Everything you need to know to trade options safely, for maximum returns
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Dear Investor,

Welcome to one of the most misunderstood, yet highly profitable, means of investing: options trading.

Sometimes, the mere mention of options causes would-be investors to shy away from this investment tool, retreating back to what they perceive is a safer world... that of stocks or bonds.

Too many investors lose money in options simply because they don’t know what they’re doing. Others hear the stories about how someone made a killing on option XYZ – and dive right in. Too many shy away from options altogether, because they’re confused by the terminology, unsure of the risks and skeptical of the profit potential.

It’s a huge mistake.

Many investors are passing up what can be rather lucrative profit opportunities, simply because they don’t understand the options world properly. Options are a simple and profitable way to balance and strengthen your portfolio. Sure, they can be risky – but so can all investments.

The trouble starts when investors look for so-called “easy money,” or follow the crowd to the “hot” investments. But experienced traders know that any misstep in options trading can mean the difference between a 10-bagger and being left holding the bag. So it’s critical for you to understand the risks, terminology and phrases used in options trading.

The good news is that options can be as speculative or conservative as you want – and are a lot more profitable than you might think. You don’t need to use complicated strategies to net very healthy returns. And it’s highly possible to routinely make double-, triple- and even quadruple-digit gains on options. And with the right information (such as this guide book), cashing in has never been easier.

This concise, easy-to-understand guide is written for both the novice investor and the more experienced trader. In it, we’ll remove some of the stigmas, debunk some of the myths and give you a one-stop reference to the options world. You’ll learn the ins and outs of options trading and tilt the odds in your favor, so you can put options investing to work for you. When you understand how they work, you’ll see why they can be so useful.
Sincerely,

[Signature]

Karim Rahemtulla
Director of Options, *Wall Street Daily*
With more than 70 years of options trading experience between them, our group can give you the tools to take advantage of the lucrative world of options.

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A former Wall Street consultant and analyst, Louis helped direct over $1 billion in institutional capital before founding *Wall Street Daily*, where he is Chief Investment Strategist. In addition to being an expert on small-cap stocks, Louis is also well versed in contrarian investments and special situations, including mergers and acquisitions and spinoffs. His commentary has been featured in several media outlets, including *MarketWatch*. And he’s also a top-rated speaker at financial conferences throughout the country. A New Jersey native, Louis earned his MBA with honors from the Crummer Graduate School of Business at Rollins College. He draws upon both his academic and professional experiences to edit his short-term trading service: *MicroCap Tech Trader*.

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The Ultimate Options Primer

Everything you need to know to trade options safely, for maximum returns
PART ONE

OPTIONS BASICS
What Are Options?

An option is an investment that gives you the right (but not the obligation) to buy or sell a specific security at an agreed-upon price, within a set period of time.

Options are flexible in this way. Whether you choose to exercise that right is completely up to you, depending on how the option is performing within that “set period of time.”

All options have expiration dates. It could be a matter of weeks, months, or, in the case of certain options called LEAPS (more on this later), up to three years. If you don’t exercise your right within that given time, the option expires worthless.

You can buy options on the Chicago Board Options Exchange (CBOE), American Stock Exchange (AMEX), the New York Stock Exchange (NYSE), the Chicago Board of Trade (CBOT), the Pacific Stock Exchange (PSE) and the Philadelphia Stock Exchange (PHLX).

Most of the activity takes place on the CBOE and the AMEX. Options are traded just like stocks in the sense that they have a symbol, and you will be charged a commission on the transaction.

Option prices can be tracked online at a number of websites, including Yahoo! Finance and BigCharts.com.

How Do They Work?

Options are directly related to their underlying security – be it a stock, index, commodities futures, etc.

For example, you could choose to simply buy 100 shares in Company XYZ, which is currently trading for around $10 a share.

Excluding commissions, that would cost you $1,000. However, you might not want to buy 100 shares at the same time, or you might think the price for that is a little too steep.

So rather than buy the stock outright, you can instead choose to buy options on it – which are significantly cheaper. This gives you the right to buy or sell those same 100 shares at a certain price at a certain time.
The key question you need to ask yourself is whether you think Company XYZ is going to go up or down.

If you think it’s going to rise, you buy call options (calls).

If you think it’s headed for a decline, you buy put options (puts).

These are the two basic forms of options.

You then need to decide on a strike price (your target price).

Next, you need to pick a timeframe for your scenario to play out – the end of which is known as an expiration date. This can be anything from weeks, to months, to years. Options prices vary, depending on the expiration date, strike price and volatility of the market/industry and company in question.

Once you’ve done that, you’re ready to buy.

Options come in baskets of 100 shares. This is known as a contract. When you buy an options contract, be it a call or a put, it gives you the right (but not the obligation) to buy (if you’ve bought calls) or sell (if you’ve bought puts) your 100 shares before a specified date in the future (the expiration date) – hopefully when the underlying stock hits your strike price.

When you buy an option, it’s as though someone is saying to you, “I will allow you to buy (call options) or sell (put options) 100 shares of this company’s stock, at a specified price per share (strike price), at any time between now and the expiration date.”

And it’s further understood that, “For that right, I expect you to pay me a fee.” That fee is called the premium, which will vary considerably depending on the exercise price and time until expiration, as well as the stock’s volatility.

So let’s use an old example of a real company:

Let’s say that on March 6, 2012, with the shares trading at $8.84, you were bullish on Southwest Airline’s fortunes and thought the price was going higher. But how much higher? And by when? That’s up to you. But a lot of it also depends on what options are available to you in the options chain.
Southwest Airlines (LUV)

Call Options

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How to Read An Options Chain

An options chain basically lists all the available call and put options that you can buy on a company, along with the various expiration dates you can choose.

As you can see from the Southwest Airlines chart (above), these are the call and put options available that expire by a specific date. The expiration date for all options is always on the third Friday of the corresponding month.

The various strike prices (target prices) for the options are listed in the far left column, followed by the options symbol, the price of the last trade and the daily change. We’ll get to the bid and ask in a moment.

Call:

Let’s say you’re bullish and think Southwest’s share price is going to $9. That’s your strike price.

You buy the Southwest $9 Call (LUV120616C00009000) at $0.50.

$0.50 x 100 shares (remember, options come in baskets of 100) = $50.
That means you have the right to buy 100 Southwest shares at $9 any time before its expiration date. What you want is for the shares to move above $9, thus adding more value to your options when you sell them.

**Put:**

If you think there’s more downside to come for the airline sector – and for Southwest – you’d buy puts.

Let’s say you think the share price is going to drop to $8 by the expiration date.

You buy the Southwest $8 Put at $0.25.

\[ \text{\$0.25 x 100 shares = \$25.} \]

What you want now is for shares to sink to that level and below, so you can sell at $8 and turn a profit.

The expiration date and strike price will never change. But in the run-up to the expiration date, those options are now subject to the regular market factors (oil prices, overall sector weakness) and news that might help or hinder the underlying stock.

In simplest terms, call buyers are hoping the price will rise, while put buyers are hoping the stock price will fall. If the shares decline in value, then the value of your put increases. The thinking here is that you’ll buy the shares at their lower price in the future and then sell them at your strike price (that you locked into when you bought the option). Your profit is the difference between those two values.

**The Bid, the Ask and the Spread**

One of the most important parts of options trading is knowing what an option should sell for, and getting it for what it’s worth. This requires knowledge of the **bid**, the **ask** and the **spread**.

Simply put, once you own an option, the only number you’re interested in is the **bid**. This is basically the highest price someone else is willing to pay for the options contract and the money you’ll realize is quoted in this amount.

The **ask** price is the lowest price you’re willing to receive for the options contract.

The **spread** is simply the difference between the bid and ask prices.
However, you need to pay most attention to the bid, as that’s the one that market makers manipulate to profit the most. The less they pay you at the bid, the more they make – simple as that.

For example:

Shares in ABC, Inc. are trading at $15.50. You want to buy July put options and you see this:

- Last trade: $0.55
- Ask: $0.55
- Bid: $0.40

Here’s why 90% of options lose money…

A rookie looks at those numbers and immediately dives in and pays $0.55 for the option. Since the option is really only worth the bid price, he’s already down 37% before he’s even started.

When a market maker sees you buying options at market price, he knows he can take your money. Here’s how to beat him…

**Beat the Market Makers and Get the Right Price**

Use **limit orders**. Just like stocks, you can place trades between the bid and offer, in $0.05 increments. It’s the only way you can put some pressure on the **market makers** and tempt them to alter the price and bring the spread to a more reasonable level.

After all, if a large number of buyers make offers at $0.45 instead of $0.40, he might change the bid price so he can fill his orders. But if folks are willing to accept the lower price, why should the market maker change anything? This strategy does require a little more patience, but you’ll get a better price. Market makers want you to pay full price, and they know that some impatient amateur investors will. Don’t fall into their trap.

If you need a reference point, compare it to stocks. Paying “full price” for stocks isn’t nearly as damaging as with options, because stocks usually trade with a mere $0.01 spread between the bid and the ask price.

But options trade with a $0.05 difference in the spread if the options are under $3 a share and $0.10 if they’re over $3 a share. That’s a big cost to overcome. Think about it. If the prices on a stock are $10 bid and $10.01 ask, that penny difference amounts to less than 1/100 of the stock price – just a tenth of a percent.
But for an option trading at $0.60 bid and $0.70 ask, the spread is 16.6%. That means you’re in the hole by double digits right away. If the spread comes to 16%, then the option has to move MORE than 16% for you to just break even on the trade. And that’s not all. Add on commissions and deteriorating time value, and you could find yourself digging out of a hole within a few hours of your purchase.
Part Two

Buying and Selling Options
How to Buy An Option
At the Right Price

So, how can you protect yourself from starting out so far in the hole while simultaneously reducing some of your costs? Here’s a set of rules that you should always follow:

• Never buy an option at the ask price or with a market order. Use a limit order that falls between the bid and offer. Take your time. If the underlying shares don’t move, the option price will fall. If you can, place your order at the bid price. If the option is liquid, you’ll get filled at that price most of the time.

• Never buy an option that has an expiration of one month or less, UNLESS you know that it’s nothing more than a speculation and that YOU WILL lose your investment 80% of the time.

• Never pay more than $40 to ANY broker to execute a 10-contract trade.

• Even if you’re going to speculate using options, take a look at the prices for options that are two or three months away from expiration. They may be more expensive, but you’ll have more time for things to go your way. Nobody can guarantee what a stock will do in an hour, let alone over a week or two.

If you follow the four rules of options trading above, you’ll reduce your costs, your risk – and you’ll be poised for profits.

Here’s one more secret for you…

Fatten Up Over Lunch

The most intense market action happens when it opens. Futures trading typically dictates how the market will open – and this has the most profound effect on options prices.

So when the opening bell rings, traders scramble to open and close their positions. It’s remarkable to watch the floor traders yelling at the top of their lungs and waving bits of paper to get their options contracts filled. This frenzy generally lasts until 10:00 or 10:30 AM.

Then things calm down a bit. For the next hour, traders usually take stock of things. And as lunchtime approaches, volatility usually lessens
and the prices become more attractive.

When traders leave the floor to get lunch, that’s your cue to jump in. With their stations idle, they’re not there to trade. So while they’re grabbing lunch, the smaller fish finally get a better opportunity to dive in and grab some much better options prices.

Keep that in mind when you’re making your trading decisions. Some of the best bargains occur when the professional traders leave the pits.

Why Buy Options?

Options have a limited lifespan, meaning they can expire worthless if your expiration date arrives and the underlying stock price has not moved where you expected it. So, many investors ask: Why buy options at all? Why not just buy the shares?

There are two main reasons:

**Cost Control:**
Because the price and number of shares are fixed from the beginning, you’re safe in the knowledge that no matter what happens, you’ve locked in that price for the duration of the option.

**Cheaper to Own:**
It’s much cheaper to buy options than the underlying stock.

In the Southwest example earlier, buying 100 shares at $8.84 each would cost you $884. But when you buy an option, you have far more leverage. That is, you control the same number of shares, but at a significantly lower cost. Buying just one options contract on Southwest at the prices we showed would cost $25 for puts or $50 for calls. Without paying for the full cost of the shares, you can still profit handsomely. After that, you just need the stock to move in the direction you want – in the same way you would if you owned the underlying shares.

That being said, options are inherently speculative investments. You’re essentially trying to profit by making an educated guess on the future direction of the index or company in question.

As you can see from the Southwest example, time is a crucial factor in options trading. You can expect the premiums on longer-term options to be higher than the premiums on shorter-term ones. After all,
anything can happen over a longer period of time, and the more
time until expiration, the better the chance your option has to meet
its strike price. That lowers your risk, so you pay more.

Here’s the key: Buy a cheap option when nobody wants it, then sell it
when everyone does.

Try to find a cheap option you think is poised for a big move, and then
buy it. If your forecast is correct and the move happens, the price of your
option will move with it. Your option will be in demand, and investors will
be willing to pay you for it. If you sell, you have instant profits.

What to Pay to Play:
Intrinsic Value and Time Value

An option has two sources of value. The cost (or premium) of any
given option is based on its intrinsic value and its time value.

Intrinsic value refers to the portion of the option premium that’s in-the-money. Any additional value beyond that is considered time value.

For example:

A call has a current premium of $3 ($300) and a strike price of $45. At
the time you buy the call, if the underlying stock’s market value is $46
per share, then we say the following about its intrinsic value, as well as its
time value:

- This option has one point of intrinsic value. In other words, it’s
  $1 “in-the-money,” or above the strike price.
- That leaves two points (the $3 premium minus the intrinsic
  value of $1) for the time value.

Even if the stock’s value stays the same (leaving the intrinsic value at
$1), as the stock approaches expiration, its time value shrinks – leading
to a decrease in the total amount of the premium. At expiration, the time
value will equal zero, leaving the premium value equal to the intrinsic
value (in this case: $1).

All options act the same when it comes to intrinsic value. And all
options that are in-the-money will reflect that value. If an option is in-
the-money by $5 (say a call option is at a $35 strike and the current
price is $40), then the option premium will be at least five points. If the option moves $10 into the money, then the option premium will reflect at least 10 points of value.

Conversely, if the stock declines, and the option moves out-of-the-money (for example, a call option is $45 and the stock is at $44), then the intrinsic value goes to zero and the premium would only reflect time value.

Other Factors That Affect Value

When it comes to determining the time value, a number of factors come into play.

Obviously, the amount of time left until expiration is important. But so is the volatility of the underlying stock. A host of other factors affect time value, such as the perception of value by other investors, the stock’s price history, the company’s fundamental and technical indicators, the industry of the company, and whatever else investors hold important for this particular stock.

That means two companies – both priced at $55 per share and both with strike prices of $50, and with identical time until expiration – can have different premium prices.

You need to look at each stock and each situation to determine if the premium represents fair value. Remember that the clock is always ticking once you purchase an option, and that value is always at work when the option is being priced. The greater the perceived potential for price movement, the more investors are willing to pay for the time value of the premium.

So how can you determine whether an option is overpriced or underpriced? Fortunately, there’s help available.

Assessing the Fair Value of An Option

The professionals and market makers on the options exchanges use the following six factors to determine whether options are overpriced or underpriced:

- Time to expiration
- Strike price
• Value of the underlying stock
• Implied volatility of the underlying stock
• Dividends
• The risk-free interest rate

Their calculations are based on the Black-Scholes Model – a formula created by Fischer Black and Myron Scholes, who won the Nobel Prize for their work. The model is quite complex, and you certainly don’t need to memorize it! Your brokerage firm will provide online access to options prices, which usually includes a rating based on the Black-Scholes Model. You can also sign up for a service provided by the Chicago Board Options Exchange that provides real-time quotes, Black-Scholes ratings, charts and much more. Go to: www.cboe.com.

Who Qualifies to Open An Options Trading Account?

Okay, so now that you know the basics of how options work and some of the terminology, let’s talk about how you actually trade. To do that, you’ll need to open an options account with a broker.

The main stumbling block to trading options is that brokers are required by law to ensure that you’re qualified to invest in options. The Securities and Exchange Commission applies a rule called “know your customer.” As a result, brokerage firms ask potential options investors to fill out a short form (mostly multiple-choice questions) explaining their knowledge and experience with options.

Based on your responses, the brokerage will decide whether or not to let you trade options with them. And your brokerage firm does have the right to turn down your request.

But by knowing what to expect and preparing for it in advance, you’ll be able to get started with less hassle and less time. Which means you can start profiting sooner. Just as it is with stocks, online brokers are the least expensive, discount brokers are in the middle and full-service brokers are the most expensive.

Three Reasons Why You May Be Denied
**#1: No Knowledge or Understanding of Options**

To determine this, you’ll be asked to assess your knowledge of options by selecting one of the following multiple-choice answers: none, good, very good, or excellent.

If you aren’t confident that you have a good enough understanding of options to at least answer “good,” then you probably shouldn’t be trading them. You should have at least a minimal understanding of the risks in the market, the procedures and the terminology involved in trading options.

**#2: No Experience Trading Options**

This is rather like getting that first job. To get one, you have to prove you’ve got experience and have done well at your last job. But how do you do that without having a job before? Talk about a Catch-22! You have no experience trading options, but you need experience to trade options. So what do you do?

If you don’t have any options experience, the key is starting small. Don’t answer questions where the brokerage will think you’re ready to run the gamut: sell calls, sell puts, do spreads, conduct straddles, etc. This will ensure that you get turned down.

Instead, just indicate that you want to only buy calls and puts. These are the simplest options trades available and the starting ground for most traders. Then, as you become more comfortable with options, you can always add more features to your account.

**#3: Inadequate Funds**

These questions relate to your income, liquidity, net worth, etc. Basically, when it comes to options, the broker wants to make sure you aren’t investing money you can’t afford to lose. Thus, the higher your income, liquidity and net worth, the better your chance for approval.

Bottom line: There’s no verification or checking of your answers. So, you can be as knowledgeable, experienced and as rich as you want to indicate. But realize that the more you exaggerate, the greater the chances are that you could do something you’ll regret while investing in options.

Having Trouble? Three Ways to Break Down
the Door to Options Trading

Getting started trading options can present some challenges. So what can you do if you want to trade options but are rebuffed? If you’re having trouble qualifying to trade options, there are ways to ensure you get in the door:

1: Shop Around

First, check with two or three brokers. Each brokerage firm is different. They want your money, and some may be willing to cut you some slack when it comes to qualifying you. This is the best way to get in. It’s quickest, and costs the least amount of money and time.

But if that doesn’t work, you’ll have to establish your reputation by proving to the brokerage that you’re a trustworthy customer – one who presents no trouble and keeps sending money. So if you get locked out of the options world, your second choice is to prove your track record.

2: Start With a Low-Risk Strategy

If you didn’t find a willing broker by shopping around, set up an account that allows you to trade covered calls (more on this later). With covered calls, there’s absolutely no risk to the broker if you’re trading against a stock you already own. This will get your foot in the door of the options system.

Once you have that account, start with very low-risk covered call trading. This means buying 100 shares of a steady company like GE and selling a very deep-in-the-money call against it. You may only make 1% or 2% on this trade, but you will begin to develop some options history.

3: Use a Trusted Broker

Finally, once you’re established, even if it’s just with covered calls, you can go to a better solution. Contact a broker you trust.

You can call Greg Long at International Assets Advisory (800.329.1984) and see if you’re qualified to trade options with his firm. Greg has been in the business for a long time and gives the kind of service you’d want. You’ll still have to qualify, but you won’t be dealing with a wet-behind-the-ears beginner.

Once you’ve developed your history, you can answer that all-important “experience” question on the form truthfully by saying that you do have options trading experience. That will open the door to trading
all types of options in the future – including the ones that can produce triple- and even quadruple-digit returns.

Making Your Options Investment: How to Place Your Buy Order

Assuming that you qualify, and have now opened that options account, it’s time to trade.

When you buy an option, you’re opening a position. When doing so, use the term “buy to open.” This means you’re taking a new options position which, when executed, will be entered into the exchange computer.

Every options trade includes the underlying stock, option type (call or put), expiration date and the strike price. So, this is how you would tell your broker which option you want to trade:

“Buy the IBM April $60 call.”

- IBM is the underlying stock.
- April is the month of expiration.
- $60 is the strike price.
- Call is the type of option.

We highly recommend that you mention a limit order price when you place the trade. Again, a limit order is an order to buy at or under a certain price (or in the case of a sell order, only at or over the stated price).

When executing trades, make sure you place your limit order between the bid (what people are willing to buy the option for) and the ask (what they will sell it for).

Why? Well, as noted earlier, options trade in $0.05 increments. So if you have an option trading at $1 on the bid and $1.20 on the ask, you should enter a limit order trade at $1.10 or $1.15. That way, the trade will be executed when that price is hit, even if it’s just briefly.

If no buy or sell price is given, the order is entered as a market order. This is an order to buy or sell right away, at the current market price.

Make sure you also tell your broker how many contracts you want to purchase. Remember, each contract controls 100 shares of the underlying stock.
So here’s what you’d say:

“Buy five contracts of the IBM April $60 call at a limit of $4.”

Closing Your Positions

Just as “buy to open” gets you into an option, “sell to close” gets you out. You sell your option to the market, receiving money in exchange for giving up your rights to it. Worst-case scenario: If the value of the option has declined below the value of the cost of the commission to sell it, then do nothing – simply let it expire worthless on the expiration date. This is also known as “bid goes to zero.”

However, it’s very important to realize that unless you want your option to expire worthless, you must give your broker instructions regarding what you want to do with it. Don’t ever assume your broker knows your intentions or is aware of what’s happening with your option.

Your option may be in-the-money (i.e., profitable), but unless you give instructions to sell or exercise your option, it could ultimately expire worthless.

Your brokerage cannot take matters into its own hands and decide what’s best for you, with one notable exception: If the underlying stock is in-the-money by $0.75 or more on the day of expiration, the broker/firm will auto-execute your option. The broker will buy the stock at the agreed-upon price stated in the option contract and deduct the money from your account to pay for it. But any time prior to expiration, it’s up to you to decide what you want to do.

You can also give your broker a “stop-loss order.” This is an instruction to sell your holding if the price falls to a certain level to prevent further losses. This helps limit your risk and lock in gains. For instance, if you bought your option at $500 and it goes to $1,000, you might want to tell your broker to put in a stop loss at $750. This means if the price hits $750, your broker will automatically execute a sell order, thus locking in gains. But keep in mind that calling in a stop loss only tells your broker to start executing the order when it hits your sell price. If the option is dropping rapidly, by the time your order hits the trading floor, the price could be below $750.

Be careful: Make sure your broker understands that you want a stop-loss order and not a sell order — otherwise he might execute the order.
immediately, and you could end up reselling an option worth $10 for $7.50. Simple mistakes like this illustrate why it’s essential to find a broker you can trust… or learn to trade yourself.

Bottom line: Give your broker instructions regarding what you want to do with your options. Don’t leave yourself holding a worthless options contract, or holding shares you never intended to purchase.

Fortunately for you, you’ll never have to make that determination for yourself. We’ll always tell you when and how to close out an option play. Nonetheless, you should know how to do this yourself.

Holding, Folding and Cashing In

So now that you know how to open an options trade, what can you do with it once it’s open? Fortunately, it’s pretty straightforward, and there are a couple of choices.

First of all, if you’ve bought a call option, you’re not obligated to buy the 100 shares of stock (in each contract) if the strike price is hit.

Conversely, simply because you bought a put option, that doesn’t mean that you have to sell those shares if your price is hit.

Remember that the option is a right, not an obligation. In fact, the vast majority of call buyers never end up buying the underlying stock. And the vast majority of put buyers never end up selling the underlying stock.

Rather, they make their profits in one of two ways.

What to Do if Your Call Goes Up (Profitable)

Let’s use a Microsoft option as an example here:

You’ve just seen that Microsoft shares are trading at $25. So you buy the January $30 calls, with a cost (premium) of $1.05.

If the call option goes the right way for you and the market value of Microsoft rises to $40, you can do one of two things:

1) You can exercise the call option and buy the stock at $30 – a full $10 below market. At that point, you could immediately turn around and sell it for $40 (the going market price) and pocket the gains ($10 per share), or hold onto the stock for possible further gains.
2) If you don’t want to own the stock, you can sell the options into the open market. If Microsoft has gone up to $40 in price, then each option (now $10 in-the-money) is worth at least $10 (the intrinsic value). This amount could even be more with the time value added in. Let’s say that with the time value, the option climbs to $12. The difference between the $1.05 you paid for the call and the current $12 is your profit. So you would have paid $105 for one contract, which you can now sell for $1,200... a 1,042% profit.

What to Do if Your Call Goes Down (Not Profitable)

However, if the Microsoft April $30 call option goes the wrong way for you and the market value of Microsoft either doesn’t change or declines in value, then your alternatives begin to narrow. Let’s say it gets to the end of February the following year, and Microsoft is currently trading at only $26. Here are your alternatives:

1) Your first choice is to sell the call while it still has time value left. You would receive less than you paid for the option, due to the stock still being $4 out-of-the-money and the option less than two months until expiration (leaving less time for the stock to achieve the price objective). But at least you won’t be stuck with worthless paper after the expiration date. The option would, let’s say, be selling for about $0.50. You would sell the Microsoft option for $0.50, and take a loss of $55 ($105 minus $50).

2) You can hold on and hope that Microsoft shares go up and the option increases in value prior to its expiration, allowing you to recoup your costs or even make a profit. However, if Microsoft doesn’t increase in value and fails to reach your strike price before expiration, that option will expire worthless.

What to Do if Your Put Goes Down (Profitable)

Conversely, if you had purchased a put option, you’d be expecting the stock’s value to fall.

Let’s say Microsoft shares are trading at $34. You buy the January $30 puts with a cost (premium) of $1.05.

If the price of Microsoft goes the right way for you and the stock’s price falls to $20 ($10 under your $30 strike price), then you can do one
of the following:

1) Sell the put before it expires. With the option $10 in-the-money, the put option that cost you $1.05 is now worth at least $10 (the intrinsic value of the option without any time-consideration value). At $10, you’ll have made a profit on the option alone.

2) Exercise the put by buying 100 Microsoft shares at the current price of $20. You would then immediately sell those shares at the agreed-upon strike price of $30 and make $10 on every share.

3) Do nothing. If the expiration date arrives with you in-the-money, your broker may be obligated to execute the trade. But that’s putting the responsibility for your profits into someone else’s hands – not a very sensible situation.

Remember that as a call buyer or a put buyer, you’re not obligated to buy or sell 100 shares just by virtue of owning the call or put option. That’s why they’re called options – not obligations.

Okay, up to this point, we’ve pretty much concentrated on giving you an understanding of the basics of options trading. But you also need to be aware of the inherent risks involved with buying options.
PART THREE

OPTIONS:
RISKS AND REWARDS
Risks Associated With Options – And How They Can Work for You

Options are like burning matches: They will all extinguish themselves eventually.

For most investors, the thought of putting money in an investment that literally evaporates after the passing of a deadline, or one that will decline just because time goes by, is enough to make them run in the opposite direction.

And because options expire, owning them is very different than owning the shares of a company outright. If you own shares of a company outright or you’re selling the shares short, the timeframe of your ownership can be indefinite. Not so with options.

With options, not only do you have to be right about the direction of the underlying stock, the movement also has to take place within a specified timeframe.

On a positive note, your loss with an option is limited to the amount of your investment. Because an option gives you the right and not the obligation to purchase or sell shares, you’re never required to take action on an option you have purchased.

In this light, options investing allows you a sense of risk reduction for your investment.

For example:

Let’s say that in September 2010 you purchased a January 2011 $45 call option on Company XYZ. The premium cost is $2 and the stock is trading at $40. If, by January, XYZ dropped to $20, investors who purchased 100 shares would have lost a total of $2,000. But those who purchased the option contract would be out only $200 (the cost of the option). That’s quite a difference.

Be aware, though, that the opposite is also true. If the XYZ shares rebound after the January expiration of your option, all you can do is watch. The investors who bought the stock outright will be rewarded for taking the added risk of paying the full price, holding on when their shares lost half their value and riding the rebound.
Taking Risk Reduction and Leverage to the Next Level

Leverage is crudely defined as “using a little money to make a lot.” But we’ll use a more conventional definition: “Putting down a small investment to control a large amount of stock.”

And as you’ll see, that’s exactly what an option does.

Let’s use Johnson & Johnson as an example. Say the company’s stock is trading for $50. A call option with a $5 premium will let you control 100 shares for $500. However, if you bought 100 shares of the underlying stock, that would cost you $5,000. That’s a $4,500 difference.

So, in reality, you’re only putting 10% down. In terms of your profit potential, this also means that you could double or triple your investment with just a 5- or 10-point move in the stock.

That’s what is called getting the most “bang for your buck.”

For some investors, that’s still too much risk. So, in many cases, they ignore options altogether.

Unfortunately, they may also be turning their backs on other ways to profit with options. Because for the more conservative options player, there are alternatives for hedging risk, such as:

#1: Position Sizing: The Most Powerful Way to Reduce Risk

Position sizing is the most critical and important factor when it comes to investing. It’s a simple concept, yet very powerful. It’s the one practice that separates investors who succeed (especially in options) from those who periodically wipe out and either have to save up to start over, or just give up entirely.

Position sizing means investing the same amount in every investment.

For example, let’s say you have a $100,000 portfolio. Instead of investing $80,000 in a fuel cell company and the balance across 20 blue-chip stocks and options, you would be equally weighted across the board. So if you had 25 positions and $100,000 to invest, then you would put no more than $4,000 in each investment – including that incredible fuel cell company.
If You Don’t Get in Trouble, You Won’t Have to Get Out of It

Sooner or later, you’re going to encounter a loss. It happens to every investor. But it doesn’t have to hurt anything significant – except your pride for a day or two.

Nervous amateurs tend to remember every loss and fret over each one – and then set about trying to make up for it. They want to get even again. They get crazy and take ill-advised risks. Successful pros don’t do that. They don’t get even; they stay even.

The secret isn’t in better stock picks; it’s in better control.

Let’s say that your surefire investment in fuel cell stocks flamed out and fell by 30% overnight. If you’d ignored position sizing and put $80,000 of your $100,000 portfolio in fuel cells, you’d have lost more than $24,000 in a heartbeat. In the position-sized portfolio, equally spread across 25 investments, your loss would only be $1,200.

How to Cheat a Little Without Breaking Rule #1

No matter how much people want to believe in theory, real-life investing is different. Investors all too often invest emotionally. If you’re an emotional investor, then use a more liberal version of position sizing.

So, instead of position sizing with each individual stock or option, position size with sectors.

If you’re big on utilities or telecoms, then position size your portfolio so that you limit your investment in each sector to something like 10%, thus adding a strict stop-loss system. That way you can be overweight in one company or sector, but not so overweight that you’ll need radical portfolio surgery to come back from the edge.

With Position Sizing, Safe Options Are Possible

Position sizing is especially important when it comes to options.

If you have a $10,000 portfolio devoted to options, you should allocate it so that you aren’t at risk more than 5% or 10% in any one position, especially for the safer, longer-term options strategies such as LEAPS (long-term options – more on this in a moment) or covered calls.
For short-term trades, which are riskier, 5% is as high as you should go. That way you’ll still come out profitable as your winning trades carry you forward.

Position sizing will help give you the kind of control over your fate that you can’t get any other way in investing. It will also help ensure that you get the best returns for the least amount of risk when trading options.

#2: Reading Volume: A Quick Trick for Identifying Trends

Whether you’re an options buyer or seller, it’s impossible to have a one-sided market exchange. Every buyer trades with a seller. Some days the buyers are in control. And sometimes sellers rule the market.

Not only does every trade have two sides, but both of them also have to agree on the price. There’s no selling at $45.28 unless there’s a buyer who will take it at that price. There’s no buying at $34.76 unless there’s a seller willing to supply the stock at that price.

Every day, every trade has two sides and both sides are in agreement. So, how can anyone be in charge?

This is an important question when it comes to trading, because technical systems are based on the idea that you can spot whether buyers or sellers have control. Without knowing that, you couldn’t tell whether a stock was likely to head up or down – and you certainly couldn’t survive the options market without knowing that.

Sometimes when you look at a chart, it’ll be quite obvious what’s happening. The prices are clearly trending up or down. But then, for some reason, with no real news, the price line will start going the other way. Instead of continuing upward, the bullish chart turns bearish. Instead of falling closer to zero, the bearish chart gets bullish. Maybe what was clear wasn’t so helpful, after all.

Reading Volume to Find 20% Gains... In Just 45 Minutes

Very often, there are lots of methods for detecting these buying and selling climaxes. The astute technical analyst often knows when that
change is about to happen.

For example, candlestick charts have dozens of patterns. Regular charts have well-known formations like the “head and shoulders” top or “inverted head and shoulders” bottom.

Point-and-figure charts will meet their targets. A stock might cross a moving average. There are literally hundreds of specialized technical systems that will give signals, not to mention discrepancies between signals that have meanings, as well.

But if you want a quick take on whether or not a trend is still strong, volume is the best place for the beginning technical trader to focus.

Take a textbook example from a few years ago. In 2005, Priceline.com had been bullish since early February. But in late March, its usual choppiness looked like it was turning into a serious change of direction. The stock was trending down consistently. For seven days, it dropped. Was the bull run finished? Had the sellers taken charge? The chart direction looked very much as if that were the case.

But if you looked at the volume, you would have drawn an entirely different conclusion.

During that whole period when the price was falling, volume was getting weaker and weaker. Finally, hardly anyone was coming out to play. The daily volume was only a third of the norm.

That was a good sign that selling pressure was drying up. Those who wanted to sell at whatever price they could get had largely sold. Even though the chart was still dropping, the weak volume pointed to a bullish reading.

By Friday of that week, the stock had turned around – hard. At 2:30 PM, the stock that had been dropping $0.10 to $0.20 a day did an about-face and rose $1.50 in the next 45 minutes. Needless to say, the options responded with a big spike, too, gaining 20% just as quickly.

What Weak Volume Tells You

There’s no way you could have pinpointed that the change in direction would come at precisely 2:30 PM. Nor could you have known that the stock would reverse so quickly. But the weak volume signaled that the change was probably coming.
The chart had already told the basic story. Sellers were tired. The stock was dropping weekly on lower and lower volumes, and it was time for the buyers to return.

So next time you’re tempted to buy a stock that’s been rising, be sure the volume still supports it. And if you’re thinking of selling a stock that’s been falling, make sure you’re not the last seller. If the volume has sunk too low, you’ll probably wish you’d held on.

#3: Volatility: A Free Tool for Finding the Best Option Bargains

When it comes to options, you can either buy them when they’re cheap or buy them when they’re expensive.

The professionals and market makers on the options exchanges use computers to determine whether options are overpriced or underpriced, and they usually use the Black-Scholes Model mentioned earlier.

As a reminder, here are the six factors that fix options prices:

1. Price of the underlying stock
2. Strike price of the option
3. Time to expiration
4. Volatility
5. Interest rates
6. Dividends

All of the factors except for “volatility” are either set by the options exchanges or are readily available information for everyone to use.

When you’re trying to gain an edge over the market by finding the best possible prices, the “volatility” of the option is the key factor. Volatility has a direct effect on the price of an option. When a stock is fluctuating wildly, that means the stock is volatile, which, in turn, increases the volatility.

When volatility increases, so do option prices. When stocks are stagnant, volatility decreases, which brings down the option premiums.

Volatility, as it applies to options trading, is a number that quantifies
how volatile the underlying stock has been in the past, as well as how volatile it’s expected to be in the future.

There are two types of volatility that relate to options trading:

**Historical volatility** measures how erratic, or volatile, the stock has been in the past.

**Implied volatility** measures how the options market sees how erratic, or volatile, the stock might be in the future.

Since there are different timeframes in which to measure and calculate volatility, you can guess that the volatility factor that goes into pricing an option can be confusing.

Some traders like to use 10-day, 30-day, or 50-day “historical volatility” when pricing options, while others like to use the current “at-the-money implied volatility” of the front-month options.

Some like to calculate the volatility using the closing prices of the stock, while others like to incorporate the high, low and close of each session.

But you shouldn’t be overly concerned with how volatility is calculated or which measure is used. You should focus on how to tell if options are expensive or cheap before you buy them. Volatility can tell you just that.

Volatility fluctuates in the same manner as a regular stock chart, oscillating between periods of high levels and low levels. Your job is to know whether volatility is at a high or low level before purchasing your options contracts. Of course, buying when volatility is low is one of the best ways to put the odds of success on your side.

How do you tell if volatility is high or low? Just look at a volatility chart, published on various websites.

Take a look at a past one-year volatility chart for IBM on the next page.

Note how the implied volatility (IV) was much higher in January (around 40%), and hit lows in October near 20%.

At the time, if you’d priced out the IBM December 2009 $100 call using a volatility level of 20%, you would have yielded a premium of $0.70. (You can use an online options calculator to do this, like the one at www.ivolatility.com.)
But if you’d substituted a volatility level of 40%, the same $100 call would have cost you $3.50 – more than five times the price when compared to the lower volatility number. Remember: When volatility increases, so do options prices.

What This Means for You As a Trader

Clearly, if you plan on buying an option, you’d better check the volatility level to see if you’re buying a cheap or expensive option.

If you buy an expensive option and the stock doesn’t move in your favor right away, not only will you lose because the direction was wrong; you’ll most likely lose even faster if volatility starts to come down.

If you buy an option when it’s cheap and the direction goes against you, you won’t lose as fast, because the volatility is already low and it therefore won’t suck out much more value. Ideally, you want to buy cheap options (low volatility), but ones that’ll hopefully have high volatility down the road.

Bottom line: Always make sure you’re aware of the volatility levels before initiating an options position. As you take in all the other factors before making a trading decision, add this tool to your arsenal to increase your odds of success.

#4: LEAPS: Producing Big Jumps in Portfolio Value

If you’re a seasoned stock investor, this method of options trading
could be for you.

It involves the use of LEAPS options (Long-Term Equity Anticipation Securities). These options have a lifespan of up to three years and can be an effective way for you to own underlying shares of stock for a period much longer than that allowed with regular options.

While you’re still risking money in a position that could expire worthless, you have a longer timeframe for the underlying shares to move in the direction you want.

Perhaps more importantly, any upward movement in the share price will be exaggerated in the price of the LEAPS option itself, depending on the strike price chosen and the expiration date. And although the strategy is more conservative and allows for a longer investment timeframe, spectacular profits can be made quite quickly.

*Wall Street Daily’s* Director of Options, Karim Rahemtulla, has achieved this for his readers countless times over the years, as LEAPS options are his bread and butter.

**#5: Writing Covered Calls: How to Slash Your Downside Risk**

If you’re a more conservative or amateur investor, then covered calls might be the best bet for you.

Covered calls basically involve making money on underlying shares that you already own by selling call options against them. Unlike LEAPS and regular options investments, the aim of covered calls isn’t to produce home run-type profits, but to chalk up consistent profits of 2% to 3% per month.

While that might not sound like a lot, especially when regular options can pay off in triple- or quadruple-digit returns, the regularity with which they occur really adds up (24% to 36% on an annualized basis). This provides a much safer way to invest in options. Consider that you effectively double the value of your portfolio about every three years – a pretty enticing alternative to watching your retirement funds go up in a cloud of smoke.
Overall, this kind of stability, consistency and profitability builds a strong case for taking a more conservative approach to options.

Here’s an example of how covered calls work:

Say you own 1,000 shares of Company XYZ and your cost was $20 per share. You could sell an option into the market that gives someone the right to buy your XYZ shares from you at $25 in 12 months. For that right, you would receive a premium (instead of paying one to buy an option). Let’s assume the premium you receive is $4 per share.

Your adjusted cost for the underlying shares of XYZ is now $16 ($20 share price minus your $4 premium for the option), giving you an automatic 20% downside protection on the stock. In other words, if the stock drops to $16, you’re still even. Whereas, someone who owned the stock outright would be out 20% of his investment.

And if you use a 25% stop loss on your XYZ shares, the price would have to drop to $12 for you to pull the plug. For an investor who owns the shares outright, a plunge from $20 to $12 would mean losing 40% of the investment. That’s huge.

Of course, selling an option on shares of stock that you own limits your upside, as well. In this case, if you sold an option with a strike price of $25, then you’re limited to $25 on the shares, or a 25% gain, before the person who bought your option would exercise it.

But if XYZ fails to hit your strike price by the expiration date, you simply keep the shares, as well as the premium received for the option.

### Using Options to Hedge Against Down Markets

Along with hedge plays like covered calls, you can also use options to hedge against downturns in the overall equity market, protecting the stock portion of your portfolio.

For example, if you think that the market will fall, causing damage to your portfolio, you could buy insurance in the form of a put option on the broad market or your individual holdings, to offset some of that risk. If the market falls, your stock holdings might decrease in value – but your put options would increase at the same time.
#6: Conservative, Yet Profitable: Harness the Power of Uncovered Put-Selling

With a little time and effort, any investor can learn about the power of naked put-selling – a very useful, time-tested options strategy.

It has a great deal in common with a covered call. But there are distinct differences, advantages and disadvantages to each strategy.

As discussed earlier, covered call writing entails buying shares of a company and selling an option against those shares, effectively reducing your cost by the amount you’re paid for the option you sell.

The covered call investing strategy is best for those who believe that the upside potential of the shares is limited, or when a disciplined approach to investing dictates that the shares will be sold once a preset target price is reached.

Selling puts is a bit different. Here’s how it works:

Say you like IBM shares at $92. You think the stock is worth that and more, but it seems likely to experience a short-term decline first. Instead of buying the shares at $92 and selling a $95 call option against your position (as you would with a covered call), this time you don’t buy the shares at all.

You sell a $90 put option, naked (meaning you don’t own the underlying shares). The premium on this put is $2.50. That means you immediately receive $2.50 per share to use as you please – free money for now. If IBM closes above $90, the money is yours, free and clear. Nobody is going to “put” the stock to you at $90 if it’s worth more on the open market.

However, if IBM closes below $90, then you’re obligated to buy IBM shares at $90. This is called “getting put.” The only way out is to buy back the put. Unless you really want to own the shares, it’s not pleasant. Imagine waking up one day and hearing that IBM shares have fallen by 20%, because of a scandal or bad earnings. If the shares don’t recover and the option expires, you must either buy the shares at $90 or buy back the option that you sold – a big loss in either case.

When you sell naked puts, you’ll be making money even if the shares
drop a bit. As long as IBM’s price is above $87.50 ($90 strike minus the $2.50 premium), you’re profitable. But if the shares close below $87.50, then you’re losing money. So, in a sense you’re betting the shares will stay above $87.50 until expiration.

Naked or uncovered put-selling is a powerful tool. It’s a very popular strategy with many investors, because its conservative nature doesn’t require you to own the shares. So you don’t have all that money at risk. You’re required, however, to have enough money in your margin account to buy the shares in the event you are “put.”

If you’re new to options investing and have a small portfolio, it’s a very effective way to build up equity. But you must have the same discipline as a trader using any other system. Make sure to position size properly, employ sensible stop losses and always do your homework.
Part Four

Advanced Strategies: The Power of the Straddle and Strangle
Play Two Sides At Once Using Straddles and Strangles

Don’t be put off by the language – the concept of straddles and strangles is really quite straightforward. It simply involves buying a call and a put at the same time.

Far from being a conflicting strategy, it’s actually a great hedge tactic. It gives you added flexibility, lowers your risk and increases your chances to profit. And it’s perfect for a fluctuating or volatile market.

The beauty of it is, your downside is capped, but the upside can be very lucrative. Consider straddles and strangles like a game of poker. You probably know which position you want to succeed the most – but other traders can’t be sure. So you keep the professional options traders guessing by making them think you’re playing both the up and down moves. It’s a very powerful strategy.

**Straddle:** An options position where you hold the same number of calls and puts, where both have the same strike price and expiration date.

As noted earlier, you have to make three key decisions when trading options:

- Are you going to buy a call or a put?
- What’s your strike price?
- What’s your expiration date for the options?

It’s much easier to make those decisions when you’re dealing with a stock or index that’s rising or falling. You just have to pick the cheapest option with the best profit potential, so you don’t negate any gains.

Figuring out which way your investment is going to go becomes a little trickier when the market or stock is trading in a tight range.

But you don’t have to sit there and wait for something to happen. With a straddle play, you can sit on both sides of the fence. Options straddles are most effective when a stock has been traveling sideways, in a tight range, ahead of a significant news event.

For example, if you think a stock or index is poised for a big move (perhaps following a major news announcement like a merger deal, FDA approval or earnings report), but you’re not quite sure which way, a straddle is the way to go. After all, most analysts can’t accurately predict
corporate earnings on a regular basis. And even then, Wall Street often reacts in a completely bizarre manner. A stock can have blowout numbers and still go down.

By buying a call and a put – both with the same strike price (as close to the current price of the security as you can) and expiration date – you know that if the stock or index does, indeed, break out of its range, one of the plays is going to pay off for you.

If the security breaks out only to correct later and fall back again, you can profit from the initial upside and then the downside if investors get depressed and start selling. When they do, that might just make the price more attractive to other more bullish investors.

If you’re only investing in the stock, you can see that you’d have to be perfect with your timing in order to get in and get out, and claim the best profits.

That’s a very high-risk, low-reward strategy. And that’s why an options straddle makes much more sense. Your risk goes way down – but your potential reward goes way up.

Sometimes, though, the options on a stock cost too much. For instance, if your potential reward is $5 and the straddle will cost $3 for the put and $3.50 for the call, that’s not a winning trade no matter how right you prove to be.

In that case, it’s time to make a very similar, but much cheaper trade: a strangle. It’s a very powerful option because it allows you to go against the crowd by taking on a little more risk for a much bigger potential return.

**Strangle:** An options position where you hold a call and a put that both have the same expiration date but different strike prices.

A strangle is basically the same as a straddle, but with one major difference. You still buy the same number of calls and puts with the same expiration month. The difference is in the strike prices.

Again, strangles are commonly used when you have a stock or index that’s trading in a tight range, or is volatile and quite unpredictable. You don’t have to look for securities on the upswing.

Here’s an example: Take a stock at $29.32. This would be a great $30 straddle. But on investigation you find that the $30 strike options cost too much. So you go one strike further out each way to set your
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put strike price at $25 and your call strike price at $35. You’ve got the current price of the security surrounded and can profit on a breakout in either direction.

By hedging on a significant move either way, your potential return can be greater with a strangle. And doing something that few others are doing – and then being right – is always more rewarding.

However, like straddles, a strangle does cost more than simply buying a regular call or a put. You’re hedging on a move in either direction, and that will reduce your returns compared to a situation where you just buy either a call or put and end up being correct.

No Trend? A Straddle or Strangle is Your Friend

Considering that an index or stock is only in a strong uptrend or downtrend less than 50% of the time, straddles and strangles can help you squeeze gains from a meandering security and tighter trading range.

Strangles give you better odds of winning in these types of situations. Naturally, you have to stay on top of the trade and dump the losing side as soon as you can, while letting the winning side run. But this strategy wins about 70% of the time. If you play both sides and pay attention, you can do very well. But you have to be able to cut your losses and take your profits.

The strategy isn’t for the investor who likes to sit down after dinner and quietly review what happened in the market that day. If you don’t have the time to track a strangle play, use a full-service broker to do it for you. It’s in the options investing fast lane and should be treated as such.

Here’s your “strangle checklist.”

**High volatility:** A strangle is a great way to capitalize on big swings in the underlying shares, especially when you don’t know which way they’ll move. Sometimes, there’s simply no accurate way to predict what a stock will do before or after its earnings announcement. A strangle will help protect you.

**Price:** It’s often better to buy options that are in-the-money. This gives you the best chance to gain from just a small move in the price.

Buying options that are further out-of-the-money just because they’re cheaper isn’t a good idea. The farther out you go, the bigger price swing you need in order to turn a profit.
Volume: Make sure the volume on your options isn’t too thin and that liquidity in the underlying security is also reasonably good.

When volatility, price and volume are all in your favor, it’s time to strike with a strangle.

Conclusion

As you can see, options can be used as a hedge to effectively reduce risk in your entire portfolio. You can also use options to hedge against downturns in the overall equity market, protecting the stocks portion of your portfolio.

For example, if you think that the market will fall and cause damage to your portfolio, you could buy insurance in the form of a put option on the broad market or your individual holdings, to lessen some of that risk. If the market falls, your put option increases in value while your stock holdings might decrease in value.

Like anyone, you might make mistakes when you first start trading, so don’t get discouraged. Your early mistakes will be the tuition you pay in order to make double-, triple- and even quadruple-digit profits on future trades.

Remember to use the same key investment rules with options as you would with stocks. Decide how much money you’re willing to risk and only invest what you can afford to lose. Don’t blow it all in the first few months, either. Instead, spread your trades out over an entire year.

Diversify. Allocate your assets over several investments, using the same dollar amount in each position. Use calls and puts: You’ll often be surprised where the home runs come from. Once you’ve done that, you’ll be hooked.

Successful options trading takes know-how and experience. Now that you’ve got some of the know-how, it’s time to gain experience and turn the knowledge you’ve just acquired into money!
Glossary of Options Terms

**ASK**: The lowest price one is willing to receive for an options contract.

**AT-THE-MONEY**: When the current market value of the underlying stock is the same as the exercise price of the option.

**BID**: The highest price an investor is willing to pay for an options contract.

**BLACK-SCHOLES MODEL**: The industry standard model that helps determine the value of an option based on several factors. Developed by Fischer Black and Myron Scholes.

**CALL OPTION**: An investment that speculates a stock’s price will rise to a specific level within a specific amount of time.

**CLOSING TRANSACTION**: A transaction in which, at some point prior to expiration, the option holder or option seller closes out the position, thereby removing any obligation to fulfill the contract.

**CONTRACT SIZE**: The amount of shares subject to being purchased or sold when exercising a single option contract. The standard contract size for options on stocks is 100 shares. One call option contract gives its holder the right upon exercise to purchase 100 shares of the underlying stock. (Also: “unit of trading.”)

**COVERED CALL**: Selling an option against a long position in any underlying stock.

**EXPIRATION DATE**: The date in the future that a strike price must be hit for the option to be acted upon (the end of the day on the third Friday in the specific month in which the option expires).

**IN-THE-MONEY**: A call option is said to be “in-the-money” if the current market value of the stock is above the exercise price of the option. A put option is said to be in-the-money if the current market value of the stock is below the exercise price of the option.

**INTRINSIC VALUE**: This reflects the amount, if any, by which an option is “in-the-money.”

**LEAPS**: Long-Term Equity Anticipation Securities. These are long-term options with expiration dates up to one, two or three years in the future.

**LEVERAGE**: Techniques used to multiply potential gains or losses. Common ways to employ leverage are borrowing money on margin or
using derivatives such as options.

**LIMIT ORDER**: An order placed with a brokerage to buy or sell a specific number of shares/contracts at a set price (limit price). They allow investors to enter/exit a trade at a specified purchase/sell price. Particularly useful on low-volume or highly volatile stocks/options.

**LONG POSITION**: The status assumed by investors when they execute a buy order in the market. If you own a stock or a call option, you’re “long” the market. You’re anticipating an increase in the market value of the underlying stock.

**MARKET MAKER**: A certified securities dealer who has an obligation to sell when there’s a surplus of buy orders and buy when there’s a surplus of sell orders.

**NAKED OPTION**: An option written/sold without owning the underlying assets. Includes naked calls and puts. Profits are huge if the predicted move happens, but they’re risky and losses can be just as large as profits.

**OPENING TRANSACTION**: A purchase or sale transaction by which a person establishes a position as either the holder or the writer of an option.

**OPTIONS CHAIN**: A listing of all options for any given asset. Tells investors the various strike prices, expiration dates, and calls and puts available.

**OUT-OF-THE-MONEY**: If the exercise price of a call is above the current market value of the stock, or if the exercise price of a put is below the current market value of the stock, the option is said to be “out-of-the-money” by that amount.

**POSITION SIZING**: Investing the same amount in every investment.

**PREMIUM**: The price that the holder of an option pays and the writer of an option receives for the rights conveyed by the option. The premium plus commission is the buyer’s cost for purchasing an option.

**PUT OPTION**: An investment that speculates a stock’s price will decline to a specific level within a specific amount of time.

**SHORT POSITION**: The status assumed by investors when they execute a sell order in advance of a buy order. If you’ve sold short a stock or bought a put, you’re “short” the market. You’re anticipating a decline in the market value of the underlying stock.

**SPREAD**: The difference between what you can buy an option for and what you can sell it for at any given time. The spread is represented by
the bid and ask prices, with bid being the selling price and ask being the purchase price. The difference is the market maker’s profit.

**STRADDLE**: A strategy whereby you simultaneously hold a call and a put option on the same underlying stock with the same strike price and expiration date. If the stock experiences an extreme movement in either direction, the investor can profit on one option and sell the other option quickly for a slight loss.

**STRANGLE**: A strategy whereby you simultaneously hold a call and a put where both have the same expiration date but different strike prices.

**STRIKE PRICE**: The price at which an option holder has the right to either buy or sell the underlying instrument (stocks, commodities, etc.).

**TIME DECAY**: This begins to develop in options in the last 60 to 30 days before expiration. If an option is deep-in-the-money it’ll happen more rapidly; holders may discount the time value, attracting buyers and realizing intrinsic value.

**TIME VALUE**: The premium of the option in addition to its intrinsic value.

**TRAILING STOP**: A stop loss set above or below depending on what the current price is as the price fluctuates. For a long position, a trailing stop would be set below the current price and would rise as the price advances. As long as the price remains above the trailing stop, the position is held; should the price fall and reach the trailing stop, then the stop loss would be triggered and the position closed.

**VOLATILITY**: A measure of the inclination of a market or security to rise or fall sharply within a period of time. Primarily determines the value of options and time values. Two kinds: **Implied** (a future gauge, usually calculated with Black-Scholes pricing model) and **Historical** (which draws on historical statistics).

**WASTING ASSET**: Any asset that declines in value over time. An option is a wasting asset. It only exists until expiration, after which it becomes worthless.
Whether you’re just starting out in the options world or are a more seasoned trader, if you truly want to master this often-misunderstood investment vehicle, you need *The Ultimate Options Primer* by your side.

What you’re holding right now is a complete options crash course – and the perfect trading companion. In this book, you’ll learn the anatomy of options, from the very basic, essential elements – right up to the more advanced options trading techniques that you can use to really supercharge your gains.

You’ll learn:

• What options are, why to buy them and exactly how they work  
• How to open an options trading account  
• Secret tips and strategies to beat the market makers and get the right price  
• How to assess the fair value of an option  
• How to place your orders – buying and selling  
• Evaluating options risks – and how they can work in your favor  
• Using volume to identify winning trends  
• Using volatility to find the best options bargains  
• How to read and understand an options chain  
• How to use LEAPS options for big gains  
• How covered calls can slash your downside risk  
• How to use straddles and strangles to profit from any market

Most investors shy away from options, confused by the terminology, unsure of the risks, or skeptical of the profit potential. But ignoring options could be a huge mistake. They represent your best opportunity to score big returns, while allowing you to cover your risk.

That’s why we developed *The Ultimate Options Primer*. This book explains the ins and outs of the options world in a practical, easily understood form. And once you understand the essential strategies needed to put options investing to work, you can truly start to maximize your gains.

If you want to trade options, it’s critical that you have a solid understanding of the terminology, risks and rewards involved. You need *The Ultimate Options Primer*. 