The Bible of Options Strategies
The Bible of Options Strategies

The Definitive Guide for Practical Trading Strategies

Guy Cohen
To Dominic and Lulu, who keep reminding me of their omission from the Acknowledgments of my first book!
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Find Your Strategy
By Proficiency

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Find Your Strategy
By Direction

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Find Your Strategy
By Volatility

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Find Your Strategy
By Risk / Reward

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The following strategies offer an uncapped reward potential:

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# Find Your Strategy
## By Type

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Preface

How to Use This Book

Options give investors so much flexibility that when it came to writing a book named *The Bible of Options Strategies*, I found myself cursing just how flexible they can be! Sixty strategies is a lot of ground to cover, but in reviewing them all again (I’ve done it several times already!), I was reminded of the beauty of these amazing trading instruments.

Options give us the ability to do so many things—they enable us to configure our investment aims in any way we like. The benefits of options are often trotted out to new students or prospective customers as the first salvo of an up-sell campaign, but they’re worth looking at again, this time from a *practical* point of view.

Options enable us to:

- **Control more assets for less money.**

  One option contract represents 100 shares of stock and is usually a fraction of the cost of what you’d pay for the equivalent number of shares.

  For example, ABCD stock is priced at $26.20 on June 2, 2004.

  An option to *buy* ABCD shares (a call option) might be priced at $2.60. Because one contract represents 100 shares, we can therefore buy one ABCD call contract for $260.00 [100 * 2.60]. The alternative would be to buy 100 shares of the stock for a total sum of $2,620. So, in this example, we can buy ABCD calls options for around 10% of the stock price in order to control $2,620 of ABCD stock until the appropriate expiration date of the option.

- **Trade with leverage.**

  Because our cost basis is so low, the position is much more sensitive to the underlying stock’s price movements, and hence our percentage returns can be so much greater.

- **Trade for income.**

  We can design strategies specifically for the purpose of generating income on a regular basis.
Profit from declining stocks.

We can use puts and calls to ensure that we can make money if the stock goes up, down, or sideways.

Profit from volatility or protection against various factors.

Different options strategies protect us or enable us to benefit from factors such as time decay, volatility, lack of volatility, and more.

Reduce or eliminate risk.

Options enable us to substantially reduce our risk of trading, and in certain rare cases, we can even eliminate risk altogether, albeit with the trade-off of very limited profit potential!

So, with all the different benefits of options, why on earth would traders not be curious to learn more about them? Well, for a start, the initial barrier to entry is quite high, in that options are reasonably complex instruments to understand for the first time. After you’re over that hurdle, though, they become more and more fascinating! The other reason is that there is such a multitude of other investment securities for people to choose from, many will pick what seems like the simplest, rather than what may fit their investment aims the best.

Given that options can be a challenge, it’s my job to make life as simple as possible for you. One of the ways in which I do this is to break things down into pictures so we can see what we’re doing. As soon as we can see what we’re doing, life becomes much clearer when you’re creating options strategies. Everything to do with OptionEasy and all my material is designed to be visual-friendly. This goes back to when I started to learn all about options and the fact that the penny only started to drop when I converted the concepts into pictures. All of a sudden, everything fit into place, and I started to be able to extend logic faster and further than before.

This book is designed to be a reference book, one that you can pick up any time to learn about and understand a strategy. It isn’t an academic workbook. It’s a practical book, written for traders, designed to work interactively with your trading activities. As the title suggests, it’s a book about options strategies, of which we take on 58! That’s not to say you need to learn about each and every one of them, but at least you have the choice!

In order to make life easier for you, we categorize the strategies into different descriptions for the following criteria:

Proficiency Level

Each strategy is assigned a “value” in term of its suitability for different levels of trader. Each level is given an associated icon.

- ⚡ Strategies suitable for novices
- ⚡ Strategies suitable for intermediates
Strategies suitable for advanced traders

Strategies suitable for expert traders

The allocations are defined according to a subjective view of complexity, risk, and desirability of the strategy. Therefore, some highly risky and undesirable strategies have been put into the Expert basket in order to warn novices and intermediates away. Also Novice strategies are not exclusive to novice traders. It’s simply a question of suitability, and novice strategies are highly relevant and suitable to all levels of trader.

In some cases, the strategy is not complex at all but is considered unacceptably risky for novice and intermediate traders (at least without a warning). I have tried to be objective here, but I’m mindful not just of my own experiences but also the many students who regularly show me their trading disasters! Conservative by nature, I’m a believer that loss of opportunity is preferable to loss of capital (Joe DiNapoli), and perhaps some of these rankings bear testimony to this philosophy.

Market Outlook

This is where we define whether a strategy is suitable to bullish, bearish, or direction neutral outlooks.

Strategies suitable for bullish market conditions

Strategies suitable for bearish market conditions

Strategies suitable for sideways market conditions

Volatility

Volatility is one of the most important factors affecting option pricing and therefore option trading. You really should familiarize yourself with the concept, which, forgive the plug, is dealt with in my first book, Options Made Easy.

Here, we define whether a strategy is suitable for trades anticipating high volatility or low volatility in the markets. Some strategies, such as Straddles, require high volatility after you’ve placed the trade, so a Straddle would fall into the High Volatility category.

Strategies suitable for high volatility markets

Strategies suitable for low volatility markets

Risk

With any trade you’re looking to make, you must be aware of your potential risk, reward, and breakeven point(s).

Some strategies have unlimited risk; others have limited risk, even if that “limited” risk means 100% of the trade. Believe it or not, sometimes with options it’s possible to lose more than 100%. In such cases, or when there is no definable stop to the potential risk of a trade, you’re well advised to be aware of such a position in advance!
Here, we show you which strategies have capped or uncapped risk. Strategies with uncapped risk aren’t necessarily all bad, but you should at least be aware of what you are getting into. Often you can mitigate such risk with a simple stop loss provision, in which case you’re not going to be liable to uncapped risk. Often, such uncapped risk scenarios only occur if the stock falls to zero or rises to infinity, which mostly are rare circumstances, but you’re better off being aware!

- Strategies with capped risk
- Strategies with uncapped risk

**Reward**

Following the risk scenarios described previously, the strategies also have potential reward scenarios, too.

Just because a strategy has unlimited reward potential doesn’t mean that it’s necessarily a great strategy, and just because it may have capped reward doesn’t mean it’s necessarily a bad strategy.

- Strategies with capped reward
- Strategies with uncapped reward

**Strategy Type**

Strategies can be used for income purposes (usually short-term) or to make capital gains. Many traders like the Covered Call because it’s suitable for novices and because it’s an income strategy that they can use every month.

- Income strategies
- Capital gain strategies

**Strategy Legs**

Each strategy contains different legs. Some have just one, and others have up to four. Each leg must be composed of any one of the basic four option strategies (long or short call or put) or a long or short stock position. Here’s how we identify them:

- Long stock
- Short stock
- Long call
- Short call
- Long put
- Short put

All strategies contain real-life examples at the end of each guide.
Chapter by Chapter

In terms of structure, I’ve tried to make this book as easily navigable as possible, and much of that is solved by matrix-style tables of contents.

Each chapter contains strategies that are commensurate with a specific style of options trading. Inevitably there’s some overlap between chapters for certain strategies, which we address in the appropriate places.

Chapter 1 addresses the basic strategies, including buying and selling stocks and then buying and selling calls and puts. After you understand those cornerstones and how the pictures relate to each strategy, then you can fast-forward to any part of the book and any strategy you like. All strategy guides are modular and follow the same format, so that you can become familiar with the style and structure of the content.

Chapter 2 is all about income strategies. An income strategy is when you’re effectively a net seller of short-term options, which generates (monthly) income. You have to be careful, though, not to expose yourself to unlimited risk scenarios, which is why we use icons to identify excess risk.

In Chapter 3, we cover “vertical spreads.” A vertical spread is where we buy and sell the same numbers of the same options (calls or puts) but with different strike prices. Obviously, there’s some overlap here with other chapters, which is why the chapter is comparatively small.

Chapter 4 goes into volatility strategies and is bound to be as popular as the income strategies chapter! Here we address those strategies that benefit from increasing volatility after you’ve placed the trade.

In Chapter 5, we reverse this and explore those strategies that benefit from decreasing volatility after you’ve placed the trade. So here we’re looking for stocks that we think will be rangebound for some time. Typically these are short-term strategies.

Chapter 6 identifies the ratio spreads and backspreads, where you’re using increasing leverage to increase your returns. These are for advanced and experienced traders only!

In Chapter 7, we look at synthetic strategies that mainly mimic other strategic goals, using a combination of stock legs, call legs, and put legs. For example, we can replicate owning a stock purely by buying and selling calls and puts in such a way that we hardly pay any cash out. In other words, we’ve simulated the risk of owning the stock, but with no cash outlay. We can also synthetically re-create straddle positions and other strategies.

Lastly, in Chapter 8, we investigate some of the taxation issues that will confront you during your trading careers. This is not a definitive tax guide but rather more a flag raiser.
Strategy by Strategy

Each strategy is presented in a modular format. In this way, the book should be easy to navigate. The modules are numbered, and the numbering system applies throughout each chapter and each strategy:

- The first number refers to the chapter itself. So, all headings in Chapter 2 will start with “2.”
- The second number refers to the strategy in question. So, 2.1 refers to the first strategy (Covered Call) in Chapter 2.
- The third number refers to the module. So, 2.1.1 refers to the “Description” module for the first strategy (Covered Call) in Chapter 2. Because the modules are identical throughout the book, each module number is the same throughout all the strategies. Therefore, module “1,” which appears as the third decimal place, is always “Description.” The modules are outlined as follows:

  - x.y.1 Description
    Here, we describe the strategy in both words and pictures. We identify the steps for each leg and some general comments about what the overall position will mean to you.

  - x.y.2 Context
    This section describes the outlook and rationale for the strategy. We also highlight the net position in your account as a result of the trade as well as identify the effect of time decay and the appropriate time period for the strategy. Stock and option-leg selection are important elements of any trade, so these are covered as well.

  - x.y.3 Risk Profile
    This section provides, where possible, simple calculations for you to evaluate the risk, reward, and breakeven points for each strategy.

  - x.y.4 Greeks
    This is where we graphically explain each of the “Greeks.” The Greeks are simply sensitivities of options to various factors, such as price movement, time decay, volatility, and interest rates. The Greeks are as follows:

    Delta:
    The movement of the option position relative to the movement of the underlying (say, stock) position. The resulting figure gives us an indication of the speed at which the option position is moving relative to the underlying stock position. Therefore, a Delta of 1 means the option position is moving 1 point for every point the stock moves. A Delta of –1 means the option position is moving –1 point for every point the underlying stock moves.
Typically, at-the-money options move with a Delta of 0.5 for calls and –0.5 for puts, meaning that ATM options move half a point for every 1 point that the underlying asset moves. This does not mean the option leg is moving slower in percentage terms, just in terms of dollar for dollar.

Delta is another way of expressing the probability of an option expiring in-the-money. This makes sense because an ATM call option has a Delta of 0.5; i.e., 50%, meaning a 50% chance of expiring ITM. A deep ITM call will have a Delta of near 1, or 100%, meaning a near 100% chance of expiration ITM. A very out-of-the-money call option will have a Delta of close to zero, meaning a near zero chance of expiring ITM.

So, Delta can be interpreted both in terms of the speed of the position and the probability of an option expiring ITM. Some advanced traders like to trade with the sum of their portfolio Delta at zero, otherwise known as Delta-Neutral trading. This is by no means a risk-free method of trading, but it is a style that enables profits to be taken regardless of the direction of market movement. However, this is only really suited to professional-style traders who have the very best technology solutions and a lot of experience.

Gamma:

Gamma is mathematically the second derivative of the underlying asset’s price, or the first derivative of Delta, and can be viewed in two ways: either as the acceleration of the option position relative to the underlying stock price, or as the odds of a change in probability of the position expiring ITM (in other words, the odds of a change in Delta). Gamma is effectively an early warning to the fact that Delta could be about to change. Both calls and puts have positive Gammas. Typically, deep OTM and deep ITM options have near zero Gamma because the odds of a change in Delta are very low. Logically, Gamma tends to peak around the strike price.

Theta:

Theta stands for the option position’s sensitivity to time decay. Long options (i.e., options that you have bought) have negative Theta, meaning that every day you own that option, time decay is eroding the Time Value portion of the option’s value. In other words, time decay is hurting the position of an option holder. When you short options, Theta is positive, indicating that time decay is helping the option writer’s position.

Vega:

Vega stands for the option position’s sensitivity to volatility. Options tend to increase in value when the underlying stock’s volatility increases. So, volatility helps the owner of an option and hurts the writer of an option. Vega is positive for long option positions and negative for short option positions.

Rho:

Rho stands for the option position’s sensitivity to interest rates. A positive Rho means that higher interest rates are helping the position, and a negative Rho
means that higher interest rates are hurting the position. Rho is the least important of all the Greeks as far as stock options are concerned.

- x.y.5 Advantages and Disadvantages
  
  As indicated, this section highlights the strengths and weaknesses of the strategy in question and the context of suitability for the trader.

- x.y.6 Exiting the Trade
  
  This module indicates the steps required to exit the position or to mitigate a loss.

- x.y.7 Example
  
  Every strategy ends with an illustrated example. The examples are all taken from real stocks using real data. However, because they are intended to be objectively indicative of how the strategies work, I have renamed the stock “ABCD” for every example. This helps us keep our minds focused on the structure of the strategy and avoid any preconceived prejudices against the actual stocks that were selected.

Tables of Contents

With so many strategies to choose from, it’s crucial that you don’t get lost! The multi-tables of contents are designed so that you can find the appropriate strategy easily, without having to thumb your way through the entire book to get there first. Familiarize yourself with this area because it’s going to save you a lot of time as you use it later on. In print, we’re restricted to two dimensions, but on the web site, you can use the Strategy Matrix completely interactively.

Free Software for Analyzing Strategies

You can use the free Strategy Analyzers on www.optioneasy.com to analyze any strategy in this book. The dynamic Analyzers help you see the impact of changing any parameters (such as time decay and volatility) in a user-friendly and visual form. Creating these Analyzers enabled me to hone my expertise with numerous options strategies in a very quick time, and will do the same for you.

General Comments

Within the strategy modules, there are references to concepts and definitions that you’ll be able to find in the Glossary. For example, “Trading Plan” is referred to throughout the guides and is defined in the Glossary.

As options traders, we should definitely acquaint ourselves with the concepts of fundamental and technical analysis. Fundamental analysis involves the interpretation of how economies, sectors, and individual corporations are performing in terms of assets, liabilities, revenues, and profits.

Technical analysis involves the interpretation of price charts for securities. We really should understand the basic chart patterns such as pennants, flags, head and shoulders, support, resistance, and Fibonacci retracements. Remember, an option is a derivative—it is derived from an underlying security. Therefore, it makes sense for us to understand how that underlying security is likely to move and why.
I hope you enjoy this reference book and use it for many years to come. By all means, read it from cover to cover, but you’ll probably get the best value by dipping in whenever the need arises.

Good luck.

Guy Cohen

Acknowledgments

First, to my colleagues at FlagTrader, whose diligence and ability have enabled us to create institutional grade tools.

To Lulu and Dominic for being extraordinary family friends.

And finally, to the students who have attended my workshops. I have learned so much from you.
About the Author

Guy Cohen BSc ARIC MBA, is developer of OptionEasy, the world’s most comprehensive and user-friendly online options trading and training application. A successful private investor and trader, Guy has developed a global reputation for teaching technical analysis, options strategies, and trading psychology.

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For more information, go to www.optioneasy.com.
For all inquiries, write to enquiries@optioneasy.com.
The Four Basic Options Strategies

Introduction

The easiest way to learn options is with pictures so that you can begin to piece together strategies step-by-step. However, first we need to understand the four basic strategies. From that point, logic kicks in, and our learning can progress exponentially.

A risk profile chart shows us our profit/loss position for each trade. It differs from a standard price/time chart that we’re used to seeing to monitor stock prices.

There are four easy steps to creating a risk profile chart:

Step 1: Y axis for profit/loss position
Step 2: X axis for underlying asset price range

Step 3: Breakeven line

Step 4: Risk Profile line
This chart shows our risk profile for a long stock position. As the asset price rises above our purchase price (along the x-axis), we move into profit. Our risk is capped to what we paid, as is our breakeven point, and our potential reward is uncapped.

The reverse position is when we short a stock, in which case the opposite occurs. Here, as the stock price rises above our short price, our short position shows a loss, which can be unlimited as the stock continues to rise. Our risk is uncapped as the stock rises, and our potential reward is the price we shorted at, as is our breakeven point.

Now that we know how to interpret a risk profile chart, we can proceed with analyzing each strategy.

The four basic strategies that underpin your entire options trading knowledge are:

- Long Call
- Short Call
- Long Put
- Short Put

We should already know that owning an option exposes us to time decay, so typically we like to own options with expiration dates that are reasonably far away to give us a chance of our option increasing in value.

With options, we have the “Rule of the Opposites,” where if one thing isn’t true, then the opposite must be true. Therefore, if time decay hurts us when we buy options, it must help us when we sell options. Because time value decreases (or time decay increases) exponentially during the last month to expiration, we typically don’t like to own options into that last month, but we do like to sell options with one month left to expiration.

With these four strategies, we would buy calls and puts with at least three months (or more) left to expiration, thereby looking for the options to increase in value during that time.

We would short calls and puts with a month or less to expiration, thereby looking for short-term income as the option hopefully expires worthless.
The Four Basic Options Risk Profiles

Imagine that the dotted lines are mirrors and see how each strategy is the opposite of the one on the other side of the mirror.

**Buying a Call**
- Belief that stock will rise (bullish outlook)
- Risk limited to premium paid
- Unlimited maximum reward

**Buying a Put**
- Belief that stock will fall (bearish outlook)
- Risk limited to premium paid
- Unlimited maximum reward up to the strike price less the premium paid

**Writing a Call**
- Belief that stock will fall (bearish outlook)
- Maximum reward limited to premium received
- Risk potentially unlimited (as stock price rises)
- Can be combined with another position to limit the risk

**Writing a Put**
- Belief that stock will rise (bullish outlook)
- Risk "unlimited" to a maximum equating to the strike price less the premium received
- Maximum reward limited to the premium received
- Can be combined with another position to limit the risk
1.1 Long Call

<table>
<thead>
<tr>
<th>Proficiency</th>
<th>Direction</th>
<th>Volatility</th>
<th>Asset Legs</th>
<th>Max Risk</th>
<th>Max Reward</th>
<th>Strategy Type</th>
</tr>
</thead>
<tbody>
<tr>
<td>Novice</td>
<td>Bullish</td>
<td>N/A</td>
<td>Long Call</td>
<td>Capped</td>
<td>Uncapped</td>
<td>Capital Gain</td>
</tr>
</tbody>
</table>

1.1.1 Description

Buying a call is the most basic of all option strategies. For many people, it constitutes their first options trade after gaining experience buying and selling stocks.

Calls are easy to understand. A call is an option to buy, so it stands to reason that when you buy a call, you’re hoping that the underlying share price will rise.

<table>
<thead>
<tr>
<th>ITM</th>
<th>In the Money</th>
<th>stock &gt; call strike price</th>
</tr>
</thead>
<tbody>
<tr>
<td>ATM</td>
<td>At the Money</td>
<td>stock = call strike price</td>
</tr>
<tr>
<td>OTM</td>
<td>Out of the Money</td>
<td>stock &lt; call strike price</td>
</tr>
</tbody>
</table>

Buy call

Steps to Trading a Long Call

1. Buy the call option.
   - Remember that for option contracts in the U.S., one contract is for 100 shares. So when you see a price of $1.00 for a call, you will have to pay $100 for one contract.
   - For S&P Futures options, one contract is exercisable into one futures contract. If the option price is $1.00, you will pay $250 for one futures contract upon exercise.

Steps In
   - Try to ensure that the trend is upward and identify a clear area of support.

Steps Out
   - Manage your position according to the rules defined in your Trading Plan.
   - Sell your long options before the final month before expiration if you want to avoid the effects of time decay.
   - If the stock falls below your stop loss, then exit by selling the calls.
1.1.2 Context

Outlook

- With a Long Call, your outlook is **bullish**. You expect a rise in the underlying asset price.

Rationale

- To make a better return than if you had simply bought the stock itself. Do ensure that you give yourself enough time to be right; this means you should go at least six months out, if not one- or two-year LEAPs. If you think these are expensive, then simply divide the price by the number of months left to expiration and then compare that to shorter-term option prices. You will see that LEAPs and longer-term options are far better value on a per month basis, and they give you more time to be right, thus improving your chances of success. Another method is to buy only shorter-term deep ITM options.

Net Position

- This is a **net debit** transaction because you pay for the call option.
- Your maximum risk is capped to the price you pay for the call.
- Your maximum reward is uncapped.

Effect of Time Decay

- Time decay works against your bought option, so give yourself plenty of time to be right.
- Don’t be fooled by the false economy that shorter options are cheaper. Compare a one-month option to a 12-month option and divide the longer option price by 12. You will see that you are paying far less per month for the 12-month option.

Appropriate Time Period to Trade

- At least three months, preferably longer, depending on the particular circumstances.

Selecting the Stock

- Choose from stocks with adequate liquidity, preferably over 500,000 Average Daily Volume (ADV).
- Try to ensure that the trend is upward and identify a clear area of support.
Selecting the Option

- Choose options with adequate liquidity; open interest should be at least 100, preferably 500.
- **Strike**—Look for either the ATM or ITM (lower) strike below the current stock.
- **Expiration**—Give yourself enough time to be right; remember that time decay accelerates exponentially in the last month before expiration, so give yourself a minimum of three months to be right, knowing you’ll never hold into the last month. That gives you at least two months before you’ll need to sell. Longer would be better, though.

1.1.3 Risk Profile

- **Maximum Risk** [Call premium]
- **Maximum Reward** [Uncapped]
- **Breakeven** [Call strike + call premium]

1.1.4 Greeks

**Risk Profile**
As the stock price rises, the long call moves into profit more and more quickly, particularly when the stock price is greater than the strike price.

**Delta**
Delta (speed) is positive and increases at its fastest rate around the strike price, until it reaches 1. Notice how Delta is zero when the option is deep OTM.

**Gamma**
Gamma (acceleration) is always positive with a long call, and it peaks when Delta is at its fastest (steepest) rate.

**Theta**
Theta is negative, illustrating that time decay hurts the long call position.

**Vega**
Vega is positive, illustrating that volatility is helpful to the position because higher volatility translates into higher option values.

**Rho**
Rho is positive, illustrating that higher interest rates would increase the value of the calls and therefore help the position.
1.1.5 Advantages and Disadvantages

**Advantages**
- Cheaper than buying the stock outright.
- Far greater leverage than simply owning the stock.
- Uncapped profit potential with capped risk.

**Disadvantages**
- Potential 100% loss if the strike price, expiration dates, and stock are badly chosen.
- High leverage can be dangerous if the stock price moves against you.

1.1.6 Exiting the Trade

**Exiting the Position**
- Sell the calls you bought!

**Mitigating a Loss**
- Use the underlying asset or stock to determine where your stop loss should be placed.

1.1.7 Example

ABCD is trading at $28.88 on February 19, 2004.

Buy the January 2005 $27.50 strike call for $4.38.

<table>
<thead>
<tr>
<th>You Pay</th>
<th>Call premium</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$4.38</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Maximum Risk</th>
<th>Call premium</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$4.38</td>
</tr>
<tr>
<td></td>
<td>Maximum risk is 100% of our total cost here</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Maximum Reward</th>
<th>Unlimited as the stock price rises</th>
</tr>
</thead>
<tbody>
<tr>
<td>Breakeven</td>
<td>Strike price + call premium</td>
</tr>
<tr>
<td></td>
<td>$27.50 + $4.38 = $31.88</td>
</tr>
</tbody>
</table>
1.2 Short (Naked) Call

<table>
<thead>
<tr>
<th>Proficiency</th>
<th>Direction</th>
<th>Volatility</th>
<th>Asset Legs</th>
<th>Max Risk</th>
<th>Max Reward</th>
<th>Strategy Type</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advanced</td>
<td>Bearish</td>
<td>N/A</td>
<td>Short Call</td>
<td>Uncapped</td>
<td>Capped</td>
<td>Income</td>
</tr>
</tbody>
</table>

1.2.1 Description

Although simple to execute, shorting a call (without any form of cover) is a risky strategy, hence its categorization as an advanced strategy. A Short Call exposes us to uncapped risk if the stock rises meteorically, and brokers will only allow experienced options traders to trade the strategy in the first place.

A call is an option to buy, so it stands to reason that when you buy a call, you’re hoping that the underlying share price will rise. If you’re selling or shorting a call, it’s therefore logical that you’d want the stock to do the opposite—fall.

Sell call

Steps to Trading a Short Call

1. Sell the call option with a strike price higher than the current stock price.
   - Remember that for option contracts in the U.S., one contract is for 100 shares. So when you see a price of $1.00 for a call, you will receive $100 for one contract.

   **Steps In**
   - Try to ensure that the trend is downward or rangebound and identify a clear area of resistance.

   **Steps Out**
   - Manage your position according to the rules defined in your Trading Plan.
   - Hopefully the stock will decline or remain static, allowing your sold option to expire worthless so you can keep the entire premium.
   - If the stock rises above your stop loss, then exit the position by buying back the calls.
   - Time decay will be eroding the value of your call every day, so all other things being equal, the call you sold will be declining in value every day, allowing you to buy it back for less than you bought it for, unless the underlying stock has risen of course.
1.2.2 Context

Outlook

- **Bearish**—You are expecting a **fall** in the stock price; you are certainly **not** expecting a rise in the stock.

Rationale

- To pick up short-term premium income as the stock develops price weakness.

Net Position

- This is a **net credit** transaction because you are receiving a premium for the call.
- Your maximum risk is uncapped.
- Your maximum reward is capped to the price you receive for the call.

Effect of Time Decay

- Time decay is helpful to your naked sold option, so take advantage of the maximum time erosion. Maximum time decay (or theta decay) occurs in the last month before the option’s expiration, so it makes sense to sell one-month or less options only.
- Don’t be fooled by the false economy that selling longer options would be more lucrative. Compare a one-month option to a 12-month option and multiply the shorter option price by 12. You will see that you are receiving far more per month for the one-month option. Also remember that you want the person on the long side of this trade to have as short a time as possible to be right.
- Give yourself as little time as possible to be wrong because your maximum risk is uncapped.

Appropriate Time Period to Trade

- One month or less.

Selecting the Stock

- Choose from stocks with adequate liquidity, preferably over 500,000 Average Daily Volume (ADV).
- Try to ensure that the trend is downward and identify a clear area of resistance.
Selecting the Option

- Choose options with adequate liquidity; open interest should be at least 100, preferably 500.
- **Strike**—Look for OTM strikes above the current stock price.
- **Expiration**—Give yourself as little time to be wrong. Remember that your short position exposes you to uncapped risk, and that time decay accelerates exponentially (in your favor when you’re short) in the last month before expiration, so only short the option with a maximum of one month to expiration, preferably less.

1.2.3 Risk Profile

- **Maximum Risk** [Uncapped]
- **Maximum Reward** [Call premium]
- **Breakeven** [Call strike + call premium]

1.2.4 Greeks

**Risk Profile**
As the stock price rises, the short call loses money more and more quickly, particularly when the stock price is greater than the strike price.

**Delta**
Delta (speed) is negative and moves at its fastest (negative) rate around the strike price, until it reaches -1. Notice how Delta is zero when the option is deep.

**Gamma**
Gamma (acceleration) is always negative with a Short Call, and it peaks inversely when Delta is at its fastest (steepest) rate. Gamma is zero when the position is deep OTM or ITM (i.e., when Delta isn’t moving).

**Theta**
Theta is positive, illustrating that time decay helps the short call position. As an option seller, this is of course completely logical.

**Vega**
Vega is negative, illustrating that volatility is unhelpful to the position because higher volatility translates into higher option values. As the seller of option premium, we’d rather the option value decreases.

**Rho**
Rho is negative, illustrating that higher interest rates would harm the Short Call position.
1.2.5 Advantages and Disadvantages

Advantages
- If done correctly, you can profit from falling or rangebound stocks in this way.
- This is another type of income strategy.

Disadvantages
- Uncapped risk potential if the stock rises.
- A risky strategy that is difficult to recommend on its own.

1.2.6 Exiting the Trade

Exiting the Position
- Buy back the options you sold or wait for the sold option to expire worthless (if the underlying stock falls and stays below the strike price) so that you can keep the entire premium.

Mitigating a Loss
- Use the underlying asset or stock to determine where your stop loss should be placed.

1.2.7 Example

ABCD is trading at $28.20 on February 19, 2004.
Sell the March 2004 $30.00 strike call for $0.90.

<table>
<thead>
<tr>
<th>You Receive</th>
<th>Call premium</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$0.90</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Maximum Risk</th>
<th>Uncapped</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Maximum Reward</th>
<th>Call premium</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$0.90</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Breakeven</th>
<th>Strike price + call premium</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$30.00 + $0.90 = $30.90</td>
</tr>
</tbody>
</table>

1.3 Long Put

<table>
<thead>
<tr>
<th>Proficiency</th>
<th>Direction</th>
<th>Volatility</th>
<th>Asset Legs</th>
<th>Max Risk</th>
<th>Max Reward</th>
<th>Strategy Type</th>
</tr>
</thead>
<tbody>
<tr>
<td>Novice</td>
<td>Bearish</td>
<td>N/A</td>
<td>Long Put</td>
<td>Capped</td>
<td>Uncapped</td>
<td>Capital Gain</td>
</tr>
</tbody>
</table>
1.3.1 Description

Buying a put is the opposite of buying a call. A put is an option to sell. When you buy a put, your outlook is bearish.

<table>
<thead>
<tr>
<th>ITM</th>
<th>In the Money</th>
<th>stock &lt; put strike price</th>
</tr>
</thead>
<tbody>
<tr>
<td>ATM</td>
<td>At the Money</td>
<td>stock = put strike price</td>
</tr>
<tr>
<td>OTM</td>
<td>Out of the Money</td>
<td>stock &gt; put strike price</td>
</tr>
</tbody>
</table>

Buy put

Steps to Trading a Long Put

1. Buy the put option.
   - Remember that for option contracts in the U.S., one contract is for 100 shares. So when you see a price of $1.00 for a put, you will have to pay $100 for one contract.
   - For S&P Futures options, one contract is exercisable into one futures contract. If the option price is $1.00, you will pay $250 for one futures contract upon exercise.

Steps In
   - Try to ensure that the trend is downward and identify a clear area of resistance.

Steps Out
   - Manage your position according to the rules defined in your Trading Plan.
   - Sell your long options before the final month before expiration if you want to avoid the effects of time decay.
   - If the stock rises above your stop loss, then exit by selling the puts.

1.3.2 Context

Outlook

- With a Long Put, your outlook is **bearish**. You expect a fall in the underlying asset price.

Rationale

- To make a better return than if you had simply sold short the stock itself. Do ensure that you give yourself enough time to be right; this means you should go at least six months out, if not one or two year LEAPs. If you think these are
expensive, then simply divide the price by the number of months left to expiration and then compare that to shorter-term put prices. You will see that LEAPs and longer-term options are far better value per month, and they give you more time to be right, thus improving your chances of success. Another method is to buy only deep ITM options.

**Net Position**

- This is a net debit transaction because you pay for the put option.
- Your maximum risk is capped to the price you pay for the put.
- Your maximum reward is uncapped until the stock falls to zero, whereupon the maximum profit is the strike price less what you paid for the put.

**Effect of Time Decay**

- Time decay works against your bought option, so give yourself plenty of time to be right.
- Don’t be fooled by the false economy that shorter options are cheaper. Compare a one-month option to a 12-month option and divide the longer option price by 12. You will see that you are paying far less per month for the 12-month option.

**Appropriate Time Period to Trade**

- At least three months, preferably longer depending on the particular circumstances.

**Selecting the Stock**

- Choose from stocks with adequate liquidity, preferably over 500,000 Average Daily Volume (ADV).
- Try to ensure that the trend is downward and identify a clear area of resistance.

**Selecting the Option**

- Choose options with adequate liquidity; open interest should be at least 100, preferably 500.
- **Strike**—Look for either the ATM or ITM (higher) strike above the current stock.
- **Expiration**—Give yourself enough time to be right; remember that time decay accelerates exponentially in the last month before expiration, so give yourself a minimum of three months to be right, knowing you’ll never hold into the last month. That gives you at least two months before you’ll need to sell. Longer would be better, though.
1.3.3 Risk Profile

- **Maximum Risk**  [Put premium]
- **Maximum Reward**  [Put strike – put premium]
- **Breakeven**  [Put strike – put premium]

1.3.4 Greeks

**Key:**
- **Expiration**
- **Today – 6 months**
- **Time(t) – 1 month**

**Risk Profile**
As the stock price falls, the long put moves into profit more and more quickly, particularly when the stock price is lower than the strike price.

**Delta**
Delta (speed) is negative and moves at its fastest rate around the strike price, until it reaches -1. Notice how Delta is zero when the option is deep OTM.

**Gamma**
Gamma (acceleration) is always positive with a long put, and it peaks when Delta is at its fastest (steepest) rate.

- **Theta**
  Theta is negative, illustrating that time decay hurts the long put position.

- **Vega**
  Vega is positive, illustrating that volatility is helpful to the position because higher volatility translates into higher option values.

- **Rho**
  Rho is negative, illustrating that higher interest rates would reduce the value of the puts and therefore hurt the position.

1.3.5 Advantages and Disadvantages

**Advantages**

- Profit from declining stock prices.
- Far greater leverage than simply shorting the stock.
- Uncapped profit potential with capped risk.
Disadvantages

- Potential 100% loss if the strike price, expiration dates, and stock are badly chosen.
- High leverage can be dangerous if the stock price moves against you.

1.3.6 Exiting the Trade

Exiting the Position

- Sell the puts you bought!

Mitigating a Loss

- Use the underlying asset or stock to determine where your stop loss should be placed.

1.3.7 Example

ABCD is trading at $28.88 on February 19, 2004.

Buy the January 2005 $30.00 strike put for $4.38.

| You Pay | Put premium | $4.38 |
| Maximum Risk | Put premium | $4.38 |
| Maximum Risk | Maximum risk is 100% of our total cost here |
| Maximum Reward | Strike price – put premium | $30.00 – $4.38 = $25.62 |
| Breakeven | Strike price – put premium | $30.00 – $4.38 = $25.62 |

1.4 Short (Naked) Put

<table>
<thead>
<tr>
<th>Proficiency</th>
<th>Direction</th>
<th>Volatility</th>
<th>Asset Legs</th>
<th>Max Risk</th>
<th>Max Reward</th>
<th>Strategy Type</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intermediate</td>
<td>Bullish</td>
<td>N/A</td>
<td>Short Put</td>
<td>Capped*</td>
<td>Capped</td>
<td>Income</td>
</tr>
</tbody>
</table>

*Risk uncapped until the stock falls to zero.

1.4.1 Description

Selling a put is a simple, short-term income strategy. A put is an option to sell. When you sell a put, you have sold someone the right to sell. As the stock falls, you may be obligated to buy the stock if you are exercised. Therefore, only sell puts Out of the
Money and on stocks you’d love to own at the strike price (which is lower than the current stock price).

The maximum risk of a naked put is the strike price less the premium you receive. Some people consider this to be an unlimited risk profile, and others consider it to be limited risk. A compromise is to consider it unlimited until the stock falls to zero—in other words, unlimited until the stock falls to zero.

Sell put

**Steps to Trading a Naked Put**

1. Sell the put option with a strike price lower than the current stock price.
   - Remember that for option contracts in the U.S., one contract is for 100 shares. So when you see a price of $1.00 for a put, you will receive $100 for one contract.
   - For S&P Futures options, one contract is exercisable into one futures contract. If the option price is $1.00, you will pay $250 for one futures contract upon exercise.

**Steps In**

- Try to ensure that the trend is upward (or sideways) and identify a clear area of support.

**Steps Out**

- Manage your position according to the rules defined in your Trading Plan.
- Hopefully the stock will rise or remain static, allowing your sold option to expire worthless so that you can keep the entire premium.
- If the stock falls below your stop loss, then exit the position by buying back the puts.
- Time decay will be eroding the value of your put every day, so all other things being equal, the put you sold will be declining in price every day, allowing you to buy it back for less than you bought it for, unless the underlying stock has fallen of course.

1.4.2 Context

**Outlook**

- **Bullish**—You are expecting the stock to rise or stay sideways at a minimum.

**Rationale**

- To pick up short-term premium income as the share develops price strength.
- To lower the cost basis of buying a share (if the put is exercised).
Net Position

- This is a net credit transaction because you receive a premium for selling the put.
- Your maximum risk is the put strike price less the premium you receive for the put. This is considered a high-risk strategy.
- Your maximum reward is limited to the premium you receive for the option.

Effect of Time Decay

- Time decay works with your naked sold option. To take advantage of the maximum rate of time decay, sell the put in the last month before the option’s expiration.
- Don’t be fooled by the false economy that options with longer to expiration are more lucrative. Compare a one-month option to a 12-month option and multiply the shorter option price by 12. You will see that you are receiving far more per month for the one-month option.

Appropriate Time Period to Trade

- One month or less.

Selecting the Stock

- Choose from stocks with adequate liquidity, preferably over 500,000 Average Daily Volume (ADV).
- Try to ensure that the trend is upward and identify a clear area of support.

Selecting the Option

- Choose options with adequate liquidity; open interest should be at least 100, preferably 500.
- Strike—Look for OTM (lower strike) options, below the current stock price.
- Expiration—Give yourself as little time to be wrong; remember that your short position exposes you to uncapped risk (until the stock falls to zero) and that time decay accelerates exponentially (in your favor when you’re short) in the last month before expiration, so only short the option with a maximum of one month to expiration, preferably less.

1.4.3 Risk Profile

- Maximum Risk  [Put strike – put premium]
- Maximum Reward [Put premium]
- Breakeven       [Put strike – put premium]
1.4.4 Greeks

**Risk Profile**
As the stock price falls, the naked put moves into loss more and more quickly, particularly when the stock price is lower than the strike price.

**Delta**
Delta (speed) is positive and falls to zero after the position reaches its maximum profit potential after the stock has risen above the strike price.

**Gamma**
Gamma (acceleration) is always negative with a naked put (because you are net seller of options), and it peaks inversely when Delta is at its fastest (steepest) rate, which is when the position is ATM.

<table>
<thead>
<tr>
<th align="left">Key:</th>
</tr>
</thead>
<tbody>
<tr>
<td align="left">Expiration</td>
</tr>
<tr>
<td align="left">Today – 6 months</td>
</tr>
<tr>
<td align="left">Time(t) – 1 month</td>
</tr>
</tbody>
</table>

**Theta**
The stock price falls, the naked put moves into loss more and more quickly, particularly when the stock price is lower than the strike price.

**Delta**
Delta (speed) is positive and falls to zero after the position reaches its maximum profit potential after the stock has risen above the strike price.

**Gamma**
Gamma (acceleration) is always negative with a naked put (because you are net seller of options), and it peaks inversely when Delta is at its fastest (steepest) rate, which is when the position is ATM.

**Vega**
Vega is negative, illustrating that volatility is harmful to the position because higher volatility translates into higher option values.

**Rho**
Rho is positive, illustrating that higher interest rates would help the naked put position.

1.4.5 Advantages and Disadvantages

**Advantages**
- If done correctly, you can use Naked Puts to gain a regular income from rising or rangebound stocks.
- The Naked Put is an alternative way of buying a stock at a cheaper price than in the current market. This is because if you’re exercised, you’re obligated to buy stock at the low strike price, having already received a premium for selling the puts in the first place.

**Disadvantages**
- Naked Puts expose you to uncapped risk (as the stock falls to zero) if the stock falls.
- Not a strategy for the inexperienced. You must only use this strategy on stocks you’d love to own at the put strike price you’re selling at. The problem is that if
you were to be exercised, you’d be buying a stock that is falling. The way to avoid this is to position the put strike around an area of strong support within the context of a rising trend. A Fibonacci retracement point would be the type of area you’d use to position your naked put strike... well below the current stock price.

1.4.6 Exiting the Trade

Exiting the Position

- Buy back the options you sold or wait for the sold put to expire worthless so that you can keep the entire premium.

Mitigating a Loss

- Use the underlying asset or stock to determine where your stop loss should be placed.

1.4.7 Example

ABCD is trading at $27.35 on May 12, 2004.

Sell the June 2004 $25.00 strike put for $1.05.

<table>
<thead>
<tr>
<th>You Receive</th>
<th>Put premium</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$1.05</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Maximum Risk</th>
<th>Strike price – put premium</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$25.00 – $1.05 = $23.95</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Maximum Reward</th>
<th>Put premium</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>$1.05</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Breakeven</th>
<th>Strike price – put premium</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$25.00 – $1.05 = $23.95</td>
</tr>
</tbody>
</table>

| Return on Risk       | 4.38%         |

| Cushion (from Breakeven) | $3.40 or 12.43% |
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