Wiley Trading

THE COMPLETE GUIDE TO OPTION STRATEGIES

Advanced and Basic Strategies on Stocks, ETFs, Indexes, and Stock Index Futures

Michael D. Mullaney

The Complete Guide to Option Strategies

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MICHAEL D. MULLANEY

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To my wife, Sue, for her support, encouragement,
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continues to do so as she pursues her dream of becoming a
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Preface

Why should you read a book on options? Rapid and severe declines in the stock market demonstrate that the buy and hold method of investing has a lot of risk and that traders need a different vehicle to control risk. Individuals who recognize and embrace the shift to a trader's market have the best chance to prosper, and the best trading vehicle available is options. Options can help you in volatile and unpredictable markets by enabling you to profit in numerous ways.

Options are probably the most versatile trading tool today. No other investment vehicle seems to have such a unique set of characteristics and flexibility. Options have become a popular tool for individuals and, fortunately, you do not have to work on the floor of an exchange to understand options. Trading options can empower an individual trader to move quickly in comparison to institutions, which must stay invested at all times with large and diversified portfolios.

Your chances of success increase if you have a game plan, establish goals, and understand how options move. Focusing on becoming a better trader to make money should be the main purpose of reading a book on options. I realize that a book on options can also be read for the enjoyment of learning the theory, mathematical applications, and technical jargon. (Who would not enjoy learning about the assumptions underlying options?) There is nothing wrong with tackling the intellectual challenges associated with learning, but our time is valuable, and it is more important to stay focused on how to become a better trader.

The Complete Guide to Option Strategies is intended to describe option principles in an understandable manner by starting with the basics, then moving up the educational ladder to the intermediate level, and finally to an advanced level. This book provides the tools that will allow you to prosper in many market conditions and enable you to trade options not only on stocks but also on exchange-traded funds (ETFs), stock indexes, and stock index futures. The content of these pages describes the option buying and selling strategies that you should know and would most likely be interested in using.

This book addresses simple and complex strategies by using hundreds of examples, tables, and graphs. Some option strategies are known to be difficult, but the examples, tables, and graphs add great clarity; as they say, a picture is worth a thousand words. The presentation means you have a comprehensive and step-by-step analysis of each strategy. The consistency of the examples is designed to make it easy for you to compare one strategy with another. I even decided to include a chapter on option terminology to

provide a framework with which you can view options so you can quickly analyze any option position at a glance.

A separate chapter is devoted to every main strategy. This book avoids shortcuts when describing strategies so it gives you full and complete understanding. As much as possible, each chapter stands on its own. Occasionally, of course, you may want to flip back and forth between chapters. This approach is intended to help you gain a thorough understanding of option strategies and make the book easier to follow. As a result of this approach, you will notice some repetition; however, this is intentional because it should help reinforce your knowledge of strategies and principles. The book uses similar language to describe variations of the same strategy, again, to make it easier to follow. The overall approach is to first show how a strategy can be executed from the approach of buying calls, then buying puts, followed by selling calls, and then selling puts. The typical strategy, therefore, approaches the strategy from four different perspectives.

Each strategy chapter (Chapters 7 to 22) is organized in a similar manner to make the chapters easier to read and to ease comparisons of one strategy with another. Chapters typically include opening remarks, an overview, a description of each variation of the strategy, and a comprehensive example of each strategy. After strategy examples, each chapter includes a section called "Beyond the Basics" and concludes with a section called "Final Thoughts."

HOW TO USE THIS BOOK

The Complete Guide to Option Strategies is intended to be a reference book, although it also can be read from cover to cover. If you are very familiar with basic concepts, you can simply skip chapters and go directly to the discussion that you are looking for.

The book begins with the basics and, in the process, describes hundreds of options terms, most accompanied by an example. It then covers more fundamentals, such as option pricing, the Greeks, buying versus selling, and terminology.

It takes the approach that basic option strategies can be broken down into buying a call, buying a put, selling a call, and selling a put. Once you understand this framework, you should be able to comprehend any option strategy at a glance. A separate chapter is devoted to each of the four basic option strategies before moving forward to more complex strategies in later chapters. Each basic strategy is analyzed from different perspectives; for example, the chapter on a call option provides a description of the strategy and comprehensive examples at strike prices of 90, 95, 100, 105, and 110. Likewise, the chapter on a put option provides a description of the strategy and comprehensive examples at the same strike prices. Spread strategies are covered in later chapters. After considering the different variations in strategies, this book covers hundreds of option strategies.

After the strategy chapters, a comparison of options on stocks, ETFs, stock indexes, and stock index futures is presented. The final part of the book covers advanced topics,

such as volatility, exercise and assignment, risk management, margin, and taxes. *The Complete Guide to Option Strategies* is divided into the following five parts:

Part One: Learning the Fundamentals

Chapters 1 to 6 describe option basics in depth. Part One includes Chapter 1, "Getting Ready to Trade"; Chapter 2, "Option Fundamentals"; Chapter 3, "What Determines an Option's Price?"; Chapter 4, "Tools of the Trade—Greeks"; Chapter 5, "Buying versus Selling"; and Chapter 6, "Understanding Spread Terminology."

Part Two: The Four Basic Option Strategies

Chapters 7 to 10 cover the four basic strategies. Part Two includes Chapter 7, "Long Call"; Chapter 8, "Long Put"; Chapter 9, "Short Call"; and Chapter 10, "Short Put."

Part Three: Spread Strategies

Chapters 11 to 22 cover spread strategies. Part Three includes Chapter 11, "Vertical Spread"; Chapter 12, "Iron Condor"; Chapter 13, "Unbalanced Spreads"; Chapter 14, "Straddle and Strangle"; Chapter 15, "Butterfly Spread"; Chapter 16, "Condor Spread"; Chapter 17, "Calendar Spread"; Chapter 18, "Diagonal Spread"; Chapter 19, "Covered Call"; Chapter 20, "Combination"; Chapter 21, "Collar"; and Chapter 22, "Covered Combination."

Part Four: Comparing Underlying Instruments

Chapters 23 to 26 examine the differences in trading options on different underlying instruments. Part Four includes Chapter 23, "Comparing Stocks, ETFs, Indexes, and Stock Index Futures"; Chapter 24, "ETF Options"; Chapter 25, "Stock Index Options"; and Chapter 26, "Stock Index Futures Options."

Part Five: Advanced Topics

The final part of this book (Chapters 27 to 32) covers advanced topics. Part Five includes Chapter 27, "Assessing Volatility"; Chapter 28, "Exercise and Assignment"; Chapter 29, "Risk Management"; Chapter 30, "Margin"; Chapter 31, "Placing an Order"; and Chapter 32, "Taxation of Options."

Appendixes A, B, and C

Appendix A covers ETF option strategies, Appendix B covers index option strategies, and Appendix C covers stock index futures option strategies. At a glance, the strategies included in the appendixes illustrate many of the strategies covered throughout this book.

A glossary with approximately 200 definitions is included as a reference tool that can be used before, during, and after your reading of the book. A comprehensive index is provided to assist you in finding key topics and definitions.

From what I can tell, the Greeks seem to scare new (and some experienced) traders. The Greeks are tools that tell you how option values are expected to change based on certain assumptions. The Greeks are addressed step-by-step throughout this book, in case you are interested in advanced principles. However, you do not need to be an expert

in the Greeks to trade many option strategies. You should not let specialized options terminology scare or intimidate you from becoming an outstanding option trader.

This book explains the option terms you need to know because the option industry has its own language. For simplicity, most of the discussions and examples in this book refer to options on stocks, but the principles and strategies can be applied equally to ETFs, indexes, and stock index futures. For the most part, I use the word *stock* to mean any underlying instrument, such as a stock, ETF, index, or stock index futures. Continually using the phrase *underlying instrument* can be cumbersome and confusing because most traders do not use the phrase very often. The word *stock* is simple and to the point. I contemplated using the word *security*, but it seems legalistic. So, let us just call it "stock," among friends. I realize that there are important differences in underlying instruments (primarily relating to the size of contracts, exercise, margin), and that is why an entire part of this book is devoted to explaining how each works.

Examples Are Consistent

To make it easy to compare one strategy with another, examples are presented in a consistent format from chapter to chapter. Each example assumes that XYZ stock (a hypothetical stock) is initially trading at $100 a share and then shows the gain or loss from each strategy, at the expiration date of the option, assuming that the stock is at $75 to $125, in five-point increments.

Before engaging in any option transaction, you should determine your maximum gain, maximum loss, break-even point, and probabilities of success. It is useful to back test option strategies, like you would other strategies. With options, however, you should learn how to forward test strategies by making assumptions about a range of possible outcomes in the future. In this book, the comprehensive examples show a wide range of possible outcomes. A table and chart both show the gain or loss. After you examine the table, you get a chance to graphically see the gain and loss pattern on a chart. It does not get any better than this.

Examples assume an initial XYZ stock price of $100 a share, consistent option pricing for both puts and calls, rounded option prices, the same entry date for the trade, and the same expiration date so that you can focus on the principles that need to be understood without having to deal with the confusion associated with changing facts. The use of $100 a share and the same entry date of the trade should make it easier to see how options move.

The prices on the profit and loss graphs are consistent from example to example and from chapter to chapter to make them easier to follow. After the graph, each example includes hypothetical Greeks, the effects of later expiration, and exercise and assignment. The consistency of the examples is designed to make things easy for you to compare one strategy with another.

Putting It All Together

You do not need to become an expert on each strategy, but learning multiple strategies will enable you to choose which strategy or strategies are best for you. You should refer

to Appendixes A, B, and C and examine the strategies at a glance because they illustrate many of the strategies covered throughout this book and are presented according to whether they are primarily bullish, bearish, profit inside a trading range, or profit outside a trading range.

There are risks associated with buying and selling options because there is no free lunch (or any other free meal, for that matter). Personally, I prefer to sell options instead of buying them. In some respects, selling options is like eating chocolates: Once you get a taste of it, you will want more. In fact, I have gained a few pounds since I began selling options.

New Option Traders

The book provides all of the definitions and fundamentals of options that you need. However, it is helpful to actually trade options to more easily understand the principles.

Some individuals to whom I have talked are afraid to try trading options because they are confused or intimidated by the complexity of strategies and option terminology, especially the Greeks. A great way to overcome such concerns is to open an account at a brokerage firm and trade in a practice account (also called paper trading or simulated trading). This way, you can practice buying and selling options without the fear of losing money. If simulated trading is not available at your broker, you can trade one option at a time, making sure that the amount of money you are paying is small and that you have limited risk. It is certainly understandable how difficult option strategies can appear without actually having the benefit and experience of executing some trades.

PREPARATION IS THE KEY

In some cases, traders do not fully understand the risks of trading and the probabilities of success and are forced to spend a great deal of time and effort (and money) cleaning up the mess. They seem to be relying on the Will Rogers risk management strategy: "If stupidity got us into this mess, then why can't it get us out?" No investment strategy is risk-free, but the risk–reward profile of options can be attractive if you understand what you are doing. Risk management strategies are described throughout this book, and an entire chapter is devoted to this important topic.

As you can tell, I am very excited about the opportunities in option trading. My intention is to provide a great tool to help you elevate your trading to the next level and, therefore, help you trade options with confidence. This book is written from the perspective of how an individual trader can make money by trading options. After reading this book, you should have an understanding of the power of options. Let us get started.

MICHAEL D. MULLANEY

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M. D. M.

PART ONE

Learning the Fundamentals

Part One provides the fundamentals necessary to build a solid foundation before you begin trading options. It includes how to get ready to trade, the all-important basics of options, factors that affect an option's price, the *Greeks*, the advantages and disadvantages of buying versus selling options, spread terminology, and more. After learning the fundamentals, you should be ready to move on to other parts of this book and learn the four basic option strategies, advanced spread strategies, how to apply what you have learned to different underlying instruments, and advanced concepts.

CHAPTER 1

Getting Ready to Trade

The good news is that there are many different ways to make money by trading options. You may be attracted to buying call or put options because you want large gains for a relatively small price, or you may be attracted to selling options because you want consistent returns and the odds on your side. Option buying and selling is sometimes described in a manner that makes you think option trading is simple. The reality is that making money in the financial markets on a consistent basis over a long period of time is not easy. However, it can be accomplished with proper preparation. Probably the best way to maximize your chances of success in the financial markets is to become as knowledgeable as possible so you can make educated decisions.

To get the most out of this book, you should read the Preface to understand how the book is organized. This chapter will cover the reasons why you should trade options, the importance of developing a game plan, risk management, option basics, and key definitions.

WHY TRADE OPTIONS?

Options can be used to manage risk, generate income, take advantage of leverage, and potentially profit under almost any market condition. Options can enable you to *speculate* on whether a stock, *exchange-traded fund* (*ETF*), *stock index*, or *futures* will rise, decline, or move sideways within your selected time frame. With options, you can engage in a high- or low-probability trade or a trade with limited or unlimited risk. With options, you have the ability to take advantage of a price decline in a stock (or other instrument) just as easily as a price increase, and even potentially profit from sideways movement. The versatility of options, in combination with leverage, is what distinguishes options from other trading vehicles.

With options, you can generate income from the up, down, and sideways movements of a stock, ETF, index, or futures. The key is to first determine your view of a stock (or market) and time frame and then determine the option strategy that can meet that perspective.

Sometimes the markets go through periods in a trading range that can last for weeks, months, or years. In these periods of consolidation, markets seem to fluctuate sideways and back and forth. Traditional stock and mutual-fund investing is typically not profitable in such an environment and can cost you the opportunity of earning interest on the money (or investing elsewhere) while you are waiting for the markets to move higher. Using options, you can speculate that a stock (or futures) will be stuck in neutral and you can design option strategies to profit from the lack of movement. For example, the S&P 500 index reached the 1,500 level in 2000, declined to below 800, and did not reach 1,500 again until 2007, only to substantially decline again. Even worse, the NASDAQ Composite reached the 5,000 level in 2000, plunged all the way down to nearly the 1,000 level, and has had great difficulty getting back to its old highs. The emerging markets have produced outstanding returns in some years, but they are inconsistent, and there are significant risks involved.

To understand options, you need to think a little outside the box because an option is unlike other investments. Trading options can be a way to diversify your income in a manner that is uncorrelated to other investments. Option strategies come in all shapes and sizes. Option strategies can be used to generate income, manage risk, *speculate*, and *hedge* in rising, declining, and sideways markets. Buying an option can be an attractive strategy because you can have limited risk with high profit potential, whereas *selling* (*writing*) an option can be attractive because you may have the odds on your side. Many traders are familiar with buying, in which the object is to buy low and sell high. Option selling works contrary to how trading is viewed by many people. The goal of option selling is the same as that of traditional trading but in reverse order: When selling an option, the goal is to sell high and buy low. If you are a novice trader, at first you may be confused about what it means to write (sell) an option because it involves selling first and buying later. Because markets can trend sideways for many years, selling options can provide a unique tool to potentially profit in sideways markets. The fact that option selling can work is demonstrated by the large number of institutional investors and professionals who sell options to enhance returns.

DEVELOPING A GAME PLAN

You may be under the impression that buying an option is the best strategy because you have a defined risk and can quickly make a lot of money; or you may have heard that selling an option is best because you have the odds on your side. So which is it? The answer is that sometimes buying an option is best and, at other times, selling is best,

depending on what you are trying to accomplish and your views of the underlying stock and market.

Many option traders may be attracted to buying options because they are familiar with buying stocks (or other assets, such as a home), and they are attracted to limited risk and the possibility of large profits. Buying a call can be a good place to start when learning how to trade options. However, remember that consistent profits are possible by selling options, without having to pick the home run along the way. One advantage of selling an option is that close is sometimes good enough—in comparison to buying, where you need to be more precise in timing and direction. Ideally, you should develop strategies for both buying and selling options.

Selecting the best underlying instrument is one of the most important trading decisions you will make. In general, I have found that a broad-based index, such as the S&P 500 index, can be a good candidate for option selling: An option sale is a bet against volatility, and an index is typically less volatile than an individual stock. On the other hand, I find that stocks can be a good candidate for buying options because stocks can be very volatile.

Treat Option Trading Like a Business

If you were running a business, you would put together a business plan that encompasses trading strategies and details of how to operate the business and control expenses. The same perspective and focus should be developed when trading options. Developing a plan and working hard are essential to your success. Remember that the definition of luck is "preparation meets opportunity." The more knowledge you have, the greater your chances of success.

You cannot always play the offensive if you want to win. Playing the defense is important if you want to trade successfully over the long run. As a result, before trading options, you should have an understanding of risks. You should have a thorough understanding of risk management strategies, have access to specialized option software and trading platforms (free or low-cost software are accessible), learn strategies that maximize your probabilities of success and can limit losses, and appreciate the importance of education. You should keep expenses low; maximum interest income credited to your account; and open accounts to trade options on stocks, ETFs, indexes, and futures. You should try to utilize their strengths when trading options. It is important to protect your investment capital. Manage risk by observing the following tips:

- If selling options, establish positions with probabilities of success of at least 75 percent.
- Trade limited-risk strategies.
- Have an exit strategy with defined profit and loss objectives.
- Have the courage to exit a position at a loss to protect capital.
- Use stop losses to automatically exit positions.

- Do not overtrade or feel compelled to be in the market at all times.
- Use *technical analysis* to time when and where to establish positions.
- Trade liquid options.
- Control expenses.
- Keep your losses small.
- Have a plan.
- Do not get greedy.

Create a Plan

Before engaging in any option transaction, you should determine your maximum profit, maximum loss, break-even point, and probabilities of success. You should develop a clear view of the direction, timing, and magnitude of the underlying stock and have strategies readily available to place yourself in a position to maximize your return and limit your losses. Unfortunately, some option positions are doomed from the start because they are poor trades from a risk–reward perspective and have little chance of success.

Before you get started, you should open brokerage accounts to take advantage of margin, and you should understand how option trading can be affected, depending on whether an account is a taxable account versus an individual retirement account (IRA) or a futures account. You should also understand how to maximize interest income and minimize commissions and taxes. You should practice option strategies using a practice (simulated) account until you become proficient at what you plan to trade.

Discipline and decisiveness are factors critical to your success, and you should not allow your emotions to control your investment decisions. To trade successfully, it is important that you develop guidelines on when to buy and when to sell. Buying and selling options, like other investments, can be an emotional roller coaster, if you let it become one. You should trade when you are levelheaded and calm, using a systematic approach determined beforehand.

Establish Goals

Which option strategies are best for you depends in part on the amount of your capital; your risk tolerance; and your confidence in determining the direction, timing, and magnitude of various moves in the marketplace. For example, if you are confident in your ability to predict direction, timing, and magnitude, then you may want to buy a call or put, depending on the direction. If you are uncomfortable with being so precise, you may want to sell options.

An option can, in some cases, be sold for what can appear to be a small premium, but when returns are calculated on an annualized basis, the returns can be outstanding. The object is to repeat the selling cycle monthly or quarterly to enhance returns throughout the year. Because you have the short-term odds on your side, you may be tempted to

generate large profits by selling a large number of options; however, you should resist the urge because it usually means excessive risk. Remember the Wall Street adage: Bulls make money, bears make money, and pigs get slaughtered.

Ideally, you should exit a position with predetermined profit or loss objectives; for instance, if you buy an option, a rule of thumb may be to exit a position if a loss reaches 50 percent of the amount paid to establish a trade. If you sell an option, a guideline may be to close out a position if you have a profit of 70 percent of the maximum possible profit in a position.

One of the main risks that many option buyers and sellers encounter is that they trade too many contracts: thus, when things go wrong, the leverage of options works against them. If, in addition, they engage in low-probability trades, they are setting the stage for financial failure. Overtrading and establishing excessive positions should be avoided. Risk increases where too many options are bought (or sold), as leverage cuts both ways. In the world of options, each option you add affects the mathematical probabilities of the others you already own or have sold to establish a position.

Develop an Edge

The average investor finds it difficult to compete with big mutual funds that spend millions of dollars on research. However, the small investor can have an edge over big funds because he can enter and exit the market as opportunities develop and not be hindered by requirements to be invested at all times. Confidence and discipline are key components of developing your edge, and it is important to remember that always following the crowd can be hazardous to your wealth.

Protect Capital

It is important to protect your investment capital. A popular risk and money management strategy is to let profits run and keep losses small. You simply cannot let your losses run too high. As the old saying goes: An ounce of prevention is worth a pound of cure. If you lose a certain level of capital, it becomes more difficult to ever get back to where you began; for example, if you have $100,000 in an account and lose $50,000, you must earn 100 percent to get back to even. As you can see, once you lose a substantial amount of your capital, it will limit how much you can invest going forward, and it may take you completely out of the investment picture if you are not careful. If you do not have the emotional or psychological ability to cut your losses, then you should not trade options.

Probably one of the most difficult aspects of successful trading is deciding when to exit a position. Most of the damage that was done after the stock market bubble burst in 2000 and 2008 was the result of investors who were frozen like a deer in headlights. More important, when wrong, know when to get out and act accordingly. It is best to take proactive action for risk management purposes. In such times, capital preservation should be your main priority.

Use Limited Risk Strategies and Stop Losses

There are numerous option strategy techniques that can reduce the net cost of options purchased and limit the exposure for options written (sold). A *stop loss order* is an order placed with a broker to sell an option when it reaches a certain price. It is designed to limit an investor's loss on an option position. For example, if you purchase an option for $5, you can have a plan to close the position at a loss if it reaches $2.50. You should use discipline in adhering to protective stop losses. Your goal in some market conditions is simply to preserve capital.

Utilize a Practice Account

New option traders are understandably nervous about trading options because options are more complicated than stocks. But, the good news is that some firms have developed practice accounts (also called "paper trading" or "simulated trading") so you can buy and sell options without the fear of losing money. In a practice account, some brokerage firms have developed trading platforms that parallel their live trading platforms but with simulated trading, which does not use real money. Therefore, simulated trading enables you to practice trading, as well as track gains and losses, without the risk of loss by using the trading platform of your broker. It can be an effective way to learn the unique features and capabilities of your broker's software (trading platform) so you can efficiently enter and exit option trades. Simulated trading can help you become familiar with the types of option orders that can be entered; using a practice account prior to executing any real trades can help you gain confidence. If simulated trading is not available at your broker, you can trade one option at a time, making sure that the risk is small.

WHAT IS AN OPTION?

There are two types of options: *calls* and *puts*. A call option is a contract that provides the *buyer* (purchaser) the right, but not the obligation, to buy an asset (100 shares, if a stock) at a particular price (called the *strike price* or *exercise price*) within a defined time frame. A put option is a contract that provides the buyer the right, but not the obligation, to sell an asset (100 shares, if a stock) at the strike price within a defined time frame. You can buy or sell a call or put option. A call *seller* is obligated to sell at the strike price within a defined time frame, and a put seller is obligated to buy at the strike price within a defined time frame.

Buy Call: Right to buy 100 shares at strike price

Buy Put: Right to sell 100 shares at strike price

Sell Call: Obligation to sell 100 shares at strike price

Sell Put: Obligation to buy 100 shares at strike price