to you, however those who take this advice to heart are going to be better traders than those who ignore it. This advice is based on the experience of actually going out and trading options, so we can save those who are willing to study the trouble of having to make mistakes that others have learned from already.

Have Specific Goals

The first thing to realize about trading options is that you should treat it as a serious business, even if you are only planning on trading on a part-time basis. After all, real money is involved so why do otherwise?

Any successful business is going to be built around specific goals. You need to have an idea of where you are going and be able to chart your progress along the way. With that in mind you should start with a goal for an amount of income that you want to earn from options trading. Start with a monthly target, rather than an annual target. That way you can adjust your numbers as you gain experience and develop your trading skills. You can also target weekly goals instead.

Over the long term, you should have an annual income in mind. Are you looking to replace your job, or make a certain amount of money from trading options? Or are you simply looking to earn some extra money?

Depending on your financial goals, you are going to need to figure out how much time you are willing and able to devote to trading. If your goal is to make $100k a year trading options, then working on it 5 hours a week is probably not going to be sufficient. So keep a realistic perspective on how much time you are going to devote to trading and how much money you intend to make. Keep in mind that you don't have to get everything done in a single step and you can grow into your ultimate goals. So if you want to become a full-time trader making a six-figure income, you might start small, only trading a few hours a week with a goal of making $1,000 a month right now. Then as you gain experience, you can set new goals.

Keep a Trading Journal

Of course the computer and your broker will keep a record of your trades, but one thing I have found is that those who are more likely to attain success are those who keep a trading journal. Get a notebook and record your trades, and keep a running tally of your income. Each time you open a new trade, enter it in your notebook. Then record it in your notebook when you exit the trade, and note the net profit or loss on the trade.

It is important to track wins and losses in your notebook. One of the bad habits people have while engaging in an activity like options trading is the winning trades stick to their memory, but oddly enough they seem not to remember the losing trades. It's important to keep a running tally that includes your *net* income as well as a win-loss count of your trades. If you win 2 trades but lose 10 trades, that is an indication that you have some learning to do. Keeping a trading journal where you record every single action that you take can help you be honest with yourself as well as help you keep a reliable record of your trading activities. That way you will know where you really stand.

Set a Profit Taking Amount Per Option Contract

Each trade that you enter into should have clearly defined exit criteria. That means that you should have a fixed profit level that you use to exit trades. With options, it is very easy for a good trade to suddenly go bad. Remember that options magnify small price movements in the stock, and so you can lose money just as fast as you make money.

For that reason, it's better to set a fixed profit level per option and per trade that gets you in the habit of taking fixed dollar amounts that add up over time. All too often, when it comes to options trading holding on while you hope to make $100 or more on a single trade can lead to a $50 loss instead. Or maybe if you are lucky, you will break even.

Two things to remember while options trading are the following. First, there is always another trade around the corner. Think of all the new options contracts that you can find to trade each and every single day. Second, remember that options are time limited. So holding on hoping to make more profits is not the best approach.

Small dollars add up as well. Remember that many people become millionaires by saving small amounts of money. In the world of options trading, you might be thinking in terms of one contract at a time, but as you gain experience and get better judgement about what is a good trade and when to enter and exit your trades, you can move up to trading multiple contracts at a time.

A good rule to set is an exit rule when you earn profits. It should be at least $30 per contract, but at most $100 per contract. While it might not be exciting to make say $50 on an options trade, try imagining doing that many times per day instead. You can get to the point where you are trading 10 or 20 options at the same time, and so you can make $500 or $1,000 per trade. Over time, you can do that more frequently and trade even more contracts simultaneously.

But what happens when you set a $30 or $50 take profit level per options contract is that you increase the probability that you are going to be able to exit a trade in a profitable state. You also get out of the practice of "winging it" as you are trading. Successful options traders are disciplined and have specific plans that they execute. You can't expect to be a successful options trader if you are acting "on the fly".

As I've said and I want to emphasize again, I routinely see options hit a profitable zone when you have made $50 or so on a contract. If you wait it out, there is a strong probability that you are going to see that go south on you. It's really not worth waiting around for a larger profit level. Yes, sometimes that will happen but remember the market maker – they are playing on the probabilities of the options market. You should do that as much as possible too.

Have a Stop Loss

A stop loss order with stocks is a fixed amount of losses per trade that the trader is willing to accept. Generally speaking, financial advisors say that you should not risk more than 2% of your account per trade. With stocks, you figure out 2% of your account size, and then divide that by the number of shares you are trading. Then you can place a limit order, which is a type of order on stocks that only executes if the price specified is reached. In this case, the limit order would be a sell order that would automatically sell your shares if the price dropped by the amount specified.

You can do the same concept here, but the way I do it is a fixed dollar amount per options

contract. You have to be careful with this, because with options contracts there is always a good chance of a turn around. Like the take profit level, this is some value you are going to have to figure out for yourself. The idea is to be able to get out of options trades that don't look good, but you want to get out without losing the entire amount that you paid for the option.

But you also have to consider that options can quickly turn around and move the other direction. Remember that a $0.50 move on the stock against the direction you are hoping for can mean a $40 or even $50 loss on your option, and that is not much price movement. So setting some small level like $10 would not be realistic. You have to give the stock some breathing room to move up and down. I generally pick a level of about $100. You can also look for a consistent downtrend. That is, if the stock keeps dropping with no end in sight, you might get out of the trade rather than let it carry through to the next trading day, leaving you with even more losses due to time decay.

Don't Let Emotion Rule Your Trades

The previous two tips help with the biggest problem of them all, letting emotion rule your trades. If prices on a financial market are dropping by significant amounts, this can get people into trouble because they will panic at the thought of large financial losses. When that happens, they exit trades too soon, and they end up missing out on later price gains. And as we've mentioned before, this can happen with rising prices as well. If you don't have a take profit rule that you stick to, you can end up holding onto your assets for too long. That can mean at best reduced profits, but it can also mean breaking even or having to exit your trades at a loss. So you want to stick to your profit rule no matter what. Don't hold on after its reached the profit level hoping that you are going to be making larger and larger profits.

Go Against the Herd

When the markets are dropping, don't sit on the sidelines. Don't move into cash. Remember that as an options trader you have an level of flexibility that stock traders (generally) don't have. That means that bear markets and dropping stock prices are an opportunity to earn profits.

Use Alerts

If you can sign up for email alerts with your broker or through another service, this is something you can do in order to ensure that you are staying on top of your trades. You can use alerts so that you can keep up with changing stock prices, whether it's getting into a trade at the right moment or exiting your trades. Alerts sent to your email inbox or as text messages can help you keep up with things without having to be directly following the market all day long.

Don't Try Making Up For Past Losses

Besides trading on emotion, another mistake beginners make is trying to make up for past losses by doubling or tripling up on the next trade. You need to maintain a disciplined trading program, and if you are not ready or experienced enough, doubling up or more on your future trades in a desperate attempt to make money back is a bad idea. Rather than help you recover from losses, more times than not this is going to deepen them instead. Another way this can rear its ugly head is buying call options on a stock that keeps dropping. Traders will do this hoping to make up for previous losses, thinking that they are getting the stock at a bargain. Be careful and wait until you see the stock showing solid signs of price movement before you take action like that.

Trading Illiquid Options

Remember in earlier chapters we emphasized that you should only trade options that have an open interest of 100 or more. Trading illiquid options can get you into trouble. Let’s say that you are trading a call option on some stock that has less trading interest than the top players. The stock moves up $1, and your in the money option goes up $90 and so you place a sell order. But you’ve made the mistake of trading an illiquid option, and there are no takers. As you wait for the order to fill, the stock starts dropping. Pretty soon your $90 profit has dropped to $40, and then to $20, until finally your deal closes with a buyer.

So now you’ve lost all that profit.

If the option is a popular one, with an option interest of 100 or higher, that kind of scenario is not likely to happen. You want to stick with options that are going to trade in an instant, so that you will be able to get in and out of your trades when you need to.

Chapter 5: Understanding The Options Greeks

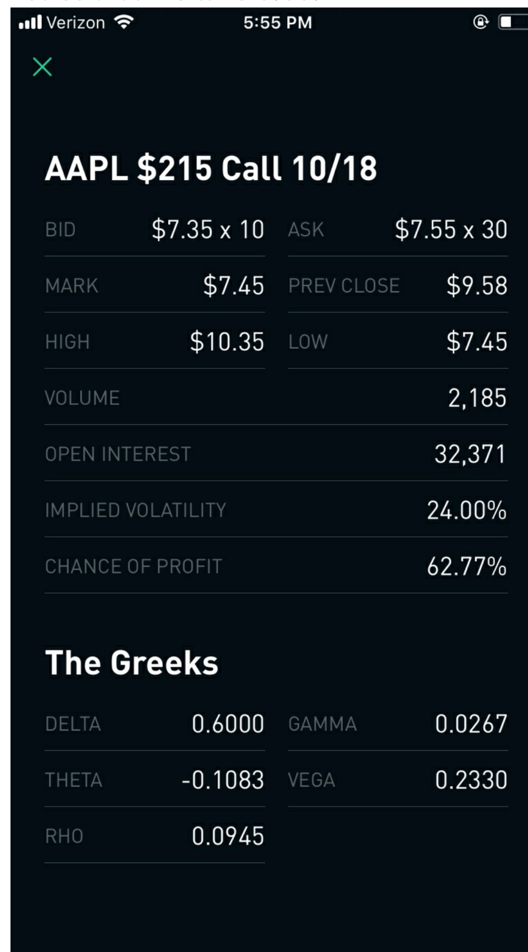
Every stock option has four metrics associated with it called the “Greeks”, because they are denoted by Greek letters. If you are going to trade options you don’t need to know the mathematical details of how the Greeks are calculated, but you need to know what the Greeks represent and how to interpret their values.

The Greeks are the underlying factors that will let you determine future options pricing. Keep in mind that when you look up the Greeks, you are seeing a snapshot. The values of the Greeks will change when the underlying fundamental values change.

In all, there are five “Greeks”. You can look them up for any option and they are going to be straightforwardly listed under “The Greeks”. These are delta, theta, rho, gamma, and vega. In this chapter we will learn what each of these means and how you can use them to make better options trades.

Delta

The first Greek is one of the most important, delta. This Greek gives you an estimate of how the price of an option is going to change in response to the change in the price of the underlying stock. In the image below, we see the Greeks for an Apple call option with a strike price of $215 that expires on 10/18. Here notice that Delta is 0.60.



This means that if the stock were to rise or fall by $1, the price of this option would rise or fall by $0.60. Currently the share price is $217.75, and the option price is $7.45. So if the share price rises to $218.10, a gain of $0.35, the option price will rise by 0.60 x $0.35 = $0.21 to $7.66. Remember that this is a per share price, so the actual option price will rise from $745 to $766, a pretty substantial gain.

Something you need to get a feel for is how delta tends to change as time passes for the option. Looking at the $215 call option for Apple, we can compare different dates. It is now Sept. 22, to give you a reference point. Here is delta for the same $215 call for the following expiration dates:

- Sept. 27: 0.6537
- Oct. 4: 0.6072
- Oct. 18: 0.6
- Jan. 17: 0.58
- Jan. 21 (in 2 years): 0.6474

Notice that the LEAP (expiring in 2 years) has a delta that is similar to the option that expires in a week. This makes trading LEAPS valuable, because LEAPS are not nearly as impacted by time decay, but they can gain value by price movements of the underlying stock.

Also notice that the option that expires in a shorter time period has a higher delta than options that expire further out. Ignoring LEAPS, options that expire in a shorter time period have more impact by Delta. The closer to expiration the option gets, the higher delta gets.

Now let's look at the relationship between strike price and delta. So we will stick to one expiration date, and for this discussion we will use the September 27th expiration date for the Apple call options. Here is delta for some different strike prices:

- $225: 0.1544
- $220: 0.3834
- $215: 0.6000
- $200: 0.9488

The share price is $217.75, so the $225 and $220 call options are out of the money, and the $215 and $200 call options are in the money. The more in the money an option is, the higher delta will be. Notice that for the $200 call, delta is practically at 95%. So the more in the money a call option is, the more closely it will track the share price.
As a general rule of thumb, if an option is in the money by 10% of the share price, that means that your delta will be 0.95 or greater. So if you are looking to trade options with a high delta so that you can maximize gains, for a stock with a share price of $100, buy a call option with a strike price of $90 or lower. For a stock with a share price of $200, buy a call option with a share price of $180 or lower, and so on.

Out of the money options are going to be more heavily influenced by time decay, than they are by the share price. This is reflected in the Apple options, where we see that the out of the money option with a strike price that is $2.25 out of the money has a delta of 0.3834, while the option that is $7.25 out of the money has a delta of 0.1544. This is one reason why it's harder to make

profits trading out of the money options if they are far out of the money, because for that example if the stock were to rise by $1 you would only gain a little more than 15 cents a share. But, it’s also important to recognize that you would still be making profits and the amount of capital you’d have to invest would be smaller. Let’s compare the amount of profit you’d make from a $1 move in the stock price to the price paid to buy the option.

First let’s take the $200 option. The price is currently quoted at $18.10, and so you would pay $1,810 to buy this option. If the price of the stock goes up $1, you would gain $0.9488 per share, or a total gain of $94.88.

Your ROI would be:

$94.88/$1810 x 100 = 5.24%

Now let’s compare this to the $220 option, which has a delta of 0.3834. The $220 call option is only $1.80, so your total investment would only be $180, and a $1 rise in the share price would mean a gain of $38.34.

Your ROI in this case would be:

$38.34/$180 x 100 = 21.3%

This is an important lesson – it shows that you can make money on out of the money options. When you read online articles about this, they dump on the idea and label it a “beginner” mistake. The problem is a lot of people writing online articles about options traders are academics who never actually trade options. Would you be worried about a “beginner mistake” that brought you 21% returns?

You would have to sink $1810 into a single option in order to make the $95 profit. What if you bought 10 $220 options instead? Then you’d make $383.40 on an investment of about the same size.

Keep this in mind when determining what options to trade. Every stock is going to be different, but in the case of Apple at the present time trading in the money options is an expensive proposition – but you can earn money trading out of the money call options and do it even better.

If an option is at the money or close to it, the value of delta is going to be around 0.50.

Now let’s take a look at put options. When you see delta for a put option, it’s quoted as a negative value. The reason is that the relationship between put options and the price of the underlying stock is an inverse relationship, and so to describe it you need the negative sign. So all that means is if delta is -0.35, the price of the option will increase by $0.35 a share if the price of the stock *drops* by $1. Conversely, if the price of the stock rises by $1, the price of the option will drop by $0.35 a share.

Otherwise, the relationship between delta and the price of the underlying stock works the same way. That is think in terms of expiration date and whether or not the stock options is in the money, out of the money, or at the money. If a put option is out of the money, meaning that the strike price is below the share price, then the delta will be less than -0.50, and the more out of the

money the option is, the smaller delta will be.

If the strike price of a put option is higher than the share price, the put option will be in the money. This means that delta will be larger than -0.50 (larger meaning more negative).

Looking at Apple for some specific examples, a $220 put option is slightly in the money, and has a delta of -0.6149. A $225 put option, which is more in the money with a share price of $217.75, has a delta of -0.8356.

Now consider some out of the money examples. The $215 put is slightly out of the money. We find that the delta value for this option is -0.3420. The $210 put has a delta of -0.1666.

Delta as a Probability

Another way to look at delta is it gives you a rough probability estimate that the option will expire in the money. So if you see a call option with a delta of 0.84, this can be basically taken to mean that there is an 84% chance that this option is going to expire in the money. In contrast, if you find an out of the money option that has a delta of 0.38, say, that means there is only a 38% chance that particular option is going to expire in the money.

The same interpretation works for put options, but take the absolute value or just drop the negative sign. If you see a put option with a delta of -0.62, that would mean there is a 62% chance that the option would expire in the money.

If you are going to be looking into selling options rather than just trading options (that is, selling to open options contracts) then this will be an important metric to look at. This is because as a seller of options contracts you actually don’t want them to expire in the money, and so you want to sell options that have a relatively low probability of expiring in the money.

Gamma and How Delta Changes

Gamma is a Greek that gets less attention, but Gamma tells you how Delta changes. Every time that either the underlying stock price changes or the days to expiration change, delta will change. The amount that delta will change with future changes in price is estimated by Gamma.

As an example, consider a stock with a share price of $200 and a strike price of $200, with 20 days remaining until expiration. In this case, gamma is going to be 0.04. So that means that if the share price rises by $1, the call option will see delta increase by 0.04. This relationship is approximate, you might see it actually rise by 0.05.

Gamma is the same for call and put options with the same strike price and expiration date. The only difference is that put options will see the opposite relationship, that is if the share price rises by $1, delta will drop by about the value of gamma. If the share price decreases by $1, then the value of delta for a put option will grow larger by about gamma.

If the share price of a stock was $201 with a put option having a strike price of $200, gamma is 0.04 and delta for the put option is – 0.45. So we are going to expect to see delta go to -0.49 or so if the share price of the stock drops by $1. In fact that is exactly what would happen.

The greater the distance between the share price and the strike price, the smaller gamma becomes. This reflects the fact that delta is not going to change as much if there is a larger gap.

For in the money options, delta will be approaching 1.0, and so there will be less movement in the value of delta with each change in the share price. Far out of the money options also don't see delta change much in response to changes in the underlying share price.

Now let's keep everything fixed for the moment, and focus on call options for the sake of simplicity. Let's say that the share price is $200 and we have a call option with a strike price of $198. Keeping everything fixed to see how gamma changes, we will consider the values at 30 days, 15 days, 10 days, and 3 days to expiration. At 30 days to expiration, delta is 0.59 and gamma is 0.04.

Now at 15 days to expiration, keeping everything else the same except the time to expiration of the option, delta changes to 0.61, and gamma rises to 0.05. This indicates that the option is becoming more sensitive to changes in the underlying stock price. At 10 days to expiration, delta rises to 0.63, and gamma rises again, this time to 0.06.

Remember that gamma is the same value for a put option that has the same strike price and expiration date.

Now let's move to 3 days to expiration. At this point, delta for the put option rises to 0.72. Gamma rises again as well, this time reaching a value of 0.10.

Delta Values for the Put and the Call

Another interesting observation is that throwing out the negative sign for the delta value for the put option, the sum of delta for the call and for the put for the same strike price and expiration date is 1.0.

Using the previous example, at 3 days to expiration with a share price of $200 and a strike price of $198, delta for the call option is 0.72 and delta for the put option is 0.28. Using the probability, we have an estimate that there is a 72% chance that the call option is going to expire in the money, and there is only a 28% chance that the put option is going to expire in the money. Since they sum to unity, as they must for a probability, you know what the delta value is for the other type of option that has the same strike price and expiration date.

Intrinsic and Extrinsic Value

Options have pricing value that is divided into intrinsic value and extrinsic value. Intrinsic basically means "inside" or internal value, so its value due to the option itself that comes from the underlying asset. An option gets intrinsic value from the price of the underlying stock as well as from the implied volatility, something that we are going to talk about in a little bit. Extrinsic value is "outside" value, and this comes from the time left to expiration. The less time there is to expiration, the less extrinsic value the option has. The price of the option is found by adding up the extrinsic and intrinsic value. A call option with a strike price of $198 and a share price of $200 with 30 days left until expiration has a price of $542. The extrinsic value of the option is $342, and the intrinsic value of the option is $200. The $200 reflects the difference in the strike price and the share price, which is $2.

If all things remain equal, at 3 days to expiration the intrinsic value is still $200- that is expected because the underlying facts haven't changed as far as the worth of the option which comes from its strike price relative to the share price. At this point, however, extrinsic value has dropped by a large amount. Now the extrinsic value is only 0.60 (per share) giving a total contribution of $60

to the option price of $260. Note that in the money options have intrinsic value but out of the money options have no intrinsic value.

Theta

The third Greek that is of interest is a very important Greek – this is theta. It's important because it is an estimate of time decay. Remember that options lose value as the expiration date approaches because there is less time for the option to move in the money enough to make it worth exercising. This is the true value of the option, whether it's worth exercising to buy or sell the shares. Even if you are trading options only to trade them, keep that in mind.

So what theta is going to tell you, is it will give you the amount of value your option is going to lose at rollover to the next trading day. Theta is quoted as a negative number to reflect the fact that the option is going to decrease in price, and it is given on a per share basis, just like everything else related to options.

So if you see theta quoted as -0.10, that means that at the start of the next trading day, your option will drop in value by 10 cents a share for a total of $10 at market open. You will see this happen if you are following your option at market open, but it is possible that other factors are going to be in play. Let's illustrate this with an example so that we can understand how this works.

Let's return to our example of an option with a $198 strike price, and a share price of $200. We will consider both the call and the put options to see how this works. Theta will be similar for the call and the put options, but it won't be exactly the same. In this case, for the call option theta is -0.12. So that means the option will drop in value by $12 at market open. For the put option, it will drop about the same amount, theta in that case is -0.118.

The call option at our hypothetical market close with 10 days left to expiration is priced at $363, with an extrinsic value of $163. The total price loss will be for the extrinsic value, so at market open the following morning the extrinsic value for this option is going to drop to $151, since theta is -0.12.

The put option has a similar extrinsic value, of $1.62 on a per share basis. So we expect it to drop to $1.50 the next morning. Note that since this put option is out of the money, it has zero intrinsic value.

Rolling over to the following morning, the price of the options drops as expected. The call option drops to $351 for the total price. As expected, the extrinsic value has dropped to $151. Nothing can be done about this – it will keep dropping with each passing day and it doesn't matter what happens to the other factors associated with the option.

But does that mean that the options is a losing bet? Not at all – changing share prices can change the price of the option far more than time decay. In this case, for the call option delta is 0.64f, so for every $1 rise in share price, the price of the option is going to rise by around $64. So if the share price were to rise to $201, the call option would rise in price to $418. We lost $12 in extrinsic value, but the rising share price means that we've had a net gain of $55. The put option drops in price to $117 in this scenario.

Now let's step back and return the share price to $200 to see what happened as a result of time

decay to the put option. The price of the put option dropped from $162 to $150 as expected from the theta value. So we see that if the share price rises to $201 after market open, the put option drops even further to the $117 price we noted earlier. But if instead the share price dropped to $198, the put option would actually increase in value by a lot, to $235. That scenario would totally wipe out the value lost due to time decay.
The point of this exercise is to understand that every single day at market open, options lose some value from time decay. However, markets are not static and small changes in share price can more than account for the losses associated with time decay. So it’s not necessary to panic when worrying about time decay, or when you see your option drop in value during the first few minutes the market opens. By the end of the day things can be quite different. Time decay only happens once a day at market open.

Vega

Vega is a “Greek” that is related to changes in implied volatility. As you know from looking at any stock market chart, stock prices are “volatile” which basically means that they change a lot. Stock market curves are not smooth, they are jagged as prices swing up and down. This up and down movement is referred to volatility and the more wild the price swings the more volatile the stock.

Volatility is something that has an impact on options prices. Remember what we discussed with time decay. Options have more extrinsic value when there is more time before option expiration because that gives the stock more chances to move, and move in such a way that the option gains in value because for a call option the share price can move higher than the strike price, or for a put option that gives more opportunity for the share price to move lower than the strike price.

More volatility also means more value for an option as well. The more volatility there is, the larger the price swings that the stock is experiencing. And so that means there is an increased probability that the price is going to swing in such a way as to make the option worth more. It might even only be worth more for a short time period, but that is an opportunity to sell and make larger profits.

Implied volatility is a little bit different than volatility. You can look up any stock and get an idea of how it’s volatility relates to the market average. This is done by checking *beta*. If beta is equal to 1.0, then the stock has average volatility. If beta is greater than 1.0, then the stock has more volatility than average. A volatility of 1.72 means that the stock is 72% more volatile than the stock market average. If beta is less than 1.0, then the stock is less volatile than the market average.

Volatility is not something that is fixed. It will increase as you get closer to the date of an earnings call, for example. For options, the key concept is implied volatility, which is volatility that is expected in the future. Higher implied volatility can make options prices rise. If volatility is lower, then options prices will drop. As you approach an earnings call, which can send stocks moving aggressively in one direction or another, implied volatility can increase by large amounts causing options prices to increase by large amounts.

If volatility is 19%, then vega will be 0.124. That gives us a rough idea of how the options price will change if the volatility goes up or down by a point. Considering a strike price of $95 for an option on a stock with share price of $100. With 14 days to expiration and a volatility of 14%, a

call option will have a price of $504. Vega is 0.013. A 2 point rise in volatility will cause the option price to rise to $508. If the volatility rose to 20%, the option price would rise to $518. Vega changes as volatility changes, it would rise to 0.032. That indicates that the more volatility rises, the more sensitive the option price is to further changes in volatility. Volatility doesn't have as much impact on options pricing as changes in the underlying asset price, but near events like earnings calls volatility can rise quite high, making it an important factor. In our example, if volatility rose to 42%, then the option price would jump to $631.

Rho

The final "Greek" is Rho, which is related to interest rates. When interest rates rise, this tends to hurt options prices, but the impact is not that large. Rho gives an estimate of the impact of a 1% rise in interest rates. This is given in terms of the "risk-free rate", which is related to 10 year US Treasuries.

Chapter 6: Options Strategies for Unchanging Prices: The Iron Condor and Iron Butterfly

A lot of the focus in introductory treatments of options is on buying calls or puts to take advantage of rising or falling stock prices. However, these kinds of options trades suffer from one major weakness – having to predict the direction of a price move.

Of course sometimes this is possible within reasonable bounds. You can learn subjects like technical analysis, chart signals, trending, and candlestick charts to make fairly reasonable estimates of price-movements of stock. However this is still fairly risky activity, in the sense that you are just as likely to be wrong as you are to be right in many cases. There are some options traders that do trade straight call options, but most professional options traders do not approach the markets in this way.

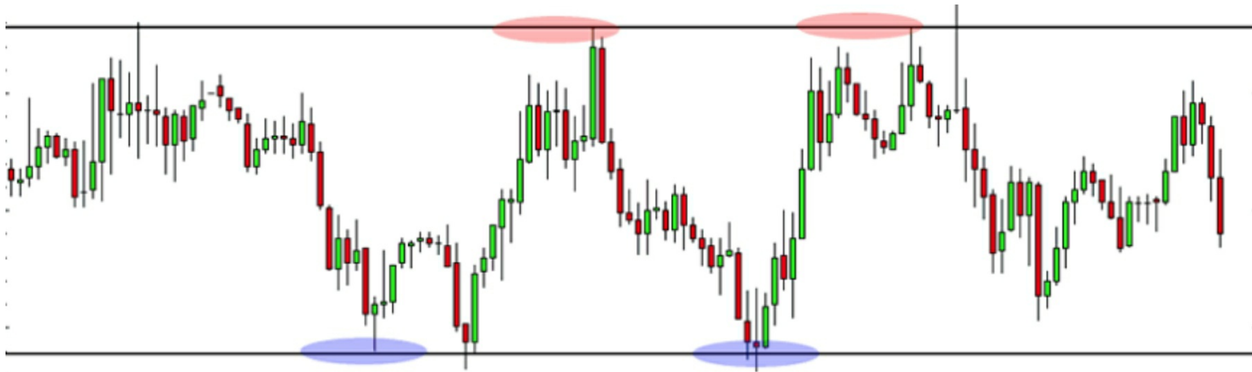
That is because while you can strike gold sometimes, it's hard to do it day in and day out. The main weakness in the equation is predicting the direction of a stock price move. But what if we approach options trading in a new and different way, and instead of doing that, remove the directional movements entirely? There are a few different strategies that can be used to do this.

There are also many different situations that occur in the stock market. After an earnings call, the stock can move high or low by large amounts in one direction. As you may know, this usually depends on whether or not earnings "beat" or fail to beat expectations. To be completely honest, this is a bit absurd. If the analysis believe a certain amount of profit is going to be made in a given quarter, but the company makes profit but it's less profit than was projected, this is considered a major "disappointment" and it can cause stock prices to drop by a large amount. If the company happens to beat these imaginary expectations, then stock prices can be sent soaring.

But at other times, the stock is going to be trapped within a range of prices. This can happen for long time periods. The range might be quite constrained, and so it can be hard to make profits by trading calls and puts when the stock is in this pattern. But it turns out that the ability to have calls and puts together enables us to come up with schemes that can earn profits in unexpected ways. We are going to have a look at some of these in this chapter.

The Iron Condor

The first type of trade that we are going to look at is called an iron condor. This is something you want to apply when the highs and lows of stock prices seem to be bounded. It is as if the stock price is trapped. It never breaks above a certain pricing level, called *resistance*. But it never drops below a given price level, which is called the *support*. Sometimes stock can be trapped in this pattern for a long time period. It will look something like this:



In order to have support and resistance, you want to see the price touch the line of support at least two times, and the line of resistance at least two times. The difference in prices might be relatively small. Of course, there are some possibilities for trading calls and puts, when the price drops down to the support level, you can buy call options and take profit as the price goes back up toward the resistance price level. Then you can buy put options and sell them when the price drops back down to support.

But there is another way to profit from this kind of price trap, as I like to call it. This type of trade is called an iron condor. Among options traders looking to earn an income, the iron condor is one of the most popular ways to trade. If you set it up correctly, it’s possible to earn repeated income.

Let’s take a minute for an important aside before we show you how to setup the trade. There are two kinds of options traders. One type of options traders is a profit seeking trader. Of course all traders hope to make profits, but a profit seeking trader is one who makes bets on what the stock is going to do, and they roll the dice and gamble hoping to make profits.

The other type of options trader is an income trader. This type of options trader seeks to minimize risk and setup trades so that they can earn regular income from the markets. There are many different ways to do this, and most of them involve *selling* rather than buying options. When you are a regular options trader, you *buy* to open your positions. So you are going to be running your business buying low, and selling high in order to make profits.

An income trader sells to open their positions. They seek to make money selling options and while you have been concerned about things like theta and time decay so far, as an income trader you actually value time decay and can’t wait for options to expire.

An iron condor is the first type of strategy that we are going to consider that works in this fashion. When you trade an iron condor, you are going to sell it to open your position. Then you are going to make money from the time decay. As long as the stock stays within the range that you use to define the iron condor, you will earn a profit. If it moves outside the range of the iron condor, then you are going to lose money.

So let’s see how its setup. The idea of an iron condor is to set boundaries on the stock price, so we are going to be looking for a ranging stock price as shown in the graph above. To set upper bounds, we are going to use call options. The lower bounds of the range are going to be set by using put options.

A single iron condor isn't going to make you a huge amount of money. The basic philosophy behind it is that this is a limited risk – limited profit type of trade. It eliminates having to guess which direction the stock is going to move, and instead we are only going to estimate the bounds of stock price movement over the lifetime of the option. Under normal conditions this type of bet is going to work in most cases. Of course, if there is unexpected news, such as bad news coming out about the company, that can cause prices to move outside the bounds of the iron condor and turn the trade into a loser. Unexpectedly bad news about the economy or political situation can have the same effect.

Let's also talk about volatility. If you recall from the last chapter, when volatility is high that means stock prices are swinging between high highs and low lows. Since we are looking for a situation where stock prices are basically bounded in a narrow range of prices, that means that an iron condor is a type of trade you want to use when volatility is relatively low.

To create an iron condor, we are going to trade 4 options at once. We are going to sell two options and buy two options. First let's look at the high price range for the trade. First, we want to sell a call option with a lower strike price. The strike price used for the call option sets the upper boundary of the iron condor. So you are setting this up with the belief that the stock price is not going to exceed the strike price of the call option that you select.

Second, we are going to buy a call option that has a higher strike price than the first call option. This is done because we are going to use it to hedge our risks a little bit. Let's see how that would work. For our example, we will assume that the stock price is $200.

We could sell a call option with a strike price of $205. This means we are setting up our iron condor with the belief that from now until the expiration date of the option, the price of the stock is not going to rise above $205. If there are 30 days to expiration, and volatility is a relatively low 15%, the price of a call option with a $205 strike price is going to be $1.55.

The breakeven price is found by adding the cost of the call option to the strike price, which would give $206.55. As long as the share price stays at $206.55 or below, it's not worth it for the option to be exercised. However, if the share price goes above that value, the option can be exercised. In the case of a call option, as the options seller, this means that you have to sell 100 shares of stock at the strike price of $205 a share.

So how would that work in practice? The way it actually works is your broker buys the shares at the market price, sells the shares to the counterparty to the option contract to close the transaction at the lower strike price, and then they stick you with the losses. So if the share price was $208, you would have a $3 loss per share, or a total loss of $300 for each contract that would cover 100 shares of stock.

Of course stock prices can rise to any value, at least in theory. So you could be getting into real trouble if the stock price rose much higher. The iron condor caps maximum losses by including a second call option, with a higher strike price. You buy this call option, which means you cap possible profits because you have this added expense. But besides limiting possible profits, it will also cap possible losses.
Since you are buying a call option, you can exercise your rights on that option and buy shares of stock at that strike price that you can sell at the higher market price to make up for some of the

loss.

Using our price setup, we could choose $210 as the second strike price. Suppose that the stock price rises to $212. In this situation, the first option with the $205 strike price is going to be exercised. So we have to buy shares at $212 and then sell them to the counterparty of the $205 option at $205 a share, giving us a net loss of $7 a share.

But now we can exercise the second call option that we have purchased. In this case, we buy shares of stock at $210, but then we sell them on the market for $212, giving us a net $2 a share. This helps mitigate the total losses, reducing the total loss to $5 a share, or a total loss of $500. The loss is capped. It’s going to be the difference between the two strike prices chosen for our options.

Now let’s turn our attention to the other side of the trade. This time, we will have two put options. First we set the lower boundary for the iron condor by selling a put option. We can make it any value we want, but to have a nice symmetrical iron condor we will choose a strike price of $195. Generally speaking, a ten dollar range is a very good one to have for an iron condor. The probability of the stock price going outside a range of ten dollars is relatively low, assuming you have correctly picked a low volatility situation.

The options that you sell are the ones that set the boundaries for the iron condor. In this case, we have the call option with a strike price at $205, and a put option with a strike price of $195. That means as long as the stock price stays in between $195 and $205 between the time we sell to open this position and when the options expire, we will earn a profit.

In addition to selling a put option, we will attempt to mitigate risk in the same way that we did with our setup of the call options. This means that we are going to buy a put option with a lower strike price in order to set the final lower boundary for the iron condor. Again, it can be any value, but for the sake of clarity we will put it at the same $5 distance.

Now let’s take a look at what would happen if the stock price went outside the range we have setup to the downside. We have sold a put option with a strike price of $195, and purchased a put option with a strike price of $190. If the share price of the stock falls below $195 but remains above $190, the put option that we sold is can be exercised. When a put option is exercised that means that we will be forced to buy shares of stock at the strike price. So, we have to buy shares at $195 a share even though the price on the market is between $190 and $195, let’s say for the sake of example it’s $192. We then have to sell the shares at the market price. So if we sell the shares for $192, we are out $3 a share for a total loss of $3 a share.

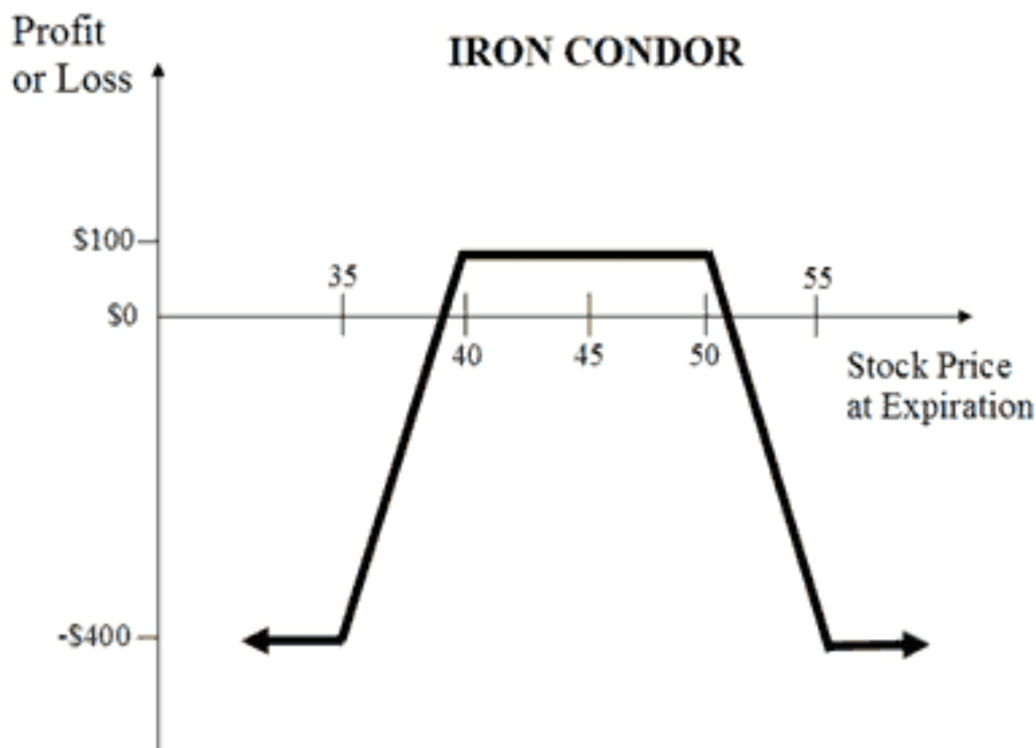
If the stock price kept dropping, we would find ourselves with ever increasing losses. But that is why we buy the second put option, it serves the same purpose as the second call option in mitigating our losses. So if the share price drops to say $170, our losses will be capped at the difference between the strike prices of the two put options. Instead of being forced to sell the shares at the market price of $170 a share, we would be able to exercise the second put option and sell the shares at $190 a share. So we had to buy them at $195 a share even though the market price was $170 a share, but then we are able to sell them to someone else for $190 a share.

I’ve actually simplified the discussion a little bit, because you have to incorporate the net costs of entering the positions. Since you get a credit for entering an iron condor – you sell it to open – this actually mitigates your risk even further. Let’s see what the prices are for each of the options in this case:

- $210 Call Option (BUY): $0.57
- $205 Call Option (SELL): $1.55
- $195 Put Option (SELL): $1.45
- $190 Put Option (BUY): $0.47

The cost of buying the two options is $0.57 + $0.47 = $1.04. But, we receive a credit from selling the other two options of $1.55 + $1.45 = $3. Our net credit is $3-$1.04 = $1.96.

We start out ahead by $1.96. So if we end up losing on the trade because the stock breaks one way or another, our losses which were already capped at $5 are actually reduced by this amount, and so our total possible loss in any situation is $5 - $1.96 = $3.04. That means the maximum possible loss is $304 (for the total of 100 shares) and the maximum profit, which is fixed, is $196. This type of situation is shown in an iron condor graph:



The above example shows an iron condor with inner strike prices of $40 and $50 for a lower priced stock, with a max profit of $100 and max loss of $400.

In the two examples we’ve discussed so far, the losses seem to outstrip the gains. However, that is a deceiving way to look at the trade. With an iron condor, the probability of winning on the trade – provided that you’ve done your homework and picked a stock in a low volatility

situation, means that your probability of winning on the trade is high. The key to succeeding with an iron condor is carefully studying and choosing your trades. Don't just randomly pick a stock and then enter an iron condor.

If the iron condor stays within the range you setup, the options are going to be losing value from time decay as the days pass because all of the options are going to be out of the money. For this reason iron condor traders often say they are making money from time decay.

Buying Back to Close

One strategy people use is they buy back the iron condor to close the position. You can chose to do this or not. The reason you would do it would be if there is a possibility of the stock breaking one way or the other, and then you would be put in a position of having the options that you sold exercised. That means that the counterparty to the transaction would choose to buy or sell the shares of stock. When you sell an option and it's exercised, we say that you have been assigned.

When you are assigned you have an obligation to carry out the terms of the contract, however this all happens automatically in these types of options trades. The broker is going to take care of this for you and so you aren't even going to know what is happening other than seeing the losses that show up in your account.

You can trade iron condors on different time frames. The longer you select for your time frame, the longer you are going to have to wait for either time decay to work well enough for you to buy it back and still make a profit, or for you to let it expire and make the maximum profit.

If you decide to buy it back early, then you can still make a profit but it will be a smaller profit than you could have made. The closer to the expiration date the better. If the stock price is staying within the range, and there isn't any indication that it's going to breakout one way or the other, then it is generally pretty safe to simply let the iron condor expire. Many traders like to play it safe and buy it back with a few days left. At that point, the time decay has whittled down the prices of the options, so buying them back is not going to eat into your profits too much.

Assignment can happen at any time, but its most likely going to happen when the options expire. Many people get misled by statements such as "most options expire worthless". Here is a fact – if you have in the money options that you have sold, and they are allowed to expire – they are going to be exercised. All in the money options that expire are exercised automatically by the broker. In the case of a trade like an iron condor, losses are mitigated. So hopefully you have enough funds in your account to cover any losses.

If you are close to expiration and there is a breakout one way or the other, rather than letting the contracts expire, buy them back. You are going to take losses in that case, but it's better to take limited losses than it is to let the options expire and then get stuck with an even worse situation. The point is buying them back early is more than likely going to mean buying them back, taking some losses, but avoid having the options exercised.

Iron Condor: Summary

So an iron condor is a type of trade that you want to get into when you believe that the underlying stock is not going to see much price movement between the time that you open the position and the expiration date of the options. Although we've talked about each of the four options that are involved in setting up an iron condor as if these are separate trades, you enter an

iron condor in a single trade. All four options will have the same expiration date, but they will have different strike prices as described. You can setup an iron condor for any time frame that you like, but most professional traders tend to go for a 30 or 45 day time frame prior to expiration.

Maximum profit for the iron condor is given by the net credit your receive when opening the position. So it's the sum of the payments you receive for selling the two options with the inner strike prices, minus the amount you pay to buy options with the outer strike prices. The inner strikes set the price boundaries for the iron condor. You have losses if the share price goes outside the boundaries set by the inner strikes at expiration.

Possible losses have to be calculated at both sides of the trade. In our example, we setup an iron condor that was symmetric and so possible losses were the same. For each side of the trade, the maximum possible loss is the difference between the outer strike price and the inner strike price, minus your net credit for selling the iron condor.

There are tradeoffs to be made in setting up iron condors. You can increase the probability of profit, but this will decrease the amount of possible profit you can make. Taking more risk means you can earn more profit. A higher risk scenario means that the range setup by the inner strikes is narrower. However, you can increase your profit margins by selecting wider ranges between the inner and outer strike prices. But that means if the trade turns out to be a losing trade, you can end up losing higher amounts of money.

In most cases, iron condors are going to have possible losses that are larger than maximum possible profit. But the loss is capped, and then probability of profit is higher.
The strategy used by most iron condor traders is to enter trades with smaller profits, and higher probability of profit and then make up for it by entering into a larger number of trades. If you are making $200 per trade and want to make $5,000 a month trading iron condors, then you simply enter into 25 trades a month.

You can do multiple instances of a given trade if you think it has a high probability of success, but you should also use some diversification in your trading strategy. Just like trading calls and puts, trading iron condors is going to have some risk of failure, and you are going to be losing on some of the trades.

Iron Butterfly

An iron butterfly is a different type of trade that also involves four options. This time, you are hoping to hit a specific share price to maximize profits, but the trade can also be setup with a directional bias one way or the other. In the case of an iron butterfly, we modify the iron condor by selling put and call options at the same strike price.

For the iron condor example, we sold a call and put option at inner strike prices of $205 and $195, respectively. Then we bought a call and put option with outer strike prices at $210 and $190 respectively. The setup made a profit if the stock stayed in between the inner strike prices, that is within the range of $195-205.

In the case of an iron butterfly, we would set up the trade as follows. We would sell a call option with a strike price of $200, and also sell a put option with a strike price of $200, and both with

the same expiration date. Then we would set up a range by buying a put option at $195 and buying a call option with a strike price of $205.

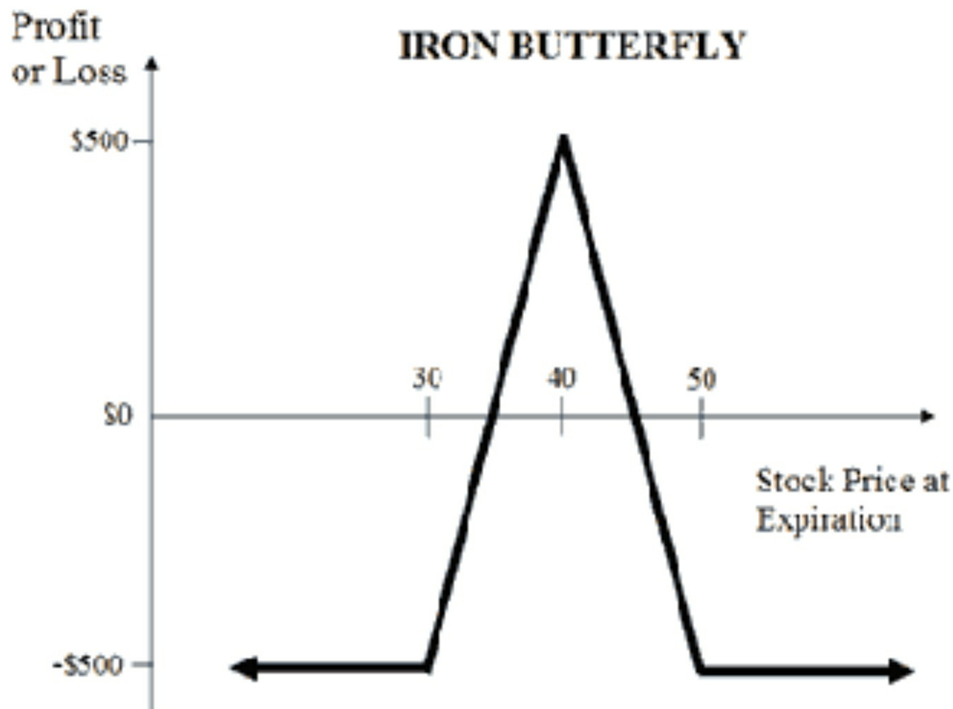
The hope with the iron butterfly is that the stock price stays at or close to $200. This will give us the maximum profits. We can close out the position early if necessary just like with the iron butterfly.

The net credit received for an iron butterfly are the premiums you receive for selling the call and put at the center strike price, minus the premiums paid for buying the outer call and put options.

The maximum loss is going to be the larger of either: the difference between the middle strike price and the lower strike price less the credit received, or the difference between the upper strike price and the middle strike price less the credit received.

In our example, we made it symmetrical and so we can take the middle strike price minus the strike price of the purchased put option, or $200-$195 = $5, and then subtract the net credit received. For the case of a $200 strike price, we would receive a credit of $6.87 per share. The $195 put would cost $1.45, and the $205 call would cost $1.55, so the net credit is ($6.87 - $1.45 - $1.55) x 100 = $387. That would be the maximum possible profit if the share price stayed close to $200.

A graph of an iron butterfly from the options guide on Wikipedia is shown below.



Summary: Profits From Stock Not Moving

The iron condor is a more popular trading strategy, because the iron butterfly relies on the stock

staying basically at the same price, while the iron condor gives the stock a range that it can move about in. An iron condor is a good strategy that can be used to generate regular income. Many traders only trade using iron condors, but you can also mix up iron condor trading with other strategies in order to produce a level of income that you want.

Chapter 7: Trading Breakout Prices Using Strangles and Straddles

In the last chapter, we considered the case of stock prices staying within a certain range. Now we are going to consider the opposite situation, and that would be a stock price breaking out. The stock price can break out to the upside or the downside, it doesn't matter. That is the beauty of options strategies, we can take advantage of price movements without knowing or having to estimate which direction the prices are going to go.

There are two main strategies that are used for this purpose. They are called strangle and straddle. The setups are a little bit different but they accomplish the same purpose. Strangles are more popular.

Before setting up a trade like this, think about the reasons that you would do so. When we setup this type of trade, the reality is that the trade can make a profit from a price movement of increasing stock prices, or a price movement of decreasing prices. So the direction of the price movement is not relevant. The price movement does have to be relatively large, so we are looking for a breakout price movement.

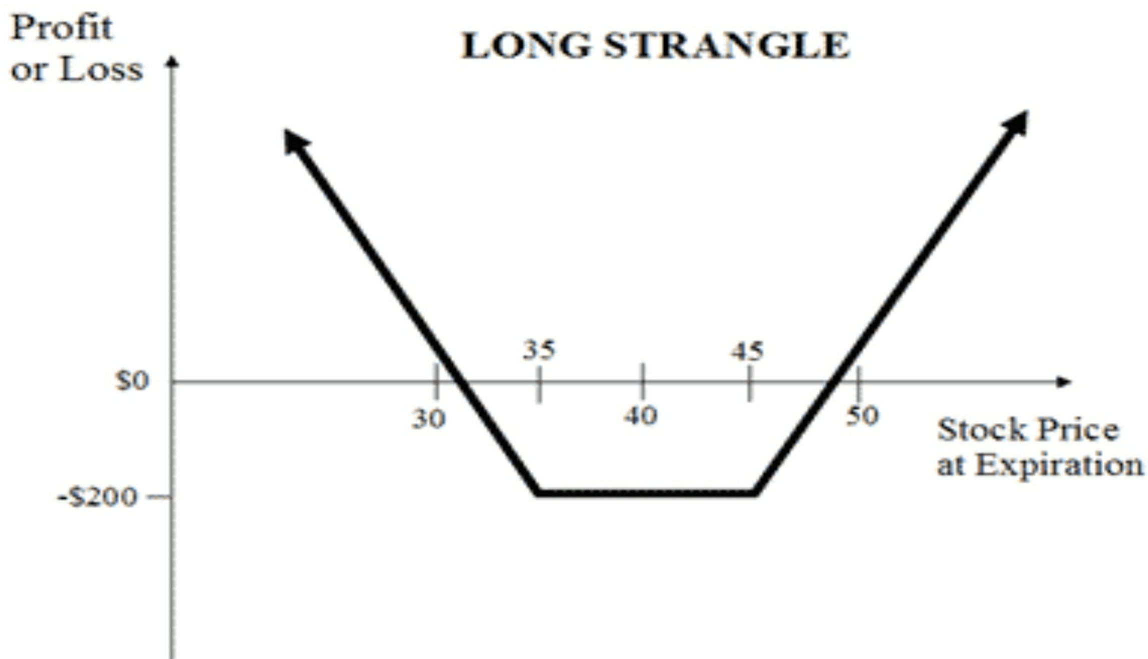
This would indicate that some important news or event is going to be the time to apply this strategy. In fact, there are four times a year you can apply this type of strategy on any stock. That would be when quarterly earnings are reported. Strong breaks in prices are very common after earnings calls. The beauty of these strategies is that we know there are going to be large movements in stock prices after the earnings calls of companies that are popular to trade, however we don't care which direction the stock moves. New productions, product, or service announcements can also lead to large price movements in a stock.

You can also apply these strategies on index funds, which will change dramatically in response to events like interest rate changes, GDP growth announcements, jobs reports, and international or political events. DIA and SPY are two index funds you can use with these strategies.

Strangles and straddles are debits, that is you buy to open these positions and then sell them to close out your position, hopefully at a profit.

Strangle

A strangle is set up by using a call and a put option in order to set a bounded range of stock prices. But unlike the iron condor, the goal in this case is to earn profits when the stock price moves outside the boundary that we have created, rather than profiting when the stock price stays inside of it. As the graph below indicates, we will earn a profit when the stock prices are outside the two boundaries set by a call and a put option. It is less complicated than an iron condor because we will simply buy two options to set up the trade.



The goal here is to earn a profit from a large change in share price that can move either up or down. You buy a call option at one strike price, which forms the upper boundary for the trade. Then you buy a put option at a lower strike price but with the same expiration date, that sets up the lower boundary for the trade.

The profit potential for a strangle is quite large. In theory, the profit potential on the upside is unlimited. Of course in the real world stock prices don't increase without limit. We will look at a specific example to get a handle on potential profits.

So if the stock price breaks to the upside, the put option will expire worthless. You are out the price paid for the put option. If the stock breaks to the downside, then the call option will expire worthless.

The setup has two breakeven points, on each side of the trade. On the upside, the breakeven price is the strike price of the call option plus the total premium paid to buy the two options. On the downside, the breakeven points is the strike price of the put option minus the total premium paid to buy the two options.

So let's say that we have a stock trading at $200 a share, and we are going to setup a strangle before an earnings call. We can buy a call option with a strike price of $202 for $210. We can buy a put option with the same expiration date with a strike price of $198 for $205. So our total cost is $415 to enter the trade.

The breakeven price on the downside is $198 - $2.05 = $195.95. So if the stock price drops, it has to drop at least to $195.95 before we can make a profit. On the upside the breakeven price is $202 + $2.10 = $204.10, and so the stock price has to rise at least to $204.10 before we can start making a profit.

We are assuming that we buy these options 14 days to expiration. Let's say that there is an earnings call in 7 days, and so the price action is going to take place with 6 days to expiration. We will assume that the stock price didn't move very much in the interim.

At 6 days to expiration, if there are no other changes the put option is now valued at $109, and the call option is valued at $1.12. So they have lost quite a bit of value. However, before earnings calls implied volatility tends to go up a lot. So for our exercise, we will assume that implied volatility spikes to 45% before the earnings call. Under these conditions, the call option is now priced at $370, and the put option is priced at $364. That gives us a total of $734. Just based on the volatility we could sell at a profit.

Now let's say the earnings call has some surprises and beats expectations. For a $200 a share stock, a rise in price of $10, $20 or more is not unusual. Let's say that it rises $20 a share overnight. That causes the put option to drop to $16 in value, so its worthless. The call option spikes to $1,810. We can sell it at a massive profit, found by subtracting the cost of entering the trade:

$1810 - $415 = $1,395

Now let's say that instead the earnings call has a lot of bad news, and the stock plummets to $170 a share the following morning. In that case, the put option increases in price to $2,800. This time we make a profit of:

$2800 - $415 = $2,385

So we see from this example that we are able to profit with stock moves in either direction.

What if the stock stays in the range? In that case we will lose money on the trade. The maximum loss incurred will be the price paid to buy the options. If the share price stays in between the two strike prices, both options will expire worthless.

Straddle

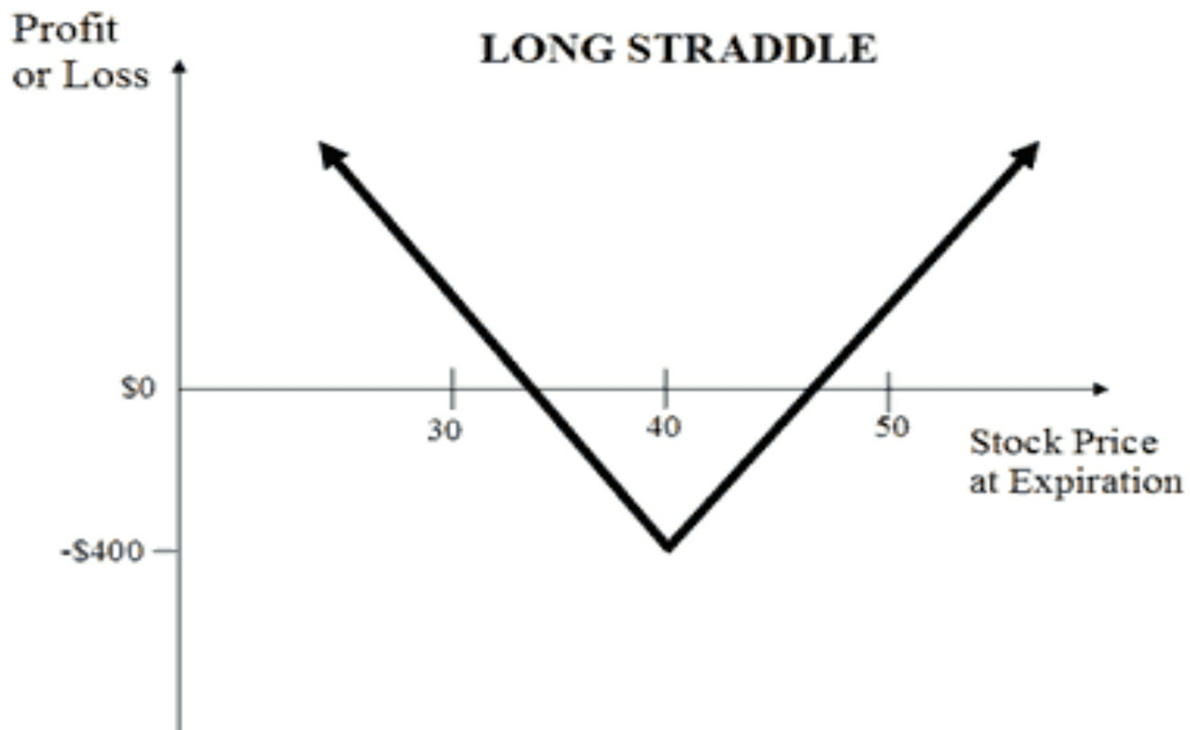
Now we will consider a similar trade that is called a straddle. A straddle is also designed to earn profits from a breakouts to one side or the other. In the case of a straddle, we will buy a call option and a put option, just like we would do with a strangle. In this case, however, we will have the same strike price for both and the same expiration date.

The goal of a straddle is the same, we hope to profit from large price moves, and it doesn't matter which direction the price goes, up or down is fine. If the price moves to the upside, in theory the maximum profit is unlimited. In reality it is going to be a finite value, minus the total cost required to buy both options to enter the position. Like a strangle, this is a net debit, and so you buy to open this position.

To the downside, in theory the stock could lose all of its value, but of course that is a very rare event. But you can still make large profits from significant drops in stock prices, such as after an earnings call.
To the upside, the breakeven price is the strike price plus the total premium paid in order to enter the position. So the stock price has to rise at least this amount in order to start earning profits. On the downside, the breakeven price is the strike price less the total price paid to enter the position.

So if the stock price drops, it has to drop at least by this amount before we start earning profits.

The maximum possible loss would occur if the share price stayed equal to the strike price used. On a graph of profits and losses, the straddle forms a V shape, with the bottom representing the maximum loss at the strike price.



Let's say that we are trading Facebook stock at $186 a share. We buy a call and put option with the at the money $186 strike price with 10 days to expiration. With a high level of volatility, say approaching an earnings call, the prices of each option would be about $429, so the total cost to enter the position would be $858.

Now say with 5 days left to expiration, Facebook announces their earnings. If the earnings call was great news, the stock price could go up, say $15 a share. In that case, the put option expires worthless and the call option rises to $1532 in value, and we earn a profit of:

$1532-$858 = $674

If instead, the news was bad, and the stock dropped $20 a share, the call option would expire worthless and the put option would be priced at $2004. Our total profit would be:

$2004 - $858 = $1,146

Summary: Strangles and Straddles

Strangles and straddles are buy to open positions. You enter into a strangle or a straddle whenever you believe the stock price is going to have a large move in one direction or the other,

but you are not sure which direction the stock is going to move. This position enables you to avoid having to predict the direction of the movement of the stock. If things work out as you thought, with a large break in price to the upside or the downside, then one of the options will expire worthless, however the other option will increase dramatically in price allowing you to earn significant profits on the trade.

Chapter 8: Debit and Credit Spreads

The next options strategies that we are going to look at involve unidirectional trading again. The first strategies that we are going to examine are called debit spreads. You can form a debit spread using either a pair of calls, which you would use if you are hoping to see the stock rise in price, or a pair of puts, used when you expect the stock to drop. These essentially serve the same purpose as trading calls and puts, however they provide mitigated risk strategies.

Next, we will look at credit spreads. Credit spreads are a completely different way of trading, with a purpose of generating income rather than looking for the stock to move in a certain way. You can use put credit spreads if it is expected that the stock will stay above a certain value, or you can use call credit spreads if the stock is expected to stay below a certain value.

Call Debit Spreads

The first strategy we will consider is a call debit spread. In this case you are going to buy a call option and also sell a call option at the same time. They will have the same expiration dates, but different strike prices. Since one strike price is higher than another, this is known as a type of vertical spread, the vertical referring to the different strike prices.

A call option with a price that is closer to the stock price is worth more money, and you are going to buy this option. You are hoping to earn a profit from the lower strike price.

So you would enter a call debit spread for the same reasons that you would buy a call option – you are expecting the stock price to increase before the options expire. The purpose of the call with the higher strike price is to mitigate losses. You will sell that call option.
Selling a call option with a higher strike price will lower the cost required to enter the position. This creates a tradeoff, however, because it will reduce the amount of profit that you can make. Like an iron condor, a call debit spread is a limited risk, and limited reward strategy. The probability of earning a profit is increased and your total risk is limited, but your profits are also capped, unlike with simply trading call options which at least in theory have unlimited profit potential.

The maximum profit you can earn on a call debit spread is found by taking the difference between the two strike prices, and then subtracting the premium paid to enter the position. Maximum profit is attained with a call debit spread if the stock price rises to or above the higher strike price. The difference between this type of trade and simply buying a call is that no matter how high the share price rises above the higher strike price, your profit is fixed.

The maximum loss is the net premium paid to enter the position. Let’s look at some specific numbers to get a better handle on the call debit spread.

Let’s say some stock is trading at $80 a share. We will create a call debit spread by buying a call option with a strike price of $80 and selling a call option with a strike price of $84. We will assume that there are 15 days to expiration.

The call with the $80 strike price is going to cost $123. We sell the call with the $84 strike price, and that brings us a $16 credit, lowering the cost to enter the position to $107. So the maximum profit on a per share basis is:

Difference in strikes – net cost to enter position = $4 - $1.07 = $2.93

Or for 100 shares, our profit will be $293.

The breakeven price for a call debit spread is the strike price of the call we purchase plus the net premium paid. In this case, that would be $80 + $1.07 = $81.07. Profits will gradually increase until we arrive at the $84 strike price, where we get the maximum profit. The maximum profit remains fixed for any higher share price.

Put Debit Spread

If you believe that instead of increasing the stock price is going to drop, but you want to mitigate the potential losses from investing in put options, you can invest using a put debit spread. This works in a similar manner to a call debit spread, but with everything adjusted to the situation of put options.

A put debit spread involves simultaneously buying and selling a put option. We will buy a put option with a given strike price, and then sell a put option with a lower strike price.

The maximum loss that can occur with this trade is the net premium paid, which is the price paid for the higher strike price put less the premium received as a credit for selling the lower strike price put option.

The breakeven point is the higher strike price less the net premium paid.
So if we have a stock trading at $100 a share, and we expect the share price to drop, we can buy a put option with a $100 strike price and sell a put option with a $95 strike price. A put option with a $100 strike price will cost $1.25. A put option with a $95 strike price will net a premium of $0.07, so the total cost to enter the position is $1.18.

The maximum profit is the difference in the strike prices minus the total cost to enter the position, which would be $5 - $1.18 = $3.82.

You can see from these examples that choosing strike prices that are spread out increases the maximum profit that can be made, but at the expense of reducing the mitigation in risk that selling the second option provides.

Put Credit Spreads

In this section we are going to completely change gears. Now we are going to talk about options trading strategies that are designed for the purposes of earning income. Income generating strategies that involve puts and calls without using something like an iron condor can be spreads or they can be traded “naked”. We will be looking at the latter case in the next chapter. In this section we are going to be looking at selling put credit spreads.

When selling a put credit spread, you don’t really care what the stock is doing as long as it doesn’t drop to the level of your strike prices. And so you are looking to sell out of the money put options, and then mitigate your risk by purchasing a put option. This will help limit your losses in the event that the option that you sold is exercised, and the stock price has also dropped below the second strike price.

The way to setup a put credit spread is to sell a put option at a relatively high strike price.

However, the strike price should be such that the put option is out of the money. You don't want to sell an in the money put option – because the put option will be exercised when it expires and you'd have to buy the stock. We are setting up this kind of trade hoping that the option is not going to be exercised.

This is an income generating trade, and so we are going to receive a credit to our account for entering the trade. Then after this, we hope that the price just moves along such that the options expire worthless. So we will hope that the strike price stays above the strike price used for the put option that we sell, but other than that we really don't care what the stock does.

The closer the strike price of a put option is to the market price of the stock, the more it is going to be worth. But that also increases the probability that the option can expire in the money, so some care needs to be used. Many successful traders actually trade put options that are far outside the money, at least a standard deviation. This significantly reduces the probability that they are going to expire in the money. But the downside to that is that you will make less money per trade, and to make an income you would then need to enter into a large number of trades.

The maximum profit earned on a put credit spread is the net premium you receive for entering the position. This is a sell to open position, and you will receive a net credit that is given by the premium received for the higher strike price less the premium paid for the lower strike price.

The maximum loss on the trade is figured from buying and selling shares when the options are exercised. Maximum loss is going to occur when the share price drops below the lower strike price.

Even though you receive a credit for entering into this position, you have to put collateral into your account in order to make the trade. The collateral is enough cash so that you could cover the maximum loss should it occur. Let's look at a couple of real world examples.

Google is trading at $1,229.93 a share. We can setup a put credit spread by selling a put option with a strike price of $1232.50, and buying a put option with a strike price of $1,222.50. The two put options used in a put credit spread will have the same expiration dates. Selling a put option is how you make money on this trade, and you buy the other put option to limit the maximum possible loss, should the stock price drop unexpectedly.

This is another limited-risk, limited-reward type strategy. This strategy has fixed profits and losses when entering the trade.

In the case of Google, the $1232.50 put option is selling at $12.60. So we sell this and receive the premium. The $1222.50 put option is $7.60. The profit that we make on this trade is equal to the difference in prices required to enter the trade, $12.60-$7.60 = $5. So we would earn $500 from this spread, if the share price was at or above the upper strike price at expiration.

Now let's look at possible losses. Suppose that the share price stays below the upper strike price. The breakeven point is the upper strike price minus the premium paid. We are actually thinking of the breakeven price for the buyer, because we want to see at what point they would exercise the option. With a high price like this, $12.50 to buy the put option, the breakeven price is $1232.50 - $12.50 = $1220. So the stock has to drop all the way to $1220 before its even worth

exercising the option.

But let’s say the share price drops low enough so that we hit maximum losses. This occurs when the share price drops below the lower strike price, to say $1210 a share. In that case, the put option we sold will be exercised, meaning that we have to buy shares of stock at the higher strike price of $1232.50. That is a bad scenario for sure, but we can now sell them at the strike price for the other put option, which we had purchased in order to mitigate risks.

Therefore we sell the shares at $1222.50. So right now, we are at a loss of $10 a share, but we received a net credit of $5 a share. Subtracting this from our loss, the total loss on the trade is limited to $5 a share, or $500 in total.

In many cases, it might be more likely that the option gets exercised. If the share price is in between the two strike prices your losses will be lower than if the share price drops below the lower strike price. The function of the lower strike price is to put a cap on the possible losses.

In order to enter into the trade, you would have to make sure that there was enough money in your account to cover possible losses. So in this case, we’d need to have about $500 in our account to act as insurance.

Assuming that you are picking good trades, most of the time you are not going to experience losses on them. So you can use your collateral over and over again when making trades. In this case, you could do weekly repeats of the same trade. Most traders pick around 3-4 stocks that they want to focus on. This approach allows you to get to know the company really well, and so you will be able to have an idea of how the stock moves and make good choices for your strike prices. You could then trade Google every single week, selling put credit spreads that expire every Friday. Using this method you could cobble together a pretty high six figure income using collateral of a few thousand dollars.

Call Credit Spreads

There is another approach which is to use call credit spreads. Under most market conditions, traders prefer to use put credit spreads. But in a bear market, call credit spreads may be more appropriate. With a call credit spread, you are expecting the stock to stay the same or drop in value.

With a call credit spread, you are going to sell a call option with a lower strike price, and buy a call option with a higher strike price. To be successful, you are going to sell your call option that is out of the money, and you are going to hope that the call option will stay out of the money.

If a stock is trading at $200 a share, we could sell a call option with a strike price of $202 with 30 days to expiration for $346. Then we could buy a call option with a strike price of $210 for $114. So when you have a call credit spread, you sell an option with a lower strike price that is out of the money, and then you buy a call option with a higher strike price that is also out of the money.

The profit is fixed, and is equal to the net credit received. For a call option with a lower strike price, you will receive more money than you will pay for a call option with a higher strike price.

The call option that you buy will help you mitigate the risk if the share price rises. Maximum losses will occur if the share price rises above the higher strike price. In that case, you will be assigned and have to sell shares of stock at the lower strike price, but then you can buy share of stock at the higher strike price, and then sell them on the market to recoup some of your losses. The maximum loss is going to be equal to the difference in the strike prices minus the net credit received.

Buying Back to Close

If you sell put or call credit spreads, buying back to close is always a viable strategy to avoid assignment. You want to wait until it is close to expiration. Most options that are exercised are not exercised until they expire, so you can buy back to close and avoid assignment either if the trade has gone bad, meaning that the share price moved in a way against the trade, or you’re fearful of a dramatic move of the share price on expiration day. In the event that you are not concerned about price movements of the stock and your options are out of the money as expiration day approaches, you can let the options expire worthless and in that case you will receive the maximum possible profit on the trade.

Chapter 9: Selling Options

In the previous chapter, and also in the chapter on the iron condor, we explored selling options strategies. These were complicated setups that involve trading multiple options in a single trade, and it can involve buying and selling options simultaneously. Selling individual options is a simpler strategy that can be used, but there are some caveats.

The first way of selling options that we are going to look at are covered options. That is, you cover the trade by either having shares of stock on hand or by having enough cash available to buy 100 shares of stock.

The second way of selling options is so-called "naked" selling. In this case you can sell call and put options that are not backed by anything (but in fact you will need to deposit some cash that will function as collateral).

Naked selling is actually the easiest way to earn money as an options trader that is selling premium for income. However, you are required to open a margin account in order to do naked selling, and you have to deposit at least $2,000 cash in order to do this. To sell enough options to make a good living, you will probably need to put more cash than that. The amount of money required is far less than you would need to actually cover buying shares of stock, but it is still a non-trivial amount of money if you are looking to make a six figure income selling options premium.

Covered Calls

The simplest method of options selling that is known is the covered call. Remember that with a call option, the buyer has the right to buy 100 shares of stock at the strike price. So when you are selling a call option, you have to provide the buyer with those 100 shares of stock if they exercise their rights under the option. In the case of a covered call, you already own the 100 shares of stock, and you are selling call options against the stock that you own.

If you already own shares of stock, this can be a way to generate income. You can sell call options on a monthly or even weekly basis, and pocket the income if you are managing to sell the options with out of the money strike prices, that remain out of the money. Keep in mind that the breakeven price is what matters, and so if you are selling options with a $100 strike price that cost $2, the share price must rise above $102 before anyone is going to exercise the option.

The idea is to be able to repeatedly sell call options against the stock so that you can generate an income from your activities.

In the event that the share price does move high, you can try buying the call options back before expiration. With American style options, they can be exercised on or before the expiration date, so in theory your options could be exercised at any time when the share price moves to breakeven price or higher. The higher the price goes, the more incentive a buyer has to buy the shares of stock. However, studies show that in most cases options are not exercised until expiration. That gives you an opportunity to get out of the trade and hold onto your shares of stock, so that you can sell better call options against them the following week.

If things are going well, you can use the same strategy that is used with credit spreads.

Some traders will buy the options back to close the trade just in case there is a dramatic move of the stock on expiration day. In that case, the options will be cheap (assuming that they are still out of the money) because they have lost their extrinsic value. However, if you feel like there is little risk of a dramatic move in share price, you can hold onto the options contracts so that you will earn maximum possible profits.

Protected Puts

A protected put is a put option you sell while putting enough funds in your account in order to cover buying the shares of stock at the strike price should the option be exercised. A protected put is not a great strategy. In the case of covered calls, we are assuming it's a viable strategy because you are someone who already owns the shares of stock. In that case, you might as well leverage that stock in order to make some income.

But in the case of protected puts, it's not clear that this would be the best possible use of your funds if you have that much money available. Putting up enough money to buy 100 shares of stock can be a substantial sum if we are talking about stocks that have decent share prices. With that much money, you could buy many options, buy shares of stock or use the money for collateral to enter into probably several more trades selling naked puts. The protected put is not a strategy that makes very much sense.

Selling Naked Put Options

Selling naked put options is the most popular income generating strategy that is used in options trading. It turns out that there is a great deal of misinformation about naked put selling. Many financial advisors claim that naked put selling is very risky. In fact it's a pretty simple trading strategy.

It is related to the put credit spread, so you can think of a put credit spread as a risk managed version of this strategy. In the case of a put credit spread, we sold a put option for profit, and then purchased a put option to mitigate possible risk in the case of assignment.

In the case of a naked put option, you are eliminating the purchase of a put option, and you are only going to sell one put option. It really isn't risky, because you can buy the contract back at any time to close the trade.
You begin selling your naked put options by carefully choosing a put option that is far outside the money. Many traders recommend selling one standard deviation below the share price. While it can happen at times, in the majority of cases stock prices are not going to move that much over the lifetime of the options contract.

You can also simply look at probabilities. The closer the strike price is to the share price, the more credit you are going to receive selling the put option. However, the risk that your put option could expire in the money is higher. You can look at delta to get an estimate of the probability that your put option is going to expire in the money, or you can look at the probabilities that your broker has calculated for each option.

It is generally considered safe to sell put options that have a 70% or higher probability of profit.

Keep in mind that if there is a chance that the stock is going to move a lot, you should sit on the sidelines. A good time to sit on the sidelines is immediately after earnings calls, or if there is major event that disrupts the markets.

Otherwise, put options are completely safe to sell.

Brokers will use a formula to determine how much cash that you need to deposit. The amount of cash required is going to be far less than that which would be required to cover buying 100 shares of stock. There are different formulas that are used, and you should check with your broker for the specific formula that they use. This formula is the margin requirement.

In a margin account, margin is the amount of cash that you are required to deposit. A margin account allows you to use leverage. For example, with stock, you can use 2:1 leverage to buy shares of stock. So if you want to buy $20,000 worth of stock, you can put up $10,000 and borrow $10,000 from your broker. In short, when it comes to options trading you have to put up a certain amount of margin – that is deposit a fixed amount of cash, in order to enter into a trade.

Let’s say that you were selling a $1225 strike on Google, with shares trading at $1229.50. With an option price of $17 (for a total credit of $1700), you’d have to put up $24,000 in margin.

That is a fraction of the amount you’d need for a protected put on the same trade. For the protected put, you’d have to completely cover the cost of buying 100 shares, and so you’d need to deposit $122,500 into your account.

However, even $24,000 is a lot of money for many people to risk. If that is the case, but you want to get to a point where you are selling naked put options, what you should do is sell put credit spreads in the meantime. The amount of money required to deposit for put credit spreads if much smaller, as we discussed in the previous chapter. So what you can do in that case is trade and buildup your account size until it gets to where it needs to go.

Many people get rich selling naked put options. You can do it too, provided that you are following a careful strategy that involves carefully picking your strike prices, paying attention to the markets throughout the day, and closing your positions when necessary. Avoid picking strike prices that are too near to being in the money.

Selling Naked Calls

Under normal circumstances, traders prefer selling naked put options. However, in a bear market, selling naked call options could be the way to go. You want to be selling call options when you believe that the stock is going to stay at or below the strike price that you select. Obviously you can do this type of trade any time, if there is a share price that you don’t believe the stock is going to reach. However, the strategy is best in a bear market of dropping prices.

Selling naked calls is going to require a margin account, just like selling naked puts. There are also going to be specific margin requirements on each option depending on the share price of the underlying stock and the price of the option, as well as the strike price that is used.

When selling naked calls, you are not required to buy the shares of stock ahead of time, in the way that a covered call is setup. So this is a case of having some cash on hand, but not owning the shares. The amount of cash is going to be small in comparison to the amount that would be required in order to buy the shares of stock.
The biggest risk with selling naked options is assignment. To avoid assignment in the case of naked calls, you would use the closing strategy if it becomes necessary. So in this case, what you would be watching out for is the case of rising share prices that could put you in a position of

having to sell the shares of stock. If that happens, you can buy your options back to close your position. Once again, this strategy relies on the fact that while an option can be exercised on or before the expiration date, in most cases they are not exercised until expiration.

Conclusion

Thank you for making it through to the end of *Options Trading Crash Course*, let's hope it was informative and able to provide you with all of the tools you need to achieve your goals whatever they may be.

The next step is to continue your education in options trading and open a brokerage account, and start trading. Start trading in small amounts and work your way up, so that you are not taking reckless risks, but instead building up experience and a sustainable business that can help you reach a zone where you are able to live a life of financial independence. Be sure to read my other books on stock trading, so you can learn about your other possibilities when it comes to trading and investing in the stock market and beyond. Thanks again!

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