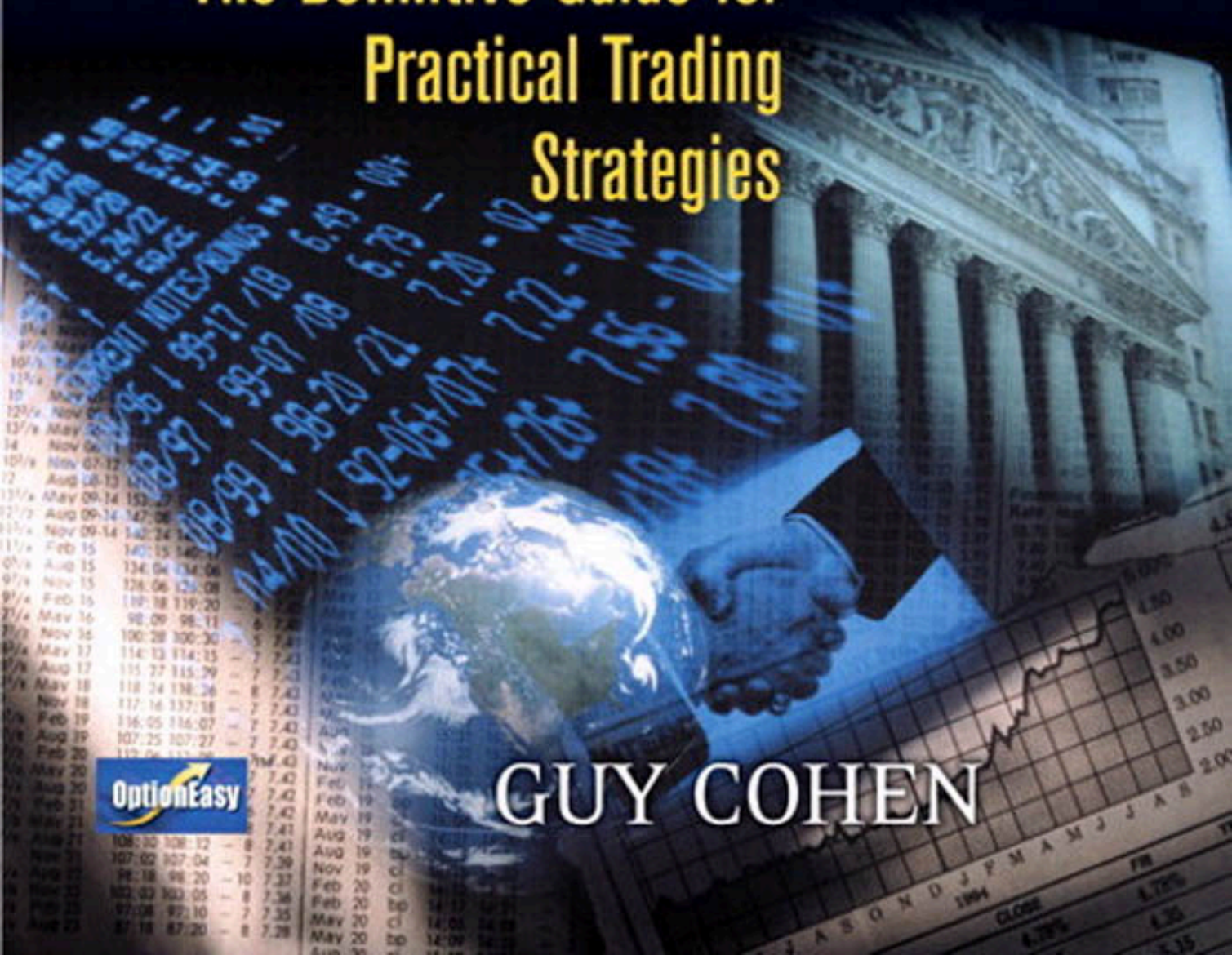
FT PH TRADING & INVESTING

the Bible of Options Strategies

The Definitive Guide for Practical Trading Strategies



OptionEasy

GUY COHEN

The Bible of Options Strategies

No exercise

Total position = (3.40) + 3.40 = breakeven

4. Scenario: stock falls to $75.00

Assuming implied volatility rises to 60%, the long puts are now worth approximately 22.40; profit so far = 5.70
Short puts expire worthless: profit = 3.40

No exercise

Total position = 5.70 + 3.40 = profit so far of 9.10

5. Scenario: stock falls to $60.00

Assuming implied volatility rises to 70%, the long puts are now worth approximately 35.40; profit so far = 18.70
Short puts exercised at $75.00:

Buy stock @ 75.00
Sell stock @ 60.00
Loss = 15.00

Sell long put for a profit = 18.70
Keep short put premium = 3.40
Loss on Exercise = 15.00

Total position = 7.10 profit

If you tried to exercise the bought put:

Procedure: exercise bought puts @ $95.00; sell stock @ $95.00.

Buy put @ 16.70
Sell put @ 3.40
Net cost = 13.30

Buy stock @ 75.00
Sell stock @ 95.00
Net profit = 20.00

Total = (13.30) + 20.00 = profit of 6.70 (less than the 7.10 profit above)

Lesson: Never exercise a long term option because you'll miss out on Time Value!

In this situation, even though implied volatility had risen significantly the puts were only worth a small amount over their intrinsic value. It's likely that such a precipitous drop in share price would be accompanied with a sharp rise in implied volatility, perhaps to more than 70%, in which case the long puts would be worth more.

As mentioned above, this example is a particularly well constructed diagonal spread, because the long side is deep ITM and the short side is sufficiently OTM. This means that even as the stock drops lower and lower, this particular Diagonal Put will continue to make virtually the same amount of profit.

Let's take the example to even more extreme levels:

6. Scenario: stock falls to $30.00

Assuming implied volatility has risen to 150%, the long puts are now worth approximately 65.20; profit so far = 48.50
Short puts exercised at $75.00:

Buy stock @ 75.00
Sell stock @ 30.00
Loss = 45.00

Sell long put for a profit = 48.50
Keep short put premium = 3.40
Loss on Exercise = 45.00

Total position = 6.90 profit

As we can see, the profit level is similar to when the stock dropped to $60.00. It's important to understand that if you had bought a Near-the-Money put instead, then the profits would have dwindled as the stock fell. This seems counter intuitive because the strategy is bearish and thrives on the stock falling. Well, this is only the case if you buy a deep ITM put in the first place.

If you had bought a Near-the-Money put then the strategy would benefit from rangebound stock price action. However, if the stock price plummeted, the strategy, despite being bearish in nature, could start to make losses even though you were right in terms of your market direction.

A similar concept applies in terms of the short leg. Your short put should be near enough to generate a decent income yield but not so close that the stock won't have a chance to move and make the long side profitable.

When trading diagonal spreads I prefer not to be greedy and will buy a deep ITM option for my long leg, and will never sell an option with a strike too close to the current stock price. This way I won't get punished for being "too" right.

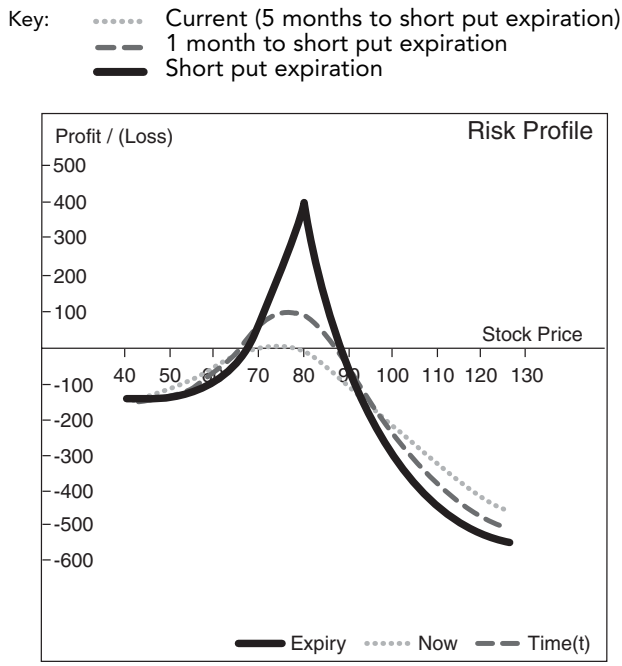
Just so you can see how this works, let's adjust the above example as follows:

- Instead of buying the 95 strike put for 16.70 we're going to buy the 85 strike put for 10.70.
- Instead of selling the 75 strike put for 3.40 we're going to sell the 80 strike put for 5.00.

Now, initially this looks better as our yield is almost 50% instead of 20%. However, look at the risk profile on the following page and compare it to the original one above.

Do you see the difference? With these tighter strikes, the strategy will actually make a loss as the stock falls below $70. With our wider strikes we kept on making money, no matter how far the stock fell. We sacrificed the initial yield in order to keep making a profit in the event of a real surprise to the downside. Ultimately the Diagonal Put is a bearish strategy. We don't want to be punished for getting it right.

In real world trading I would strongly advise you to virtual trade the diagonals and see for yourself what happens in all scenarios. I'm cautious by nature and can't bear to lose when I'm right, let alone when I'm wrong! By being conservative with my diagonals, I'm never exposed to a nasty surprise.



2.13 Covered Put (Also Known as a *Married Put*)

Proficiency	Direction	Volatility	Asset Legs	Max Risk	Max Reward	Strategy Type
Advanced	Bearish	N/A	■ Short Stock ■ Short Put	Uncapped	Capped	Income

2.13.1 Description

The Covered Put is the opposite process to a Covered Call, and it achieves the opposite risk profile. Whereas the Covered Call is bullish, the Covered Put is a bearish income strategy, where you receive a substantial net credit for shorting both the put and the stock simultaneously to create the spread.

The concept is that in shorting the stock, you then sell an Out of the Money put option on a monthly basis as a means of collecting rent (or a dividend) while you are short the stock.

The trade-off is that an OTM Covered Put will give a higher potential yield but less cushion, whereas an ITM Covered Put will give a lower yield but much more

cushion. This is not a recommended strategy (partly because it's a little confusing!), but "you pays your money, you takes your chances" on this one!

If the stock falls below the put strike, you'll be exercised and will have to buy the stock at the strike price . . . but you make a profit because you've already shorted it, so the purchase simply closes your stock position, and you retain the premium for the sold put. (You're covered because you shorted the stock in the first place.) If the stock remains static, then you simply collect the put premium. If the stock rises, you have the cushion of the put premium you collected.

Steps to Trading a Covered Put

1. Short sell the stock.
2. Sell puts one strike price out of the money [OTM] (i.e., puts with a strike price lower than the stock).
   - If the stock is purchased simultaneously with writing the call contract, the strategy is commonly referred to as a "buy-write."
   - Generally, only sell the puts on a monthly basis. In this way you will capture more in premiums over several months, provided you are not exercised. Selling premium every month will net you more over a period of time than selling premium a long way out. Remember that whenever you are selling options premium, time decay works in your favor. Time decay is at its fastest rate in the last 20 trading days (i.e., the last month), so when you sell option premiums, it is best to sell it with a month left, and do it again the following month.
   - Remember that your maximum gain is capped when the stock falls to the level of the put strike price.
   - If trading U.S. stocks and options, you will be required to sell (or be short in) 100 shares for every put contract that you sell.

   Steps In

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

   Steps Out

   - Manage your position according to the rules defined in your Trading Plan.
   - If the stock closes below the strike at expiration, you will be exercised. You will have to buy back the stock at the strike price, having profited from both the option premium you received and the fall in stock price to reach the lower strike price.

- If the stock remains above the strike but below your stop loss, let the put expire worthless and keep the entire premium. If you like, you can then write another put for the following month.
- If the stock rises above your stop loss, then either buy back the stock (if you're approved for naked put writing) or reverse the entire position (the put will be cheap to buy back).

2.13.2 Context

Outlook

- With a Covered Put, your outlook is **neutral to bearish.** You expect a steady decline.

Rationale

- To sell (short) a stock for the medium or long term with the aim of capturing monthly income by selling puts every month. This is like collecting rent after selling the stock.
- If the stock rises, you will lose money because you have shorted the stock.
- If the stock falls, you will make money because of your short position on the stock; however, you will only make limited profit because if the stock declines down to the sold put strike price, you will be exercised at that strike price. This means that you will have to buy the stock at the sold put strike price if the stock declines to that level at expiration.

Net Position

- This is a **net credit** transaction because you are selling the stock and taking in a premium for the sold put options.
- Your maximum risk is unlimited if the stock price rises.

Effect of Time Decay

- Time decay is helpful to your trade here because it should erode the value of the put you sold. Provided that the stock does not hit the strike price at expiration, you will be able to retain the entire option premium for the trade.

Appropriate Time Period to Trade

- Sell the puts on a monthly basis.

Selecting the Stock

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

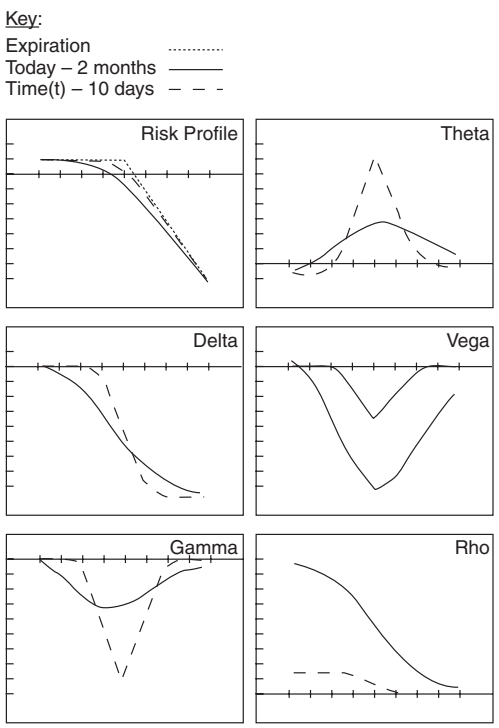
Selecting the Option

- Choose options with adequate liquidity; open interest should be at least 100, preferably 500.
- **Strike—**Look for either the ATM or just OTM (lower) strike below the current stock. If you're confident of the stock falling, then choose a lower strike; if neutral, choose the ATM strike.
- **Expiration—**Look at either of the next two expirations and compare monthly yields.

2.13.3 Risk Profile

- **Maximum Risk** Uncapped
- **Maximum Reward** [Shorted stock price − strike price] + put premium
- **Breakeven** [Shorted stock price + put premium]

2.13.4 Greeks



Risk Profile
As the stock price falls, the covered put moves into profit but slows down as it approaches the strike price and maximum profit.

Theta
Theta is positive, illustrating that time decay is helpful to the position.

Delta
Delta (speed) is negative and rises to zero as the asset price falls below the strike price and the maximum profit is achieved.

Vega
Vega is negative, illustrating that volatility is harmful to the position.

Gamma
Gamma (acceleration) is always negative with this position because you are a net seller of puts.

Rho
Rho is positive, illustrating that higher interest rates would be helpful to the position.

2.13.5 Advantages and Disadvantages

Advantages

- Generate monthly income.
- Can profit from rangebound or bearish stocks with no capital outlay.