Options Trading For Income Crash Course – Day 2

Long vs Short Vertical Spreads

- Long Vertical Spreads are great pure directional plays. They Profit when the market goes in your direction. They only profit in 1 of 3 possible market moves

- Short Vertical Spreads give you the potential to make money in all 3 possible market directions. You are collecting premium, so you make money if the market goes in your favor as well as when the market goes sideways. You even make money if the market moves slightly against you. The only move that hurts you is a big directional move in the opposite direction.

- Debit Spreads will give you a lower probability of success but a higher potential return

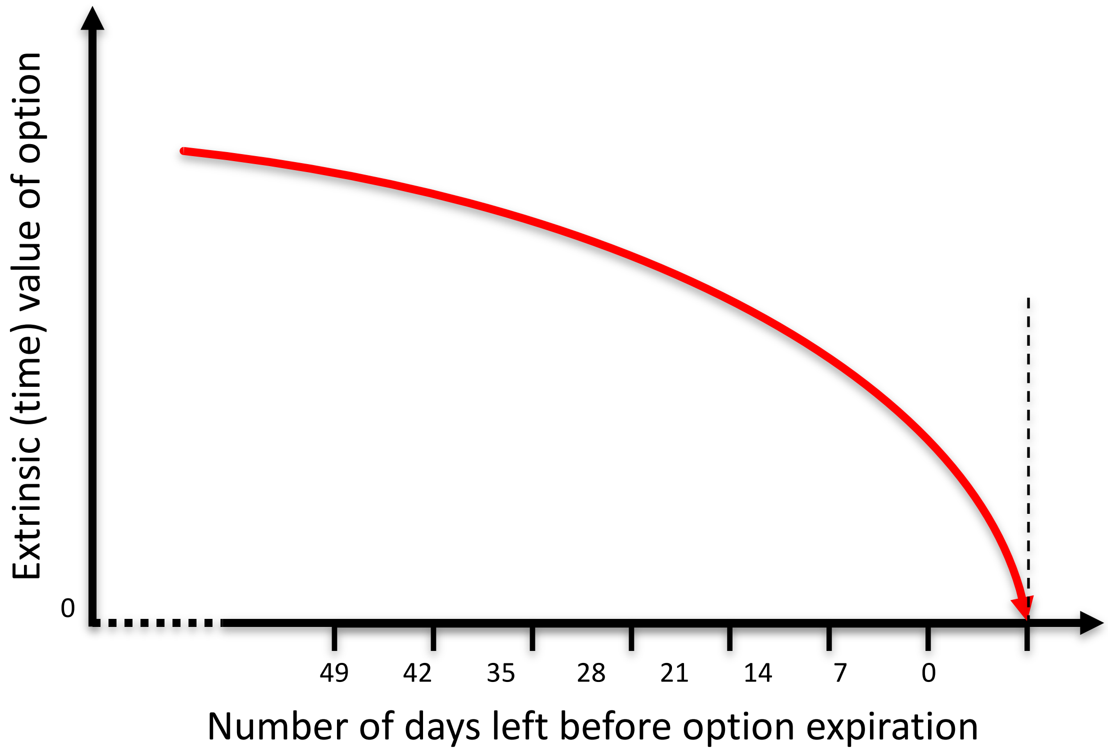
- Credit spreads will give you a higher probability of success but a lower potential return

Should I buy or sell the spread?

- **Buy the spread:**
  - When volatility is low
  - When you want to take a directional bet with lower risk

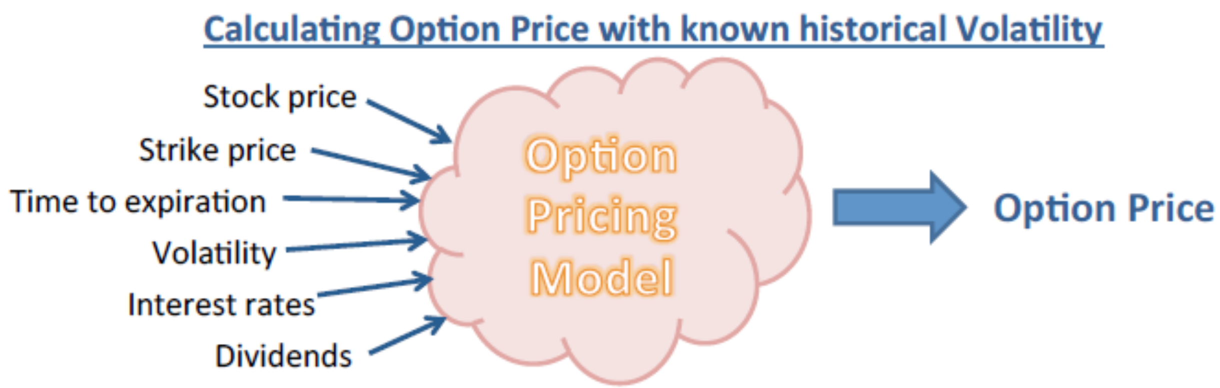
- **Sell the spread:**
  - When volatility is high
  - When you are looking for a higher probability of success…with a lower profit potential

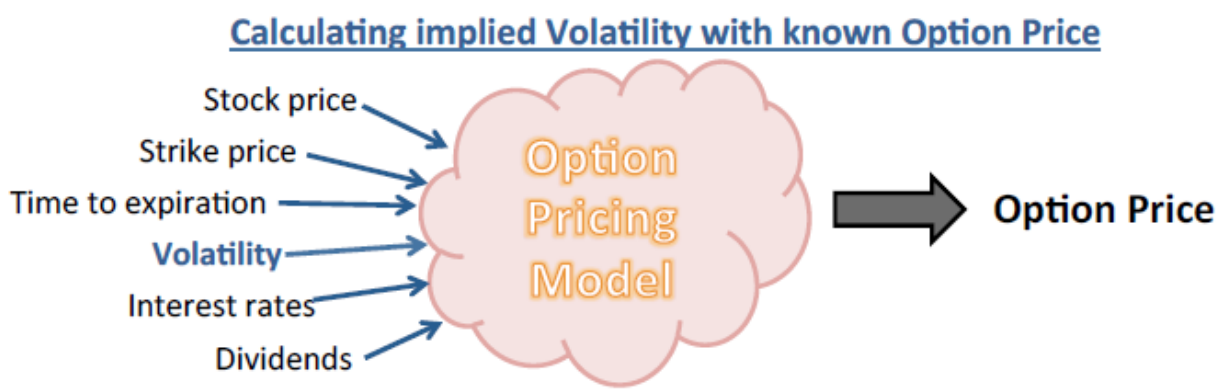
Time Decay



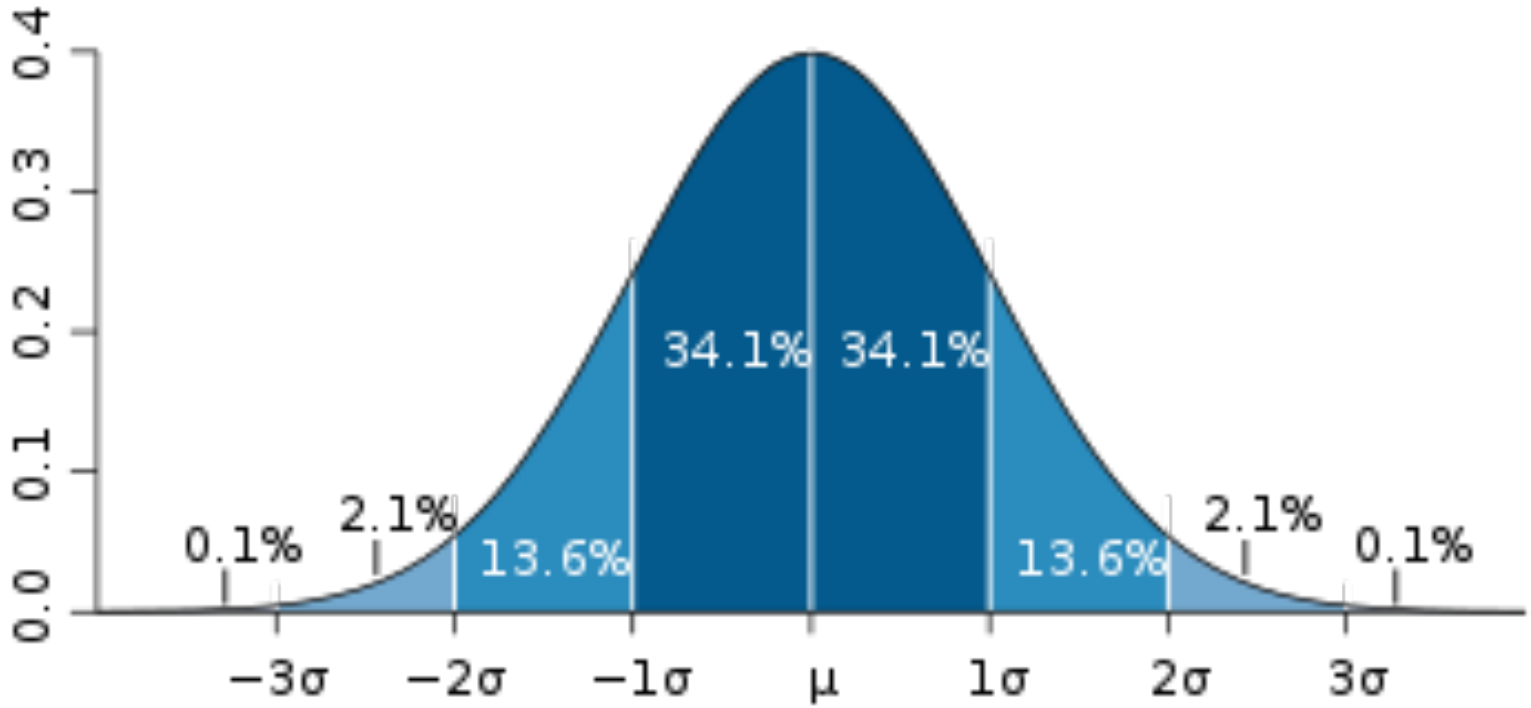
Extrinsic (time) value of option
0
49
42
35
28
21
14
7
0
Number of days left before option expiration

Implied Volatility





Standard Deviation - Bell Curve



Short Vertical Call Spread

1. What does it look like?
   - XYZ Stock $37
   - Sell 1 40 Call for $3
   - Buy 1 45 Call for put $1
     - Total Collected is $2.00
   - We have the obligation to sell 100 shares at $40
   - We have the right to buy 100 shares at $45
2. Max Profit:
   - Limited to the premium collected from selling the spread
     - $3 (short 40 call) - $1 (long 45 call) = $2.00

Short Vertical Call Spread

4. Max Loss: Difference between the strikes minus the credit received from selling the spread
   - 45 strike – 40 strike = 5
   - 5 - $2 (credit received) = $3 – Max potential loss

5. Break Even: Short Strike plus credit received for selling the spread
   - 45 + $2 (credit received) = 47.00

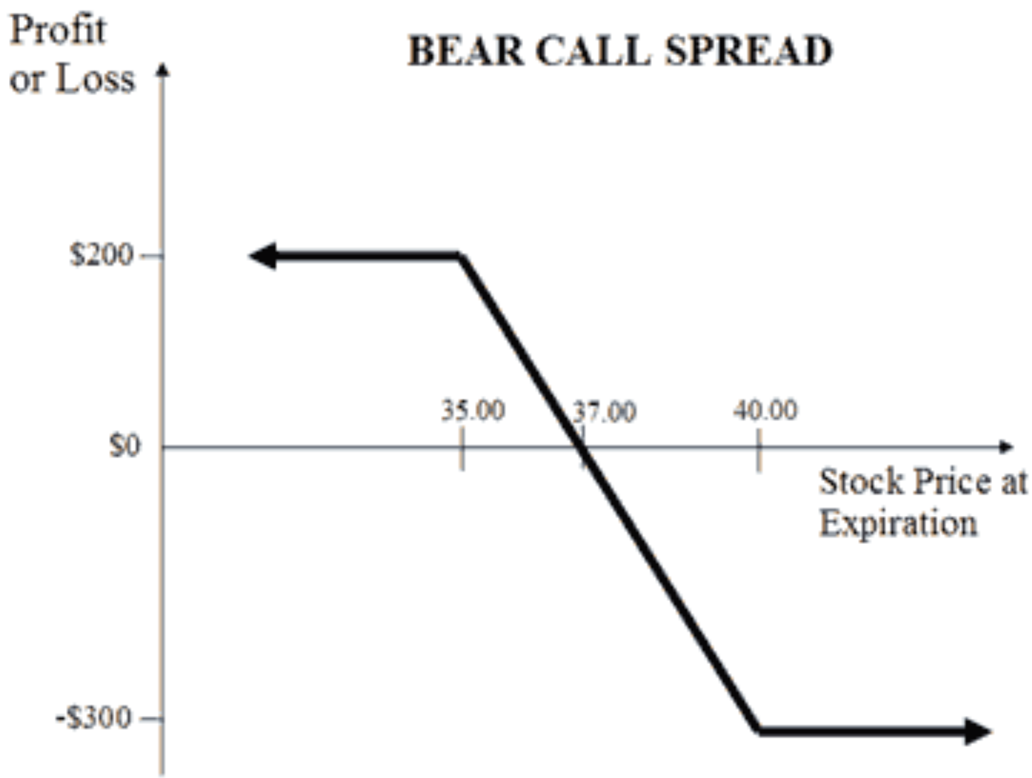
6. When do we use it?
   - When you are bearish and want to lower cost. Keep in mind you will limit your profit potential.
   - When you want to profit from 2 of 3 possible market directions
   - Defined Risk position

7. Where do we want stock/ETF to finish at expiration?
   - You want the stock to be right at or below the short strike at expiration.

8. Volatility: You want volatility to rise or at least not go lower while in the trade. Once you hit the short strike then you want volatility to go down.

9. Tips
   - We typically want to go out 25-40 days to expiration
   - Try and sell the option with a strike that is 1 Standard Deviation out of the money.

Short Vertical Call Spread – P/L Graph



Short Vertical Put Spread

1. What does it look like?
   - XYZ Stock $40
   - Sell 1 35 Put for $3
   - Buy 1 30 Put for put $1
     - Total Collected is $2.00
   - We have the obligation to buy 100 shares at $35
   - We have the right to sell 100 shares at $30
2. Max Profit:
   1. Limited to the premium collected from selling the spread
      - $3 (short 35 Put) - $1 (long 30 put) = $2.00

Short Vertical Put Spread

4. Max Loss: Difference between the strikes minus the credit received from selling the spread
   - 35 strike – 30 strike = 5
   - 5 - $2 (credit received) = $3 – Max potential loss

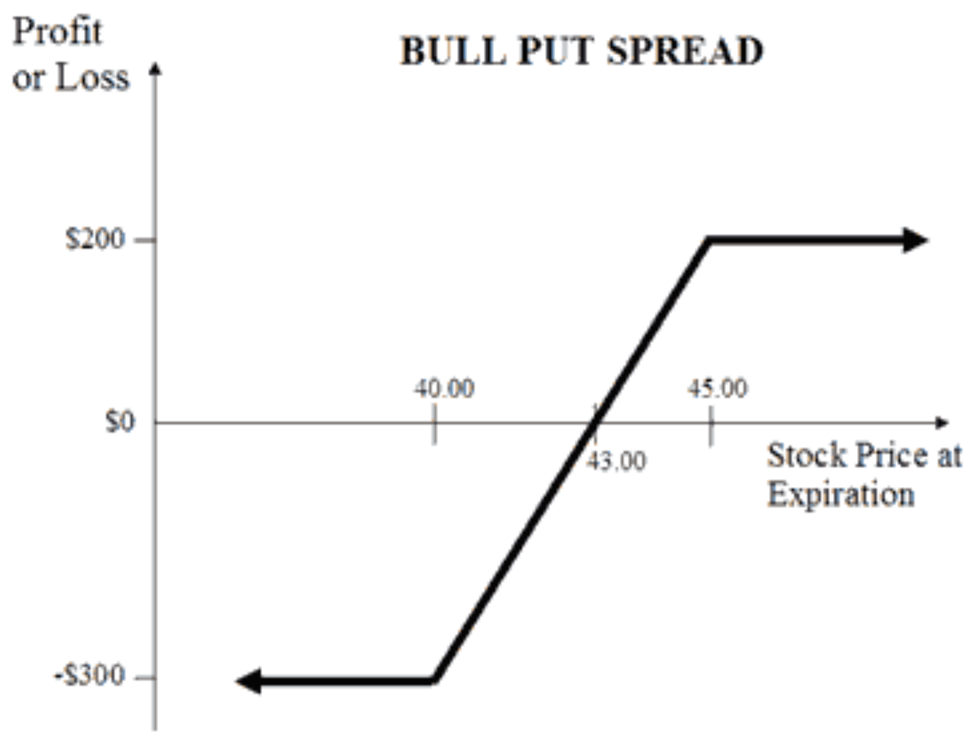
5. Break Even: Short Strike minus credit received for selling the spread
   - 35 - $2 (credit received) = 33.00

6. When do we use it?
   - When you are bullish and want to lower cost. Keep in mind you will limit your profit potential.
   - When you want to profit from 2 of 3 possible market directions
   - Defined Risk position

7. Where do we want stock/ETF to finish at expiration?
   - You want the stock to be right at or above the short strike at expiration.

8. Volatility: You want volatility go lower while in the trade.
9. Tips
   - We typically want to go out 25-40 days to expiration
   - Try and sell the option with a strike that is 1 Standard Deviation out of the money.

Short Vertical Put Spread – P/L Graph



Short Vertical Spread Criteria

1. Make sure implied volatility is higher than the 50^{th} percentile (using TOS)
2. Use the front month if there is at least 20 days left to expiration. If not, then go to the next month out.
3. We will select the spread where we can collect around 30-40% of the width of the spread.
   - $10 wide-spread: Want to collect between $3.00 and $4.00.
   - $1 wide-spread: $.35
4. Once in the trade we will look to exit when we can keep 50-75% of the potential gain. Exit the trade no later than Wednesday of expiration week if still in the position at that time.

Do we need high IV to sell premium?

- **You can sell spreads in low volatility but just realize you don't get the benefit of IV contracting. In this case you are betting strictly on time decay and a potential directional move.**
- **When selling low volatility you won't have as much wiggle room if the trade moves against you. The break-even point will be closer to current stock price.**
- **In an ideal situation you want to sell high IV. This will make sure all the pieces of the puzzle are coming together. This will give you the best odds long term.**

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Which strategy is best?

Strategy Playbook – Directional Trades

- Strongly Bullish
  1. **Individual Calls:** You will get the most bang for your buck trading individual options. You should use this strategy if you are expecting a quick move to the upside.
  2. **Long Call Vertical Spread:** This will allow you to lower your initial cost of taking the trade. It will also limit your worst-case loss scenario.
  3. **Short Put Spread:** If IV is over 50th percentile then we can sell a spread.

- Moderately Bullish
  1. **Long Call Vertical Spread:** This will allow you to lower your initial cost of taking the trade. It will also limit your worst-case loss scenario.
  2. **Short Put Vertical Spread:** If you expect to be in the trade for any length of time you can benefit from selling a spread. This will allow you to make money if the stock goes up like you expect but it also makes money if the market goes sideways. You win in 2 of 3 possible market moves.

Strategy Playbook – Directional Trades

- Strongly Bearish
  1. **Individual Puts:** You will get the most bang for your buck trading individual options. You should use this strategy if you are expecting a quick move to the downside.
  2. **Long Put Vertical Spread:** This will allow you to lower your initial cost of taking the trade. It will also limit your worst-case loss scenario.
  3. **Short Call Spread:** If IV is above 50th percentile then we can look to sell a call spread.

- Moderately Bearish
  1. **Long Put Vertical Spread:** This will allow you to lower your initial cost of taking the trade. It will also limit your worst-case loss scenario.
  2. **Short Call Vertical Spread:** If you expect to be in the trade for any length of time you can benefit from selling a spread. This will allow you to make money if the stock goes up like you expect but it also makes money if the market goes sideways. You win in 2 of 3 possible market moves.

Strategy Playbook – Volatility Plays

- These are listed in the order that I would use them:
- High Volatility
  1. **Sell Vertical Spread:** This will allow you to initiate a trade with 5 different ways of making money. While they will limit profit potential, they also increase the probability of success.
  2. **Buy Long Calls or Puts Using Weekly Options:** This will allow you to be more aggressive in a fast-moving market. It will come with more risk, so we want to keep positions small.
- Low Volatility
  1. **Long Vertical Spread:** This trade allows you to lower your cost and it will benefit from a spike in volatility.
  2. **Buy Long Calls or Puts Using Monthly Options:** Using the monthly options will allow you to put on a directional trade without the pressure of the time decay hurting you as badly.
  3. **Sell Vertical Spread:** This will allow you to initiate a trade with 5 different ways of making money. While they will limit profit potential, they also increase the probability of success.

Which strategy is best?

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Alert Types, Daily Routine, Trade Journal

Setting Alerts

- There are several ways to do this:
  1. Put a horizontal line on the chart that has an alert attached to it. Place the line just in front of the entry, target, or stop so you have some advanced warning that a level is being approached.
     – You can have this set as an audible alert to your computer or you can have it sent to your phone.
  2. Have the alert set in your broker platform.
     – This can also be set as an audible alert or sent to your phone in many cases depending on your broker platform.

Daily Routine

- I like to come in 3 times each day. Once at open, once at lunch and once before close.
- 5 minutes each time
- Look for new setups and manage open trades. Use alerts or conditional orders.
- If can't come in 3 times a day find what works for you and stick to it. Try to come in 1-3 times per day for about 20-30 min total.
- I have been doing most of my short premium trades in the afternoon between 2:00-4:00 Eastern.

Trade Journal 101

- Make sure you document every trade you take. Good, bad, and ugly.
- Document key stats (see next slide) to gauge performance on every stock/ETF on your watch list
- Review your trade journal monthly. See which areas are working/not working. Get out of your normal environment when reviewing your trade journal. Eliminate distractions as much as possible.
- Make changes to your watch list based on numbers. Be slow to change. A few losing trades doesn't justify a watch list change.

Trade Journal

- Create a Google Doc or Excel Spreadsheet to track each of your trades. Criteria to document:
  - Entry Date
  - Exit Date
  - Days in the Trade
  - Entry Price
  - Exit Price
  - P/L
  - Type of Options Trade
  - Notes (key level adjustments, news events, earnings, special situation)

Risk Management

Position Size

- Do not just trade 1 contract or 1 spread on each trade
- You want to risk a similar dollar amount on every trade
  - $200, $500, $1500 per trade
  - This way 1 or 2 trades don't dominate your P/L
  - 1 contract on AAPL is not the same as 1 contract on QCOM
- It doesn't matter to what the dollar amount is. Just make sure to keep the risk small and stay disciplined to your rules.
- Keep the risk at 3-5% of your account per trade.

Max Risk – Full Loss

- Long Calls & Puts: Max loss is whatever you pay for the option.
- Debit Spreads: Max loss is whatever you pay for the spread.
- Credit Spreads: Max loss is the difference between the strikes minus the credit received when placing the trade.

Our Risk

- Long Calls & Puts: 50% of whatever we pay for the options.
- Debit Spreads: 50% of whatever we pay for the options.
- Credit Spreads: Our typical loss on a credit spread is going to be in the 50-80% range of max risk.

How to determine position size?

- Option 1
  - Assume a worst case scenario in that you will have a 100% loss on all losing trades.
  - Determine your position size based an assumed full loss
  - This will build in a added layer of safety
  - Example:
    - If you are looking to risk $500 per trade and you are buying a debit spread for $250 then you would trade 2 spreads ($250 max loss per spread).

How to determine position size?

- Option 2
  - We know we limit our losses on a long call/put and debit spreads to 50% of the cost of the options. We can use this to determine our position size
  - Example:
    - If you are looking to risk $500 per trade and you are buying a debit spread for $250 then you would trade 4 spreads ($125 would be our worst-case loss as it would be 50% of what I pay to place a trade).

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How to setup your watch list?

Become an Expert in a small list of Stocks

- Narrow you universe of stocks down to a small number
- Master how those names move
  - ❑ What is the winning % over time?
  - ❑ How long does a trade take?
  - ❑ How liquid are the options?

- Focus on taking trades from your watch list
- Ignore noise from other stocks

Avoid These Mistakes

- A bigger watch list doesn't mean bigger profits!
- Don't overweight one area of the market…Diversify.
- Don't let the outcome of one trade prevent you from taking the next trade. Use good risk management.

Criteria for Our Hot List

1. Liquid Options – I want to trade the products with the most actively traded options. This way I can get in and our quickly at good prices.
2. Volatility – I'm looking for products that show a history of good movement back and forth.
3. Diversification – I want to establish a broad list of stocks/ETF's that cover a number of different sectors

How to pick your Watch List

1. Determine how many names you can afford to have on your list.
   - How big is your account? How much time do you have each day to check charts?
   - If all names give you trades at the same time can you afford the risk?
   - Go through and test your names. See how much it would cost to take trades on each name on your list.
2. Make sure you have following areas represented on your list:
   - Financials
   - Energy
   - Index
   - Tech
   - Global products

How to pick your Watch List

3. Have a mix of Trend Trades and Reversal Setups. Diversification is key
4. Once your list is in place trust the system. Don't skip around between markets.
5. Make sure you are using a system that is dynamic. Markets change!

Next Steps…

- Review the material from the 2 Day Workshop
- Start to establish your Options Strategy playbook
- Decide what system you are going to use and stay disciplined to that system.
- Establish your watch list of products that fits your account size and risk tolerance. Then ignore all other areas of the market not on that list.

We'd Love To Hear From You

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