

PersonalFinance

43 YEARS OF PROFITS IN BULL & BEAR MARKETS

# Options Strategy Manual



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Dear Income Seeker,

Welcome to *Personal Finance* and the wonderful world of options! In this guide, I'll share with you how to reduce risk and generate returns with options.

First, I'll describe the benefits and risks of trading options with *Personal Finance*. I'll review the basics and then discuss selling covered calls and puts in detail. I'll even walk you through my safe income-generating strategy of options spreads.

This manual will tell you everything you need to know about *Personal Finance* option trading except... which trades to make. I'll send you those trading instructions on the first Wednesday of each month. Be sure that you've taken the preparatory steps outlined in this manual so that you'll be ready to go.

One final note before we get started: You can find a full archive of *Personal Finance*'s options trades, including my latest recommendations, here:

**<http://www.investingdaily.com/personal-finance/options-trades/>**

To your wealth,



Jim Fink

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# Part 1: The Benefits and Risks of Options Trading

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## Stocks vs. Options

You're probably already familiar with traditional stock trading. When you buy a stock, you literally buy part of the company. Despite having little personal control over the company's business decisions, you get exposed to the full range of a stock's price movement—up and down—for an unlimited period of time (until you sell). Stock is a very blunt investment instrument that's sort of like being forced to buy a telephone package of local, long-distance, call waiting, caller ID, and voicemail when all you really want is a local dial tone.

In contrast, stock options are derivatives. They derive their value from an underlying “something else”—typically the value of a stock or stock index. Each low-cost option contract represents the right to buy or sell 100 shares of that underlying stock at a certain price on or before a certain date. Options allow you to limit your capital at risk to only those portions of a stock's price movement that you want—and for only the period of time you think necessary. This provides options traders with virtually unlimited flexibility to tailor their directional and temporal outlook concerning a stock and do so at the lowest possible cost. Compared to stock purchases, options are very inexpensive.

## How to Minimize Options Risks

All investments, including stocks and options, risk loss if the underlying price goes in the wrong direction. If used wisely, however, *options can actually reduce the risk of loss* from stock ownership. There are five main rules of option trading that protect you from assuming too much risk:

1. sell only the number of call options that are fully covered by 100-share blocks of stock that you own;
2. sell only the number of put options that you would feel comfortable having converted into 100-share blocks of stock;
3. limit the size of your option positions so that each option trade is only a small portion of your overall portfolio;

4. buy only options that don't expire for a long time; and
5. choose an option's strike price based on analysis of the stock's intrinsic value.

If you'll keep an eye on 1-3, I'll guide you through 4 and 5. The risks of options trading will be greatly reduced while the benefits will remain. When you participate regularly in the *Personal Finance* recommendations, I am confident that you will reduce your stock portfolio's risk and enhance returns. Reduced risk, income generation, and cost reduction are the name of the game in options as in general portfolio management.

If the benefits of option trading intrigue you, the next step is to obtain option trading authorization from your broker. Read on to learn how easy it is to get authorized.

## Setting up Your Options Account

First things first. Before you can take advantage of the many income benefits options offer, you must be authorized to trade options. Merely opening a stock brokerage account does not authorize option trading. To trade options, you must expressly request authority from your broker.

I can't stress enough how important it is to take care of this first step to options trading right away. You'll want to be ready to make your first option trade the minute my first recommendation arrives in your email inbox.

## How to Choose an Options Broker

Just because you like your current brokerage for trading stocks doesn't mean they'll suit you for trading options. You owe it to yourself to find one that will make your trading easy.

*Barron Magazine's* annual ranking of online brokers is a valuable informational resource for investors looking for a broker. You can find that here: <http://www.barrons.com/articles/barrons-2017-best-online-broker-ranking-1489811850>

The brokers we see mentioned most often by experienced *Investing Daily* members are TD Ameritrade’s thinkorswim, Fidelity, E\*TRADE’s optionshouse, and Interactive Brokers. Lately members are mentioning tastyworks and Charles Schwab’s optionsXpress, too.

Be sure to contact your top choices directly to confirm their commissions, minimum deposit amounts, and customer support capabilities. Ask them what sets them apart from their competition. You can also ask if they have any special deals—they are eager for your business.

I personally use TD Ameritrade’s thinkorswim, but any of the others are fine. I don’t get compensated for mentioning any of these brokers and I offer them up simply to provide you with some names that you can research further. Read more about options brokers here:

[www.investingdaily.com/broker-comparison](http://www.investingdaily.com/broker-comparison)

*Note: Federal regulations require that all brokers impose a \$2,000 minimum account balance to trade on margin.*

## Quick and Easy Process

Once you’ve decided on a broker, getting authorized for options trading is easy and usually takes less than five minutes to complete. I can coach you through the process in this video:

[www.investingdaily.com/personal-finance/faqs-for-pf-options](http://www.investingdaily.com/personal-finance/faqs-for-pf-options)

For online investors who are opening up an account at a new brokerage, merely check a box to indicate that you want options trading authorization in addition to stock trading. The online account application will then simply add a couple of pages of questions on options.

For investors with existing stock trading accounts that want to add options trading, you simply request an upgrade from your broker. Some brokers let you upgrade online whereas others will require you to fill out a form and send it in. In either case, once you have submitted the required information, the broker may take a few days to process your request and inform you what options trading level you have been assigned (more on trading levels a bit later).

## Qualifying for Options Trading Authorization

The information you must submit to the broker to obtain options trading authorization falls into one of four different categories:

### 1. Investment Objectives

- Speculation
- Aggressive Growth
- Growth
- Income

Your best chance for a high trading level authorization is if you put down “speculation” as one of your objectives. Many option traders simply check off all of the investment objectives listed. But even if you put down only “income” as an objective you will still probably be authorized for covered calls, which is a good options strategy.

	Call	Put
Buyer (long)	Right to buy stock	Right to sell stock
Seller (short)	Obligation to sell stock	Obligation to buy stock

*Note: Because an option is a derivative contract, it can be sold without owning it first.*

### 2. Trading Strategies

- Buy Stock
- Long Calls/Puts
- Covered Calls
- Debit Spreads
- Credit Spreads
- Selling Puts
- Short Stock
- Selling Naked Calls
- Mutual Funds

The more option trading strategies you check off as being of interest to you, the better your chances of getting a high trading level authorization. If you only select “buy stock” and “mutual funds,” you won’t get anywhere so be sure to check off more choices than those two. At the very least, check off “covered calls” and “selling puts.” Feel free to check off all of the strategies listed. Even if you don’t plan on using them now, after some education you may change your mind and it would be good to have your authorization locked and loaded when you decide you want to pull the trigger. So, the more option strategies checked the merrier!

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### 3. Trading Experience

\_\_\_ Years of Stock Trading Experience

- Number of Trades per Year
- Average Size per Trade (# of shares and/or dollar amount)

\_\_\_ Years of Options Trading Experience

- Number of Trades Per Year
- Average Size Per Trade (# of contracts and/or dollar amount)

Don't be shy when answering this question. The more years trading stock *and* options, the higher your trading level authorization will be. The average size per trade is less important for the trading strategies we will recommend, but a larger trading size number might tip the scales slightly in favor of a higher trading level.

### 4. Personal Finances

- “Liquid” Net Worth (Investments easily sold for cash—your home doesn't count)
- Total Net Worth
- Annual Income

- Source of Income (Job, Investments, Pension)

Higher numbers are better, but honesty is the best policy.

## Option Trading Levels

Every broker is different, but a typical breakdown of option trading levels is as follows:

Level 1: Covered calls

Level 2: Long calls and puts

Level 3: Spreads (both debit and credit)

Level 4: Short equity puts

Level 5: Short equity calls

Level 6: Short index calls and puts

The options trades in *Personal Finance* will be covered calls and short equity puts, so make your goal getting approved for at least Level 2. Short equity puts in a margin account require much less upfront capital, so Level 4 is the ideal trading level to strive for, but Level 4 is not necessary to benefit from *PF*.

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## Part 2: The Basics of Options

Now let's address the basic concepts behind all options trades.

### Calls and Puts

There are two types of options: *calls* and *puts*. And there are two sides to every option transaction:

1. the party *buying* the option, who has a *long* position, is also called the option *owner*.
2. the party *selling* the option, who has a *short* position, is also called the option *writer*.

Each side comes with its own risk-reward profile and its own strategies.

A call is the option to buy the underlying stock at a predetermined price (*strike price*) by a predetermined date (*expiration*, which is usually the third Friday of a month). The expiration date can be as soon as next month or as distant as two and a half years away. If the call owner (the option's buyer)

decides to buy the underlying stock itself from the call writer (the option's seller)—an act known as *exercising* the option—the call writer is obliged to sell the shares to the call buyer at the strike price.

A put option is the opposite of a call option. The put owner (the option's buyer) has the option to sell the underlying stock to the put writer (the option's seller) at a predetermined strike price until the expiration date. If the put owner decides to sell, the put writer is obliged to buy the stock at the strike price.

A call owner makes a profit when the price of the underlying shares rises. The call option's price will normally rise as the shares do, because the right to buy stock at a constant strike price becomes more valuable when compared to the higher-priced stock. The call writer is making the opposite bet, hoping for the stock price to decline or, at the very least, not rise above the strike price by more than the amount the writer received for selling the call in the first place.

The put owner profits when the underlying stock price falls. A put increases in value as the underlying stock decreases in value, because the right to sell stock at a constant strike price becomes more valuable if the stock is priced lower. Conversely, a put writer is hoping for the stock price to rise or, at the very least, not decline below the strike price by more than the amount the writer received for selling the put in the first place.

Bottom line: option buyers/owners have unlimited upside/downside profit potential but must pay money up front for this privilege. In contrast, option sellers/writers get a fixed amount of cash up front that immediately goes into their account earning interest, but expose themselves to the risk of unlimited losses if the sold option explodes in value and is not “covered” by stock or another option owned.

## “In the Money,” “At the Money,” “Out of the Money”

Traders describe options by the relationship of the strike price to the price of the underlying stock. For calls, if the stock price is above the strike price, the option has **intrinsic value**, because it allows you to buy the stock at a better (lower) price than someone who doesn’t own options could buy it on the open market. That makes the option **in the money** (ITM).

For puts, the reverse is true; the option has intrinsic value if the stock price is below the strike price, because it allows the holder to sell the stock at a higher price than available on the open market. If the stock price is equal to the strike price, the option is considered **at the money** (ATM), because it’s “on the verge” of having intrinsic value.

In both cases of calls and puts, the intrinsic value is the value the option owner could receive right now if she exercised the option. For example, if you own a call at a strike price of \$50 and the underlying stock is trading at \$57, the intrinsic value is \$7 because right now you could exercise the call, which allows you to buy the stock at the option strike price of \$50, and then sell the stock at the current market price of \$57, netting \$7 in the transaction.

An option is **out of the money** (OTM) when it has no intrinsic value. For calls, this occurs when the strike price is above the stock price and for puts, this occurs when the strike price is below the stock price. The following table illustrates the point with a fictional “XYZ” stock trading at different prices in relation to its call and put options at the \$75 strike price:

XYZ Stock Price	\$75 Call Option	\$75 Put Option
\$70	OTM by \$5	ITM by \$5
\$75	ATM	ATM
\$80	ITM by \$5	OTM by \$5

## “Time Value”

Prior to expiration, all options (even those sorry OTM ones) have another type of value: **time value**. This refers to the value of an option that is not intrinsic value:

$$\text{Time value} = \text{Price of option} - \text{Intrinsic value}$$

or

$$\text{Price of option} = \text{Intrinsic value} + \text{Time value}$$

Stock prices are always moving, so there’s the chance that an option will move ITM or, if it already is ITM, move further ITM during its “lifetime” (i.e., before it expires). Time value puts a price on that potential for—and degree of—ITM movement. At an option’s expiration, there’s no time value remaining, and the final value (if any) is limited to an option’s intrinsic value.

An option’s time value has a unique feature called time decay. Since options are, in essence, a bet on the future price movement of a stock, *time* is a prime component of an option’s value. The less time remaining until expiration, the less value an out-of-the-money call option—where the strike price is above the current stock price—has, because it becomes less likely that the stock will rise enough to let the option expire in the money. With each passing day, the time value of an option declines. The rate of decline is not constant, however. Time decay accelerates the closer you get to expiration.

Consider the following range of call options on hypothetical stock XYZ Corp as of July 7, 2017, when the stock price is \$20.28:

Call Option	Strike Price	Expiration	Intrinsic Value	Time Value	Option Price
1	\$19.00	Aug '17	\$1.28	\$0.22	\$1.50
2	\$19.00	Sept '17	\$1.28	\$0.47	\$1.75
3	\$19.00	Oct '17	\$1.28	\$0.68	\$1.96
4	\$21.00	Aug '17	\$0	\$0.33	\$0.33
5	\$21.00	Sept '17	\$0	\$0.61	\$0.61
6	\$21.00	Oct '17	\$0	\$0.80	\$0.80

There are three key takeaways here:

**Whenever the strike price is greater than or equal to the current stock price, the call's intrinsic value is zero.** In those cases, the option's value is attributable solely to its time value—the expectation (hope?) by the call purchaser that by expiration, the stock price will get itself above the option's strike price by at least the current time value.

**The less time remaining until expiration, the lower the time value.** Note that call options 1, 2, and 3 all have \$19 strike prices and thus identical intrinsic values. But # 1 expires in August (40 days away) and has a time value of only \$0.22 while #3, expiring in October (100 days away), has a time value of \$0.68. More time means more value.

**For options with a common expiration date, time value is greater the closer the strike price is to the stock price.** As the stock price moves further away in either direction, time value falls. An option's time value decreases the further ITM the option becomes because once an option is ITM, it's "made the big time" and has intrinsic value. Time now is a two-edged sword for the option—whereas before time was purely a positive when the option was OTM. Although the stock continues to have time to move in the direction that increases the option's value (positive), it also now has time to move in the wrong direction causing the option to fall back OTM (negative). On the other side of the spectrum, an option's time value also decreases the further OTM the option becomes because it becomes less likely that the stock will rise enough to let the option expire ITM and possess intrinsic value.

## Expiration

Options have a limited lifespan, which is one reason they are much cheaper than stock. In other

words, the right to exercise under an option contract expires after an agreed-upon period of time. For stocks, the expiration day is usually the third Friday of the expiration month. An option's lifespan prior to expiration can range anywhere from one week to two and a half years. The more time an option has prior to its expiration, the more time value it possesses and the more expensive the option.

Personally, *I buy long-term options* (i.e., they don't expire for more than a year) despite their higher cost because I want to make sure that my investment thesis has time to play out before I lose my rights to exercise the option. In contrast, *I sell short-term options* (i.e., they expire in 100 days or less) even though they yield less money because time-value decay speeds up nearer to expiration and I want my sold options to lose value quickly.

In reality, few retail investors hold options all the way to expiration and actually end up transacting stock through the exercise process. Options are, after all, tradable securities. As circumstances change, most investors lock in their profits (or losses) before expiration by selling to close options they had previously bought to open or buying to close options they had previously sold to open.

## Exercise and Assignment

Exercise at expiration is automatic if the option is at least one penny ITM. Most stock and ETF option traders close out their positions prior to expiration to avoid the complications of stock transactions and potential margin calls (index options settle in cash, so there are no such complications with those).

Exercise prior to expiration (i.e., early exercise by the buyer/owner, which is the same thing as early assignment to the seller/writer) may be elected by the option owner. Early exercise of options is relatively infrequent (i.e., less than 20% of the time) because it means that the owner is forfeiting whatever time value the option possesses. Early exercise, when it does occur, most often involves a call option that is deep ITM, the underlying stock pays a dividend, and/or the option is very near expiration.

The matching of an "exercising" option owner with an "assigned" option writer is handled behind the scenes by the Options Clearing Corporation,

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a triple-A rated organization that guarantees performance by both buyer and seller. Early assignment notices are allocated randomly, so some people with short options may be assigned in whole or in part while others holding the same short options may not be assigned at all.

## Exercise Style: European or American?

Options are either “European” or “American” style. These terms don’t refer to geography, but simply denote differences in the exercise stipulations attached to the options. A European-style option is one

that can only be exercised at expiration and not before. This makes European options desirable for traders who sell options because they don’t risk waking up in the morning and finding out they have been assigned early overnight. An American-style option is one that can be exercised at any time right up to expiration. Cash-settled index options are European, whereas options on individual stocks and ETFs are American.

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## Part 3: Selling Covered Calls

Here at *Personal Finance*, the two strategies recommended involve selling options—specifically,

- selling call options with strike prices above both the stock’s market price (OTM) and its intrinsic value, and
- selling put options with strike prices below both the stock’s market price (OTM) and its intrinsic value.

When you sell OTM options, you can generate consistent monthly income.

Selling call options against your pre-existing stock positions (a.k.a. “covered” calls) generates income that is similar to receiving a cash dividend.

For example, let’s go back in time to Jan. 15, 2003 and assume that you’re a longtime holder of 100 shares of **IBM** (NYSE: IBM). The company’s annual dividend was \$0.60 per share, which equaled an annual yield of only 0.7%. Since its October 2002 low of \$54, IBM has rallied strongly to its current price of \$87.59. With the stock up more than 60% in three months, you decide that you don’t expect much more upside in the short term, yet you think the stock won’t go down much, either, since it’s a bastion of blue-chip safety. You want to supplement its 0.7% yield as the stock stagnates.

Since you think IBM has topped out for now, why not sell the rights to further upside—upside you don’t think will actually occur—to some greedy

speculator who thinks differently? The closest OTM strike price to the stock’s current price of \$87.59 is the \$90 strike. You decide to sell a February 2003 call with a \$90 strike price for \$3.25 per share—remember, you don’t need to already own the call option to sell it. The \$3.25 received is like a “dividend” and equates to a yield of 3.7% ( $\$3.25/\$87.59$ ) for just one month’s time!

### Pros and Cons of Covered Call Writing

The additional income provided by covered-call writing is very attractive, but there is a trade-off involved (i.e., no “free lunch”). What are you as the IBM call writer/seller forfeiting? The ability to participate in the stock’s gain if it does move above the option’s \$90 strike price. Consequently, if IBM goes up in price, writing the February \$90 call limits your profit to \$5.66 per share (the potential \$2.41 gain in the stock between the current market price of \$87.59 and the \$90 strike price plus the certain \$3.25 you receive for selling the call). In other words, selling the covered call limits your upside over the next month to 6.5% ( $\$5.66/\$87.59$ ). For conservative investors, the guaranteed income from covered call writing is arguably more important than gambling that IBM will gain more than 6.5% in a month’s time (see table on the next page).



**IBM Covered Call: Profit/Loss at February Options Expiration (2-22-03): Per-Share Return from Covered Calls vs. Straight Stock Purchases**

IBM Stock Price at February Option Expiration	Cash Return with Covered Call*	Cash Return with Straight Stock Purchase at \$87.59	Advantage
\$80.00	-\$4.34	-\$7.59	Covered Call
\$84.34	\$0.00	-\$3.25	Covered Call
\$87.59	\$3.25	\$0.00	Covered Call
\$90.00	\$5.66	\$2.41	Covered Call
\$93.25	\$5.66	\$5.66	Equal
\$95.00	\$5.66	\$7.41	Stock Alone
\$100.00	\$5.66	\$12.41	Stock Alone

\*Assumes IBM stock purchased at \$87.59 and Feb. \$90 call sold at \$3.25.

## Covered Call Writing Wins Most of the Time

As the previous table demonstrates, covered-call writing reduces your downside risk from owning IBM stock at all price points below your purchase price of \$87.59.

Covered-call writing also increases your profit at all price points between \$87.59 and \$93.25. The only scenario where the covered call is not superior is if the stock appreciates 6.5% or more (\$93.25 or higher). If you're like me, sacrificing a bit of potential—but far from guaranteed—upside is a small price to pay for reduced risk and peace of mind.

## Profit off of Someone Else's Low Probability Gamble

What are the odds that a large, blue-chip stock will appreciate by more than 6.5% in the next month after having already gone up 60% in the previous three months? Unless you have insider information, I think it's almost always a bad bet to make. In fact, in IBM's case, the implied volatility of the February \$90 call option indicated less than a 38% chance that the stock would close above \$90 at February expiration. Consequently, based on statistics more than 62% of the time (100%-38%) writing the February \$90 call should turn out to be the right decision.

The beauty of options is that they let you profit from someone else's risky (and often wrong) bets. If somebody is greedy enough to want to pay me money for the right to profit from something that has less than a 38% chance of playing out, I'll take his money every time. Even if the "Greedy Gus" strikes pay dirt, I'll be happy with my 6.5% return in one month! And you can always buy back into IBM stock after getting exercised if you think IBM offers further upside in the months and years ahead.

## 40 Times The Yield!

Don't forget that the 3.7% yield you received for selling the February 2003 call option was only for one month. Assuming the stock stayed around its then current price of \$87.59 at February expiration, you could have written another one-month \$90 call at that time (i.e., March expiration) and pocketed another 3.7% dividend. Altogether, you could theoretically have written this call twelve times per year and received a total dividend yield of 44.4%. Pretty amazing yield enhancement potential for a stock that paid a dividend of less than one percent!

## What Actually Happened to IBM Using the Covered-Call Strategy

At the February 2003 expiration, IBM fell to \$79.95, so selling the call was definitely better than just owning the stock and doing nothing. The covered call reduced your stock's paper loss by \$3.25, but you would have still had a net loss of \$4.39 ( $\$87.59 - \$79.95$ ) + \$3.25.

With the stock now below \$80 and the February \$90 call expiring worthless, you could have sold another covered call to bring in more income, this time at a lower strike price: the March \$85 call for \$1.00. At the March 2003 expiration, IBM closed at \$84.90, so the \$85 call expired worthless, too. You could then have sold the April \$85 call for \$3.20. At the April expiration, IBM closed at \$84.26, and the call once again expired worthless.

You've now generated \$7.45 per share in income by selling covered calls for three months, money that you wouldn't have had by merely holding onto the stock. A stock-only approach would have resulted in a loss of \$3.33 per share ( $\$87.59 - \$84.26$ ), while

the covered call approach absorbed the stock losses and still generated a net profit of \$4.12, or 4.7% (\$4.12/\$87.59):

	Jan '03	Feb '03	Mar '03	Apr '03
<b>IBM Stock Price</b>	\$87.59	\$79.95	\$84.90	\$84.26
<b>Profit From Stock Only</b>	\$0.00	(\$7.64)	(\$2.69)	(\$3.33)
<b>Profit From Covered Calls</b>	<b>\$0.00</b>	(\$7.64) + \$3.25 = <b>(\$4.39)</b>	(\$2.69) + \$3.25 + \$1.00 = <b>\$1.56</b>	(\$3.33) + \$3.25 + \$1.00 + \$3.20 = <b>\$4.12</b>

Based on the above table, do you see how covered calls can turn a losing stock into a winner? Amazing!

## “Buy low, sell high”: Covered-Call Strategy Beats the S&P 500

The IBM example may be an ideal example of the benefits of covered-call writing, but its success is also representative of covered-call writing in general; it is not a fluke. In fact, academic studies have concluded that call options are often overvalued. Consequently, selling covered calls on your stock portfolio has historically outperformed a stock-only strategy. For example, a 2006 Callan Associates study concluded the following about the S&P 500 Buy-Write Index (Chicago Options: ^BXM):

The results show that the BXM Index has generated superior risk-adjusted returns over the last 18 years (18 years and 3 months, to be exact), generating a return comparable to that of the S&P 500 at approximately two-thirds of the risk. The compound annual return of the BXM Index since June 1, 1988 is 11.77 percent, compared to 11.67 percent for the S&P 500. The BXM returns were generated with a standard deviation of 9.29%, two thirds of the 13.89% volatility of the S&P 500.

## Possible Tax Implications of Covered Calls

The risk of selling a covered call—besides losing out on stock appreciation above the strike price—is that the call option may be exercised “early” (i.e., prior to expiration) and you will be required to sell the stock at the strike price, which may cause you to incur a significant tax liability if the stock is in a taxable account and your cost basis in the stock is low.

Early exercise is more likely for dividend-paying stocks. Sometimes the call option buyer will exercise the call the day before a stock’s ex-dividend date in order to capture the dividend. However, this is only a significant risk if the option expires soon and is “in the money.” If the stock price is below the strike price, the buyer would have to pay an above-market price for the stock, and it’s unlikely that collecting the dividend would make up the difference.

Of course, you may have the opportunity to buy back the covered call before it gets exercised, and thus avoid the taxable event, but there is no guarantee. At expiration, any call option that is “in the money” (the stock price is above the call option’s strike price) by at least \$0.01 will be automatically exercised by the Options Clearing Corporation. Consequently, covered calls on stocks that you have owned for a long time (and which have significantly appreciated) work best in a tax-deferred IRA or 401k account.

## Selling Covered Calls Is Worth a Try

If you are very bullish on a stock, simply buy the stock. If, however, you want to enhance your dividend income and reduce the risk of owning stock, selling covered calls against your stock holdings will be the better choice a majority of the time. The above examples of IBM and the academic studies are powerful evidence that a covered-call strategy can provide significant risk-reducing benefits to your stock portfolio.

## Part 4: Selling Puts

If you already own stock, selling call options against them is a great way to earn extra income on your stocks (especially on non- or low-dividend paying ones).

### Put Options Are Great Too

But there is another way to generate extra income that doesn't require that you own stock. It involves selling a call option's opposite twin—the put option. Selling put options allows you to buy stocks at a discount below its current market price. To paraphrase the late “Queen of Mean” Leona Helmsley, only the little people pay retail! With put options, you never need to pay retail market prices for a stock again.

Buying stock can be scary because the stock price could fall after you purchase it. One way to reduce this risk is to sell an OTM put option rather than purchase the stock directly at its current market price. The beauty of selling an OTM put is that you don't mind getting exercised because you wanted to buy the stock in the first place. By selling an OTM put, you are basically setting a limit order to buy the stock at a below-market price. Unlike a limit order, however, you get paid up front and get to keep the money even if the stock never falls to your limit price (i.e., the put's OTM strike price).

### Selling Puts or Placing a Limit Order, That is the Question

As an example, let's assume we're in the month of October and you are interested in fictional XYZ Company, a high-priced stock trading for \$135 per share. You haven't purchased the stock because, at its current price of \$135, you think it's too expensive. You only want to buy the stock if its share price falls to \$130.

I see two choices: (1) enter a limit order at \$130 and wait to see if the stock falls back to that level, or (2) sell a put option right now with a \$130 strike price that expires in January for \$4.60 per share. If XYZ falls below \$130 at January expiration, the put

will be automatically exercised by its owner and, as you hoped, you'll get to purchase the stock at \$130 per share. But don't forget the \$4.60 per share you received for selling the put—that means you're actually buying the stock for \$125.40 per share (\$130 – \$4.60). Compared to buying the stock at a limit price of \$130, selling the put saves you \$4.60 per share or 3.5%! If you ask me, 3.5% is a nice discount off of the retail price.

#### Sell \$130 Put on XYZ: Profit/Loss at January Options Expiration: Per-Share Return from Selling Puts vs. Stock Limit Order

Stock Price at Option Expiration	Return with Sold Puts*	Purchase Stock at Limit Price of \$130	\$130 Limit Never Hits and Stock Not Purchased
\$120.00	-\$5.40	-\$10.00	N/A
\$126.00	\$0.60	-\$4.00	N/A
\$129.00	\$3.60	-\$1.00	N/A
\$130.00	\$4.60	\$0	N/A
\$134.60	\$4.60	\$4.60	\$0
\$140.00	\$4.60	\$10.00	\$0
\$150.00	\$4.60	\$20.00	\$0

\*Based on selling the Jan. \$130 put for \$4.60

### There's a Catch

What's the catch and why doesn't everyone buy stock this way? Well, as with selling calls, your profit potential is capped at the premium you receive for selling the option. If the stock closes above the option's strike price at expiration, your put will not be exercised, you will never own the stock, and you will not participate in any of the stock's subsequent price gain.

### A 3.7% Return in Four Months? Sign Me Up!

But even if you don't get to own the stock, there are a lot worse things than earning a 3.7% return (\$4.60/\$125.40) in less than four months' time! That's more than 10% annualized.

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## Puts Reduce Risk at Every Price Point

As the previous table demonstrates, if the limit order is filled, selling the put is superior to the limit order at all prices below \$134.60. That's a nice risk reducer in case the stock declines or rises only a little. If the limit order is not filled, selling the put is superior to the limit order at all price levels above \$125.40.

## Limit the Number of Puts You Sell

In a margin account, brokers allow you to sell more put options than you can afford to have converted into stock. Don't be tempted by the siren song of excessive leverage! For a short put, the brokerage firm's initial margin requirement is:

$$\begin{aligned} & \mathbf{100\% \text{ of the option proceeds}} \\ & + \mathbf{(20\% \text{ of the Underlying Stock's Market Value})} \\ & \quad - \mathbf{(Out of the Money Value)} \end{aligned}$$

For example, if you sell a \$45 put for \$1.50 per share on a \$50 stock, the initial margin requirement would be:  $\$1.50 + (20\% * \$50) - (\$50 - \$45) = \$6.50$  per share (\$650 per contract). In contrast, if you were to simply buy the stock at \$50, your margin requirement would be half of \$50, or \$25 per share. Selling the put has a margin requirement that is almost 75% less than the stock purchase. Sounds great,

but this small margin requirement is not constant but can increase if the stock goes down based on the following formula:

$$\begin{aligned} & \mathbf{Market \ value \ of \ the \ option} \\ & + \mathbf{(20\% \ of \ the \ Underlying \ Market \ Value)} \\ & \quad - \mathbf{(Out \ of \ the \ Money \ Value)} \end{aligned}$$

For example, if after selling the \$45 put, the stock declines from \$50 to \$45, the put could increase in value from \$1.50 to \$3.50. Furthermore, the option's strike price would no longer be OTM. The margin requirement would increase to:  $\$3.50 + (20\% * \$45) - 0 = \$12.50$  per share. In other words, the margin requirement would have almost doubled (\$12.50 vs. \$6.50)!

Bottom line: never "max out" on the margin that your broker permits you for short puts because it is very likely this initial margin requirement will increase—perhaps substantially—during the life of the option. Trust me, you don't want to face a margin call!

One safe way to ensure that you will never receive a margin call is to limit the number of puts you sell to the number of contracts that translates into the amount of stock you would feel comfortable owning. Each option contract represents 100 shares of stock, so if you would normally buy 500 shares of stock, limit your put sales to five contracts.

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## Part 5: Options Spreads:

As I've discussed, selling call options against your existing stock position lowers the cost of your stock investment and creates dividends out of thin air. Selling put options allows you to purchase stock at a discount. In each case, options are used to lower your out-of-pocket cost and thereby reduce your risk. But there is yet another step you can take with options to reduce your risk even further. It is a secret that option professionals have been using for decades but which has only recently entered the mainstream. This extremely powerful tool is known as spreading.

### Buying Stock on the Cheap

Here's how it works using my favorite fictional stock XYZ Company. Let's say you're bullish on

XYZ's prospects, having determined that the stock is worth \$155. With XYZ very high priced at \$130 a share, you don't want to risk a large amount of your capital buying stock, so you decide to buy a call option that expires in January 2019 as a stock replacement.

### Using Calls as a Stock Replacement is the First Step

One possibility would be to simply buy the \$130 call, which currently costs \$9.30 per share or, because one options contract equals 100 shares, \$930 per contract. Buying 100 shares of XYZ stock would cost \$13,000, which is quite a bit bigger capital commitment than the \$930 needed to buy the equivalent options position, wouldn't you say? At January 2019

expiration, break-even for the options position is \$139.30 (\$130 strike plus \$9.30 option cost). If XYZ makes it up to the \$155 target by then, the call option contract will be worth \$2,500, resulting in a profit of \$1,570 or 169% (\$1,570/\$930).

In contrast, the buyer of 100 shares of XYZ stock at \$130 would make a profit of \$2,500 but only a 19% profit (\$2,500/\$13,000) because of the much higher capital commitment involved in buying the 100 shares of stock. The option buyer could easily surpass the stock buyer's \$2,500 dollar profit simply by purchasing two \$130 call options instead of one, which would generate a profit of \$3,140 if XYZ rose to \$155. This would double the option cost to \$1,860 but would still cost 85% less than buying the \$13,000 worth of stock.

## Converting Calls into Call Spreads is the Second Step

In my world of maximum risk reduction, even 85% less is still too expensive, and too much risk. Consequently, I recommend selling the \$135 call against the purchased \$130 call—thus creating the 130/135 call spread—in order to reduce the cost of the bullish position even further. Remember, since an option is a derivative contract, it can be sold without owning it first. The \$135 call is trading at \$6.90 per share (\$690 per contract), so selling it against the \$130 call would reduce your overall cost to \$240 per contract (\$930-\$690), a 74% reduction from the original cost of \$930 for buying the \$130 call option alone.

Another advantage of selling a call to reduce cost is that you can often totally eliminate the “time value” surcharge on the long-term call option that you are long. In other words, you get all of the upside of stock ownership (up to the strike price of the sold call) at a fraction of the cost of stock and without suffering any time-value decay—the best of both worlds!

## Sound Familiar?

If the mechanics of creating this call spread sound vaguely familiar, you're not imagining things. It's very similar to the covered call strategy. The only difference in the case of the spread is that you are selling the covered call against another long-term call

rather than against stock. The risk reduction benefits are simply magnified many times over in the option spread situation, since the sale proceeds of the call you are selling (\$690) is much closer in value to the call you purchased (\$930) than to the value of the 100 shares of stock you could have purchased (\$13,000).

## I'll Sacrifice Huge but Unlikely Upside for Regional Leverage Any Day

As in the case of a covered call strategy, the “catch” is that you limit your potential upside profit in the stock. In the case of the 130/135 call spread, your maximum profit at expiration would be capped at \$260 per contract (\$500 spread width – \$240 investment cost) at a stock price of \$135; any further appreciation in XYZ's stock price above \$135 is collected by the purchaser of the \$135 call you sold. But the cost reduction you enjoy by selling the \$135 call is so great that the rate-of-return potential is tremendous.

Stock Price at Expiration	\$130/\$135 Call Spread	Call Spread % Profit	Individual \$130 Call	Individual Call % Profit
\$125	-\$2.40	-100%	-\$9.30	-100%
\$130	-\$2.40	-100%	-\$9.30	-100%
\$135	\$2.60	108%	-\$4.30	-46%
\$140	\$2.60	108%	\$0.70	8%
\$141.90	\$2.60	108%	\$2.60	28%
\$145	\$2.60	108%	\$5.70	61%
\$149.34	\$2.60	108%	\$10.04	108%
\$150	\$2.60	108%	\$10.70	115%

As the above table shows, the call spread is the superior investment at all price levels under \$149.34 on a percentage profit basis and under \$141.90 on a dollar profit basis. What's so impressive about the spread's profit outperformance is that it occurs while reducing risk at the same time! Between XYZ's current price of \$130 and \$141.90 (9.2% higher), the spread makes more money on a dollar basis than the individual call and yet requires 74% less of a capital commitment.

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Because the outperformance of spreads is limited to cases where the stock rises only modestly, option traders often characterize spreads as possessing “regional leverage.” Within the region of modest price appreciation, the spread can’t be beat, but individual calls will outperform in cases where the stock makes a huge price move. But isn’t it better to bet on modest price moves than huge price moves? You betcha.

I especially like the comparison at the \$135 stock price. The spread more than doubles your money while the individual call loses 46%! Amazing. The stock only has to increase by 3.8% for the spread to gain 108%. Now that’s what I call leverage!

Financial theory always teaches us that to get more reward you need to take more risk. This options spread illustration belies that notion; you can have your cake and eat it too!

## Option Spreads are Worth a Try

If you are very bullish on a stock, simply buy an individual call option. If, however, you are only moderately bullish on a stock and think it will go up some but not a lot, buy a call spread. Substantially reducing your cost—while at the same time substantially increasing your profit potential—makes a lot of sense.

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## Part 6: Placing an Option Trade with Your Broker

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So now you know how to get option trading authority from your broker. You understand the basics of options and *Personal Finance*’s strategies of selling covered calls and puts, at least in broad strokes.

Congratulations! You are ready to trade options and take advantage of my profit-making recommendations the minute they hit your email inbox.

The next step is to actually place an option trade with your broker. How does one do this? The first thing to remember is that each option contract represents the right to buy or sell 100 shares of stock. Yet option quotes are priced on a per-share basis. So if you want to buy one call option contract on XYZ stock that is quoted at \$1.50, the cost of that trade for you would be \$150 (100 shares \* \$1.50). Do not enter an options trade expecting to pay only the per share price! Always multiply the quoted price by 100 to get the true cost of the trade per contract.

The second thing to remember is that options are derivative contracts. Consequently, you can sell an option contract when you don’t actually own it. This can be done with stock also, but the short seller of stock must first locate actual shares outstanding and borrow them from their owner prior to selling them. This “locate and borrow” requirement is not necessary when selling option contracts.

But more to the point, when you place an option trade, you must indicate whether you are creating a contract or cancelling a contract. To create a

contract, you say that you are “opening” a position and to cancel a contract, you say that you are “closing” a position. When you’re the option buyer, you’ll classify the limit order price as a “debit”—the buyer always pays, right? When you’re the option seller, you’ll classify the limit order price as a “credit.”

Lastly, when the option strategy you wish to trade involves two different securities (e.g., a stock and option combination or two options), you should enter the order as a single trade with a single limit price. Doing it this way ensures that you know exactly what the net cost of the strategy is. Always start with the “buy” portion of your order and finish with the “sell” portion. If the combined order will cost you money, then classify your limit order price as a “net debit.” If the combined order will yield you income, classify the limit order price as a “net credit.” With that introduction, let’s go through some examples of option strategies and how to enter the trade.

### 1a. Covered Call (if you already own the stock)

In my *Personal Finance* Trade Alerts I’ll tell you exactly what to say when you call your options broker to place an options trade. The instructions for a covered call will be something like this:

**“I want to sell a covered call against 100 shares of my T. Rowe Price (Nasdaq: TROW) stock. Specifically, I want to ‘sell to open’**

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**one October \$80 call for a credit of \$1.10 per share or more.”**

Of course, you can also place the trade yourself through your broker’s website. Most brokers have excellent training materials and customer service reps who are waiting to walk you through the trade.

## **1b. Buy/Write (covered-call strategy if you don’t already own the stock)**

This option strategy involves two separate securities (buying stock and selling a call option), so you should enter it as a single order. Some brokers label this a “buy/write” and others call it a “covered stock” trade. The same T. Rowe Price trade would now look like this:

**“I want to do a buy/write trade. Specifically, I want to buy 100 shares of T. Rowe Price (Nasdaq: TROW) and ‘sell to open’ one October \$80 call for a net debit of \$74.00 per**

**share or less.”**

## **2. Selling Puts**

Since this strategy involves a single security and no buy portion, just start with the sell portion. Here’s an example of what you’d tell your broker:

**“I want to sell a put on T. Rowe Price (Nasdaq: TROW) stock. Specifically, I want to ‘sell to open’ one October \$70 put for a credit of \$1.35 per share or more.”**

## **3. Option Spreads**

Similar to a buy/write, an option spread involves two separate parts that should be entered as a single trade. Here’s an example of a spread trade that I recommended through my *Options for Income* service:

**“I want to enter an option spread order on Union Pacific (UNP) stock. Specifically, I want to buy to open the November \$97.50 put and sell to open the November \$105 put for a net credit of \$1.40 per share or more.”**

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# **Now, Get Started!**

I hope you have found this beginner’s guide to *Personal Finance* options helpful.

If you have additional questions, be sure to log in to the members-only *Personal Finance* website and read our frequently asked questions section.

You can find the FAQ section at this URL:  
**[www.investingdaily.com/personal-finance/faqs-for-pf-options](http://www.investingdaily.com/personal-finance/faqs-for-pf-options)**

My final piece of advice is to make an options trade and get started! Once you are “over the hump”

with your first options trade, you will be actively engaged in a lifetime of learning and be taking control of your financial future.

Of course, it makes sense to start small—trading only one option contract per trade—during your initial learning process. But eventually, you can increase your position size as you gain confidence and start to make some big money.

So check your email inbox for my next trade alert and good luck trading!

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## Additional Resources

### Quick-Start Video Program

This six-part video series will visually take you step-by-step through my technique, illustrating the strategies that have helped me trade options for consistent income for decades:

[www2.investingdaily.com/pf-options-training/](http://www2.investingdaily.com/pf-options-training/)

### Next Steps

You may be ready to trade spreads, which can be a lower-risk, reliable way to increase your income. Because of their built-in “insurance policy,” spreads require much less margin than selling short puts or buying 100 shares of stock as part of a covered-call trade. A lower margin requirement is especially important for small account sizes because it means that you can generate much higher rates of return and diversify your options trades among several different underlying positions for a relatively small amount of capital. You can find recommendations for option spreads in these Investing Daily trading services:

[\*Options for Income\*](#)

[\*Velocity Trader\*](#)



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#### IMPORTANT NOTES:

Guidance concerning the stocks and strategies highlighted in this report is believed to be accurate and represent our best advice at the time of writing. However, market conditions change constantly and guidance at the time of this writing may not reflect our latest advice. For our current take on any recommendation in this report, it is vitally important that you check the Portfolio tables on the website and confirm that the recommendation is still active. Furthermore, confirm that the recommended investment trades below our current buy limit. Do not buy any investment above our recommended buy limits. If an investment's price exceeds our buy limit, wait for a pullback or invest in another Portfolio holding that trades below our buy limit. Any advice in the Portfolio tables, a recent issue of the publication, or our email alerts always trumps older advice in this special report. We reserve the right to substitute special reports as market trends dictate.

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