Options are speculative and involve significant risk and are not suitable for all investors. Those who trade options should read and understand the CBOE (Chicago Board Options Exchange) publication Characteristics and Risks of Standardized Options (PDF), http://www.cboe.com/resources/intro.aspx.

Top Gun Options does not promise, guarantee, or imply verbally or in writing that anything taught or promoted through our webinars, newsletters, in any printed material, email, or displayed on our website will necessarily result in a profit. While a newsletter or alert may state “Buy” or “Sell,” or those terms may be used in the live trading lab, it is with full understanding that this is strictly the opinion of the author/publisher. Therefore, we recommend you consult a professional financial advisor before taking any action on information found on this site or contained in any Top Gun Options product.

All securities and orders are tracked and monitored in virtual trading accounts. Virtual account prices and returns may differ from actual trading results. Commission costs are excluded.

Past performance is not indicative of future results. Option trading involves substantial risk. You can lose some or all of your investment when trading options. The past results posted on this site or in any product are meant to give you a reasonable idea of what you could have made or lost trading by following the Top Gun Options service but are in no way an exact reflection of what you would have made or lost. Therefore, you should not rely on past trade results as a perfect replication of what your returns or losses would have been by following any Top Gun Options service. There are inherent risks involved in trading options and these risks should be considered prior to any decision. The representatives of Top Gun Options may or may not hold a position in any stocks or options listed at the time of publication and reserve the right to buy or sell any security, option, future or derivative product without notification. The publication by the authors/publisher of a “target price” or “stop loss” for a particular security does not necessarily represent the price at which an Editor intends to sell or will sell any such securities that the Editors may directly or indirectly own.

Neither Top Gun Options or its affiliates nor any of their respective officers, personnel, representatives, agents or independent contractors are in such capacities licensed financial advisors, registered investment advisors or registered broker-dealers.

Nothing published by Top Gun Options should be considered personalized investment advice. Although Top Gun Options authors in such capacity may answer your general trading questions, they are not licensed under securities laws to address your particular investment situation. No communication by the Top Gun Options team to you should be deemed as personalized investment advice.

The owners, publishers, and agents of Top Gun Options are not liable for any losses or damages, monetary or other that may result from the application of information contained within the live trading labs, website, alerts, and/or newsletters. Within the suite of Top Gun Options products, we publish materials that meet specific criteria representing characteristics associated with described options trading strategies. Individual traders must do their own due diligence in analyzing featured options strategies to determine if they represent a suitable opportunity. Top Gun Options and any of their agents, affiliates, representatives, employees, principals, business associates or affiliates, partners or independent contractors are not responsible for any losses or profits that may result from the application of information contained within a live trading lab, website, trade alert, and/or newsletters. Under no circumstances, including but not limited to, negligence, shall Top Gun Options be liable for any special or consequential damages that result from the use of, or the inability to use, the materials in this site, even if Top Gun Options or their authorized representatives have been advised of the possibility of such damages. In no event shall Top Gun Options have liability to you for any damages, losses, and causes of action (whether in contract, tort (including, but not limited to, negligence or otherwise) exceed the amount paid by you, if any, for accessing this site or using the information provided.
Table of Contents

In Brief..................................................................................................................................................3
Lesson 1 – Synthetic Long Stock.........................................................................................................4
Lesson 2 – Synthetic Short Stock........................................................................................................17
Lesson 3 – Short Call............................................................................................................................31
Lesson 4 – Short Put.............................................................................................................................43
Lesson 5 – Bull Call Spread..................................................................................................................56
Lesson 6 – Bear Call Spread..................................................................................................................70
Lesson 7 – Bear Put Spread..................................................................................................................82
Lesson 8 – Bull Put Spread..................................................................................................................94
Lesson 9 – Calendar Spread.................................................................................................................106
Lesson 10 – The Collar.........................................................................................................................120
Out Brief.............................................................................................................................................132
Fox3 Terms Glossary.............................................................................................................................133
Quiz Answer Key................................................................................................................................136
Hello Traders!

Welcome to Intermediate Options. Intermediate Options is your next step to becoming steely-eyed options traders. You will be introduced to several new options tactics that involve multi-leg setups and multiple legs with different expiration date. These tactics will allow you to enter position at a low price while proactively controlling your risks. We go more in depth with the short call and short put so you can understand the risk involved and how to hedge against the risk.

The option tactics you will be learning during Intermediate include:

1. Synthetic Long Stock
2. Synthetic Short Stock
3. Short Call
4. Short Put
5. Bull Call Spread
6. Bear Call Spread
7. Bear Put Spread
8. Bull Put Spread
9. Calendar Spread
10. The Collar

We will complete and use example trade plans for each Tactic. Regardless of the position we are opening, we always do a trade plan. The trade plan is our foundation for disciplined trading and encompasses our Risk Management plan. Executing to our plan reinforces disciplined trading by allowing us to take the emotion out of decision making and leads to consistent Superior Execution.

As always, practice each trade in your paper trading account until you are comfortable with how it behaves in the market. Then practice some more! Build a plan for each trade and execute to your plan: treat your paper like real money...train like you fight...fight like you train. Constantly sharpen your trading sword, learn from your mistakes and carry your lessons learned to the next trade.

Enjoy Intermediate Top Gun Options!

The Top Gun Options Team
Lesson One

Synthetic Long Stock

Introduction

Options can be used in a variety of ways, including using the option to replicate a long stock position. In fact, any option or stock position can be reproduced by combining the appropriate options and/or stock in the right way. These are called “synthetics.” A synthetic position has the same risk and reward characteristics as the original trade, but sometimes a better price is achieved with the synthetic. That is why someone might choose to trade a synthetic position versus the regular option or stock position either to open or close a trade.

Depending on your particular broker you might be able to enter a synthetic long stock position with less capital upfront than buying the stock outright or buying the stock on margin. For example, in a cash account you would need $10,000 to buy $10,000 worth of stock. In a margin account the broker could loan you one-half the value so you would only need $5,000 to buy the same stock position.

But, depending on the actual option values, the initial capital requirement for synthetic long stock could be as low as $3,000 as an example. Of course the risk is still the same as buying the stock either outright or on margin.

A note on “maintenance margin.” There are actually two types of margin requirements: initial margin and maintenance margin. The initial margin requirement is the amount of capital necessary to open a trade. Then, as the market moves, if your position loses money, then you’ll be required to deposit additional capital to cover the losses in the trade. Check with your specific broker for their particular margin schedule.

Commit Criteria

When you find a stock that has bullish criteria supported by your analysis, then your next move is to select the most appropriate tactic. If your choice is to enter into a long stock position because you believe the stock is going higher, then you might look at creating a synthetic long stock position.

Fox3 Options’ Trade Principles

Just like when trading stock, you need to have a time frame in mind for how long you want to give the stock to perform as you predict it will. Once you’ve decided on the time frame, then add 45 days to that time and use that date to select your option expiration. This cushion in timing will come into play when we start looking at managing the trade going forward.
When creating a synthetic stock position you’re going to be trading two options together as a “spread.” Whenever options are traded as a spread that means that multiple options will be executed at the same time as one trade. And because it’s one trade, there is one price for the spread. Each option in a spread is called a “leg.” And, depending on the tactic, there may be several legs in one spread.

For synthetic long stock, you want to focus on the ATM options, or options near the money, in your specific time frame. Let’s now take a look at the specific set up for creating a long stock position.

**Leg Set Up**

Synthetic long stock is created by buying a call and selling a put with the same strike price and expiration. Buying the call gives you the “right” to buy stock while the put simultaneously gives you the “obligation” to buy stock if exercised. Regardless of what happens in the market, with the underlying stock moving higher or lower, this option position is going to act just like a real stock position. When the two options are combined on the risk graph, the resulting graph is this:
Let's assume that this particular synthetic long stock position is created by buying the June 55 call for $2 and selling the 55 put for $2. Since you paid the same amount for the call as you received from the put, the entry price for this trade is called “even money.” In broker language this trade is called a “combo.” If you’re buying synthetic long stock, then you’re buying the combo for even money in this example. But what’s the risk in this trade? Since it’s just like buying stock at $55, that’s the risk, just like you were buying stock.
Take a look at the option values at expiration in the chart below to see how the trade would profit or lose as the underlying stock moves.

<table>
<thead>
<tr>
<th>Stock Price</th>
<th>Long June 55 Call</th>
<th>Short June 55 Put</th>
<th>Net Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>65</td>
<td>10</td>
<td>0</td>
<td>10</td>
</tr>
<tr>
<td>60</td>
<td>5</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>59</td>
<td>4</td>
<td>0</td>
<td>4</td>
</tr>
<tr>
<td>58</td>
<td>3</td>
<td>0</td>
<td>3</td>
</tr>
<tr>
<td>57</td>
<td>2</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>56</td>
<td>1</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>55</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>54</td>
<td>0</td>
<td>-1</td>
<td>-1</td>
</tr>
<tr>
<td>50</td>
<td>0</td>
<td>-5</td>
<td>-5</td>
</tr>
<tr>
<td>40</td>
<td>0</td>
<td>-15</td>
<td>-15</td>
</tr>
<tr>
<td>30</td>
<td>0</td>
<td>-25</td>
<td>-25</td>
</tr>
</tbody>
</table>

When trading combos you’ll rarely find options that add up to “even money.” You’re usually going to find that the combined prices of the call and the put add up to either a debit or a credit. If you add the combo price to the strike price, then you’ll have the net price that you’re paying for the synthetic stock position.

Look at the example below. If you buy the call and sell the put, what price are you synthetically paying for the stock?

<table>
<thead>
<tr>
<th>Strike Price</th>
<th>Buy Call</th>
<th>Put</th>
</tr>
</thead>
<tbody>
<tr>
<td>55</td>
<td>$6.20</td>
<td>$4.50</td>
</tr>
</tbody>
</table>

Buying the call for $6.20 and selling the put for $4.50 nets out a debit of $1.70. Adding that to the strike price of $55 gives you a resulting stock price of $56.70.

Here’s another example:

<table>
<thead>
<tr>
<th>Strike Price</th>
<th>Call</th>
<th>Put</th>
</tr>
</thead>
<tbody>
<tr>
<td>45</td>
<td>$3.50</td>
<td>$6.00</td>
</tr>
</tbody>
</table>

The combo prices out to a net credit of $2.50 ($3.50-$6.00 = -$2.50). Adding this negative value to the strike price gives a net price on the stock of $42.50. Another way of looking at this is to say that you’re buying stock at the strike price of $45, but you’re receiving a credit of $2.50 to buy the stock, so your net price comes to $42.50.
## Buying Synthetic Stock to Open

<table>
<thead>
<tr>
<th>Strike Price</th>
<th>Call Bid /Ask</th>
<th>Put Bid /Ask</th>
</tr>
</thead>
<tbody>
<tr>
<td>60</td>
<td>$4.15 - $4.25</td>
<td>$3.90 - $4.00</td>
</tr>
</tbody>
</table>

Using the bid/ask spreads in the table above, price out a long synthetic stock position using the natural prices. That means you’ll buy the call on the asking price and sell the put on the bid price. How much are you paying to buy the stock?

The combo can be bought for a net debit of $0.35 by buying the call on the ask price of $4.25 and selling the put for a credit of $3.90. Adding the combo price to the strike gives a net price of $60.35 for the stock.

One additional factor to keep in mind is that interest rates and dividends play a role in the pricing of options. You’ll find that your final synthetic stock price is going to differ from the market price of the stock itself. Depending on the expiration you choose for your options, the current level of interest rates, and any potential dividends, your synthetic price may be higher or lower than the underlying stock price. This does not necessarily imply that your price is better or worse than the current market value. Just always be sure that you are trading options that have narrow bid/ask spreads so that you’re trading in liquid markets.

### Maximum Risk

Strike price plus the net debit paid or minus the net credit received.

### Maximum Reward

Again, as with real stock, there’s no cap on your profit potential.

### Break Even

Strike price plus the net debit paid or minus the net credit received.

### Pricing your synthetic stock prior to expiration

<table>
<thead>
<tr>
<th>Strike Price</th>
<th>Call Bid /Ask</th>
<th>Put Bid /Ask</th>
</tr>
</thead>
<tbody>
<tr>
<td>60</td>
<td>$1.30 - $1.45</td>
<td>$2.75 - $2.90</td>
</tr>
</tbody>
</table>

Your current profit or loss is determined by the current market prices of your options. Since you bought the combo to open this trade, you can take a look at the current prices to see your profit or loss. To do this you look at the prices you would use to sell the combo to close. That means you’ll sell to close the call on the bid price and buy to close the put on the ask price. Assuming we bought the combo for $0.35, what’s your current profit or loss?

DISCIPLINE | RISK MANAGEMENT | SUPERIOR EXECUTION
With these prices you sell the call for $1.30 and pay $2.90 for the put. That’s a net debit of $1.60. Since you paid $0.35 to open the trade, and then you paid another $1.60 to close the trade, your total loss is $1.95. However, market prices fluctuate daily based on stock movement, time to expiration and implied volatility so your profit/loss will change daily.

Another way of looking at it is to price the synthetic stock. When you paid $0.35 to buy synthetic stock at the strike price of $60, your net price is $60.35. When closing the trade you sell synthetic stock at the strike price of $60 by selling the call and buying the put. But since you paid out the debit of $1.60 to sell the stock at the strike price, you’re really selling the stock at $58.40 ($60 - $1.60). Buying stock at $60.35 and selling it at $58.40 gives you a loss of $1.95.

Let’s price another example assuming the same opening price and some positive price movement in the stock:

<table>
<thead>
<tr>
<th>Strike Price</th>
<th>Call Bid Ask</th>
<th>Put Bid Ask</th>
</tr>
</thead>
<tbody>
<tr>
<td>60</td>
<td>$6.30 - $6.50</td>
<td>$2.00 - $2.10</td>
</tr>
</tbody>
</table>

Selling the combo in this example generates a credit of $4.20 ($6.30 - $2.10). Buying the combo for a debit of $0.35 and then selling the combo for a credit of $4.20 means a profit of $3.85.

**Mid-Course Guidance**

When would you close the synthetic long stock position?

Eject Criteria: If your Commit Criteria for being bullish on the stock have changed or no longer exist, then close the trade regardless of profit or loss. Or if the stock is just not performing as desired 45 days prior to option expiration, then close the position.

From a money management perspective, if you lose 10% of the value of your stock position, then close your trade. In the above example of buying synthetic stock for $60.35 this means you would close the trade after a loss of $6.04. Use your broker’s alerts and stop loss orders to stay abreast of your risk and changes in the market.

**Profit Goal:** Profit goal 10% move up in stock.

Once the trade profits, then manage the trade actively by setting your Eject Criteria to the 10% profit level. That means to continually raise your Eject Criteria as the stock moves higher in value. Depending on your particular broker, you might be able to achieve this with an order called a “trailing stop loss.” Check with your broker.
Here's an example. You buy stock synthetically for $50 so your 10% eject level is $5 lower at $45. When the stock moves to $55, then your eject level is 10% lower at $49.50.

**Important Greeks**

The Greeks that affect this trade are straightforward.

**Delta**: This tactic has a 100 Delta just like stock. All the other Greeks are negated.

**Exit Steps**

When either your Eject Criteria or your Profit Goal is hit, then it is time to close the trade.

**Selling the combo to close your position.**

When you are ready to close this trade you will “sell the combo to close.” That means that you will sell the call to close, buy the put to close, and you do this as a spread trade. The resulting debit or credit determines your final profit or loss.

If you decide that you want to take ownership of the stock, you can do that at expiration. If the call is in the money, then it will automatically exercise and you’ll buy the stock at the strike price. Before expiration though, make sure to buy the put to close to eliminate that risk. If the call is out of the money, then that means the put is in the money and you can simply let it expire and you’ll be assigned the stock at the strike price.

One final note; since you’re short the put option, you can be assigned on the put at any time during the life of the option. If you are assigned, your risk does not increase because the synthetic long stock position already has the same risk as the actual stock. If this happens, then simply manage the stock position as you would manage the synthetic stock position.

Let’s pick a stock and build a trade plan.
**Microsoft Synthetic Long Stock**

Whether you are a Bill Gates fan or not, it is hard to argue that Microsoft (MSFT) is not a good company. Even as I type this on my Apple, I am using Microsoft Word. Ultimately we are traders and when an opportunity pops up that could be profitable, we jump on it.

Microsoft has been beaten up pretty good lately and has retraced virtually all of its years gains, see chart below:

If you are thinking the downside is overdone, this may be a good time to jump in by either entering a stock or an option position. There are many different positions we can take using options to profit from and upward move, but we will choose the synthetic put for this lesson. Let’s assume it’s June and we need some time to let this trade work so we will look several months into the future to find a position to take. So, we will look at the October strikes.
The two strikes that look interesting are the October 24 and 25 strikes. Looking at the ask for the calls and the bids for the puts, we can see that we can open a synthetic long stock position with the 25 strike for a net credit. We will receive a net credit of 82 cents, which means our synthetic stock price is $24.18, less than the current price of the stock. So, let’s build a trade plan for an October 25 synthetic long stock.
MSFT Trade Plan
June 9, 2010

Strategic Mindset:  **BULLISH**

Target:  **MSFT currently trading at 24.26**

**Commit Criteria:**

Think MSFT is oversold and this is a good time to jump in. MSFT has given up almost all of its past year gains and is undervalued at this level.

**Tactic:**  25 Strike Synthetic

**Tactical Employment:**

**Leg Set up:**
- Buy 1 October 25 Strike Call @ 1.14
- Sell 1 October 25 Strike Put @ 1.96
- Net Credit: 82 cents per share

**Max Profit:**  Unlimited, based on MSFT

**Max Risk:**  24.18 / 2418.00

**Breakeven:**  24.18

**The Greeks:**

*Delta:* Delta is 1.0; position will act exactly like the stock after it is open.

**Mid-Course Guidance:**

*Profit Target:* 10% Move in MSFT to $26.70
Threats to success:
1. Earnings release July 22.

Eject Criteria/Contingency Plan:
2. Commit Criteria no longer valid.
3. Max allowable loss of 10% to a stock price of $22.00.
4. Stock not moving as desired 45 days to expiration.

Exit Plan
1. Profit Target Reached.
2. Eject Criteria Reached.
3. To close position:
   • Sell to close 1 Oct 25 call.
   • Buy to close 1 Oct 25 put.

Planning Thoughts:
Remember why we plan. The plan lays the foundation for Discipline, it lays out our risk parameter and tells us what to do when they are threatened and when we stick to our plan we have Superior Execution. The bullet points below outline some of our thoughts with this trade plan.

1. We are bullish on MSFT at these levels.
2. Our Commit Criteria are stated simply and summarizes our thoughts when entering the trade.
3. Tactic is simply the option position we are opening.
   a. Remember our objective…Make Money, Don’t Lose It!
   b. Our strategy is to use options to support our objective.
   c. And our tactic is the options position.
4. Our Tactical Employment is simply the trade set up and the performance parameters for the trade.
   a. Profit is dependent on MSFT.
5. Mid-Course Guidance:
   a. We define our price target on stock movement for a synthetic call. Normally a 10% move up in the stock.
   b. We will keep an eye on earnings when they come out in July and be ready to exit if negative.
   c. Eject Criteria:
      i. If our bullishness on MSFT can no longer be supported.
      ii. Max allowable loss is also based on a movement in the stock. Normally a 10% downward move.
Wrap Up

A synthetic long stock allows you to enter a position that acts exactly like the underlying equity at a much lower price than actually owning the stock. It also gives you the same risk exposure as owning the stock (check with your broker for margin requirements). Next we will look how we synthetically short stock using options.

Lesson 1 Quiz

1. What is the set up for a synthetic long stock?
   a. Buy 1 put and sell 1 call.
   b. Buy 1 call and sell 1 put
   c. Buy 1 call and buy 1 put.
   d. Sell 1 call and sell 1 put.

2. What is meant by even money?
   a. The option position is open for no cost.
   b. The position is open premium.
   c. A premium is received to open a position.
   d. The premium is higher than the debit paid.

3. What is the max gain of a synthetic long stock?
   a. Unlimited.
   b. The premium paid.
   c. The premium received.
   d. The strike price minus the premium paid.

4. What is the breakeven of a synthetic long stock?
   a. The strike price plus the net debit.
   b. The current stock price plus the premium paid.
   c. The strike price minus the net credit.
   d. Both a and c.

5. What is the loss of a synthetic long stock?
   a. The strike price plus the net debit.
   b. The current stock price plus the premium paid.
   c. The strike price minus the net credit.
   d. Both a and c.
Use the Cisco Systems (CSCO) option chain above to answer the following questions.
Assumptions:
- Bullish on CSCO
- Market order and transaction costs excluded

6. What is the net debit or net credit per share to open a synthetic long stock with the October 23 strike?
   b. Net credit of 39 cents.
   c. Net credit of 36 cents.

7. Picking the Oct 23 strike, what is our break even share price?
   a. $22.64
   b. $23.37
   c. $23.00
   d. $23.50

8. What is the max risk per share of 1 synthetic long stock opened with the Oct 23 strike?
   a. 37 cents.
   b. $23.37
   c. $22.64
   d. $23.00

9. What is the max profit of the Oct 23 strike synthetic long stock?
   a. $1500.00
   b. Unlimited.
   c. $4,042.00
   d. $2,012.00

10. If CSCO goes up by $4.00, how much will our position increase in value per share?
    a. $100.00
    b. $22.63
Lesson Two
Synthetic Short Stock

**Introduction**

When you sell a synthetic short stock position, the person on the other side of your trade has the opposite position. That means that they have a synthetic long stock position.

If you’re bearish on a stock, then you can enter the synthetic short stock position yourself as an opening trade. You’re simply going to do just the opposite of what you did in Lesson One.

A margin account is needed to sell stock short (either the real stock or synthetically). And again, depending on your particular broker, you might be able to enter a synthetic short stock position with less capital requirement upfront than shorting the stock outright. For example, the initial margin requirement for short stock is typically one-half the value of the stock. So selling short 100 shares of a $100 stock would require initial margin of $5,000.

But, depending on the actual option values, the initial capital requirement for synthetic short stock could be less than $3,000 as an example. Of course the risk is still the same as selling the stock short.

As with synthetic short stock there are going to be maintenance margin requirements as the market moves. If the trade loses, you’ll be required to deposit capital. Check with your specific broker for their particular margin schedule.

**Commit Criteria**

When you find a stock that meets your bearish Commit Criteria as supported by your analysis, then your next move is to select the most appropriate option tactic. If your choice is to enter into a short stock position because you believe the stock is going lower, then you might want to look at creating a synthetic short stock position.

**Fox3 Options’ Trade Principles**

The time frame you select for the option expiration needs to match with the time frame for the stock to make the move lower that you project. Once you’ve decided on the time frame, then add 45 days to that time and use that date to select your option expiration. This cushion in timing will come into play when we start looking at managing the trade going forward.
When creating a synthetic stock position you’re going to be trading two options together as a “spread.” Whenever options are traded as a spread that means that multiple options will all be executed at the same time as one trade. And because it’s one trade, there is one price for the spread. As we stated earlier, each option in a spread is called a “leg.” And, depending on the tactic, there may be several legs in one spread.

For synthetic short stock you want to focus on the ATM options, or options near the money, in your specific time frame. Let’s now take a look at the specific set up for creating a short stock position.

**Leg Set Up**

![Short Call & Long Put](image)

Synthetic short stock is created by selling a call and buying a put with the same strike price and expiration. Selling the call gives you the “obligation” to sell stock while the put simultaneously gives you the “right” to sell stock. Regardless of what happens in the market, with the underlying stock moving higher or lower, this option position is going to act just like a real short stock position. When the two options are combined on the risk graph, the resulting graph is this:
Let's assume that this particular synthetic short stock position is created by selling the June 55 call for $2 and buying the 55 put for $2. Since you paid the same amount for the put as you received from the call, the entry price for this trade is called “even money” or a “combo.”

If you're selling synthetic short stock, then you're selling the combo for even money in this example. But what's the risk in this trade? Since it's just like selling stock at $55, the risk is just as if you were selling stock: unlimited.
Take a look at the option values at expiration in the chart below to see how the trade would profit or lose as the underlying stock moves.

<table>
<thead>
<tr>
<th>Stock Price</th>
<th>Short June 55 call</th>
<th>Long June 55 put</th>
<th>Net value</th>
</tr>
</thead>
<tbody>
<tr>
<td>65</td>
<td>-10</td>
<td>0</td>
<td>-10</td>
</tr>
<tr>
<td>60</td>
<td>-5</td>
<td>0</td>
<td>-5</td>
</tr>
<tr>
<td>59</td>
<td>-4</td>
<td>0</td>
<td>-4</td>
</tr>
<tr>
<td>58</td>
<td>-3</td>
<td>0</td>
<td>-3</td>
</tr>
<tr>
<td>57</td>
<td>-2</td>
<td>0</td>
<td>-2</td>
</tr>
<tr>
<td>56</td>
<td>-1</td>
<td>0</td>
<td>-1</td>
</tr>
<tr>
<td>55</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>54</td>
<td>0</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>50</td>
<td>0</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>40</td>
<td>0</td>
<td>15</td>
<td>15</td>
</tr>
<tr>
<td>30</td>
<td>0</td>
<td>25</td>
<td>25</td>
</tr>
</tbody>
</table>

When trading combos you’ll rarely find options that add up to “even money.” You’re usually going to find that the combined prices of the call and the put add up to either a debit or a credit. If you subtract the combo price from the strike price, then you’ll have the net price at which you are selling the synthetic stock position.

Look at the example below. If you sell the call and buy the put, what price are you synthetically selling the stock?

<table>
<thead>
<tr>
<th>Strike Price</th>
<th>Call</th>
<th>Put</th>
</tr>
</thead>
<tbody>
<tr>
<td>55</td>
<td>$3.80</td>
<td>$2.50</td>
</tr>
</tbody>
</table>

Selling the call for $3.80 and buying the put for $2.50 nets out a credit of $1.30. Subtracting this negative number from the strike price of $55 gives you a resulting stock price of $56.30 [$55 - (-$1.30) = $56.30].

Here’s another example:

<table>
<thead>
<tr>
<th>Strike Price</th>
<th>Call</th>
<th>Put</th>
</tr>
</thead>
<tbody>
<tr>
<td>45</td>
<td>$4.50</td>
<td>$7.00</td>
</tr>
</tbody>
</table>

The combo prices out to a net debit of $2.50 ($4.50-$7.00 = $2.50). Subtracting this value from the strike price gives a net price on the stock of $42.50. Another way of looking at this is to say that you’re selling stock at the strike price of $45, but you’re paying a debit of
$2.50 to sell the stock, so you're net price comes to $42.50.
Selling Synthetic Stock to Open

<table>
<thead>
<tr>
<th>Strike Price</th>
<th>Call Bid-Ask</th>
<th>Put Bid-Ask</th>
</tr>
</thead>
<tbody>
<tr>
<td>25</td>
<td>$2.15 - $2.25</td>
<td>$1.90 - $2.00</td>
</tr>
</tbody>
</table>

Using the bid/ask spreads in the table above price out a short synthetic stock position using the natural prices. That means you'll sell the call on the bid price and buy the put on the asking price. At what price are you shorting stock?

The combo can be sold for a net credit of $0.15 by selling the call on the bid price of $2.15 and buying the put for a debit of $2.00. Subtracting the combo price from the strike gives a net price of $25.15 for the stock [$25 - ($0.15) = $25.15].

One additional factor to keep in mind is that interest rates and dividends play a key role in the pricing of options. You'll find that your final synthetic stock price is going to differ from the market price of the stock itself. Depending on the expiration you choose for your options, the current level of interest rates, and any potential dividends, your synthetic price may be higher or lower than the underlying stock price. This does not necessarily imply that your price is better or worse than the current market value. Just always be sure that you are trading options that have narrow bid/ask spreads so that you're trading in liquid markets.

**Maximum Risk**

Just as with short stock your maximum risk is unlimited.

**Maximum Reward**

Your maximum reward is limited to the entry price of your synthetic short stock. More specifically: The strike price plus the net credit received or minus the net debit paid.

**Break Even**

Strike price plus the net credit received or minus the net debit paid.

**Pricing your synthetic stock prior to expiration**

<table>
<thead>
<tr>
<th>Strike Price</th>
<th>Call Bid Ask</th>
<th>Put Bid Ask</th>
</tr>
</thead>
<tbody>
<tr>
<td>25</td>
<td>$1.30 - $1.45</td>
<td>$2.75 - $2.90</td>
</tr>
</tbody>
</table>

Your current profit or loss is determined by the current market prices of your options. Since you sold the combo to open this trade, you can take a look at the current prices to see your profit or loss. To do this you look at the prices you would use to buy the combo to
close. That means you’ll buy to close the call on the ask price and sell to close the put on the bid price. Assuming we sold the combo for a credit of $0.15 in the most recent example, what’s your current profit or loss?

With these prices you buy the call for $1.45 and collect $2.75 for selling the put. That’s a net credit of $1.30. Since you collected $0.15 to open the trade, and then you collect another $1.30 to close the trade, your total profit is $1.45.

Another way of looking at it is to price the synthetic stock. When you collected $0.15 to sell synthetic stock at the strike price of $25, your net price is $25.15. When closing the trade you buy synthetic stock at the strike price of $25 by buying the call and selling the put. But since you collect a credit of $1.30 to buy the stock at the strike price, you’re really buying the stock at $23.70 \([($25 + (-$1.30)]\). Selling stock at $20.15 and buying it at $23.70 gives you a profit of $1.45.

Keep in mind that when you buy the combo, add the price to the strike. When you sell the combo subtract the price from the strike. It doesn’t matter if you’re opening or closing when making these calculations.

Let’s price another example assuming the same opening price of a $0.15 credit:

<table>
<thead>
<tr>
<th>Strike Price</th>
<th>Call Bid Ask</th>
<th>Put Bid Ask</th>
</tr>
</thead>
<tbody>
<tr>
<td>25</td>
<td>$5.30 - $5.50</td>
<td>$2.00 - $2.10</td>
</tr>
</tbody>
</table>

Buying the combo in this example generates a debit of $3.50 ($5.50 - $2.00). Selling the combo for a credit of $0.15 and then buying the combo for a debit of $3.50 means a loss of $3.35.

**Mid-Course Guidance**

When would you close the synthetic short stock position?

Eject Criteria: If your initial Commit Criteria for being bearish on the stock have changed or no longer exist, then close the trade regardless of profit or loss. Or if the stock is just not performing as desired 45 days prior to option expiration, then close the position.

From a money management perspective, if you lose 10% of the value of your short stock position, then close your trade. In the above example of selling synthetic stock for $25.15 this means you would close the trade if the stock moves up by $2.52 (10% of $25.15) to a price of $27.67. Use your broker’s alerts and stop loss orders to stay abreast of your risk and changes in the market.

Profit Goal: Profit goal 10% move down in stock.
Once the trade becomes profitable, then manage the trade actively by setting your eject criteria to the 10% profit level. That means to continually lower your eject criteria price as the stock moves lower in value. Depending on your particular broker, you might be able to achieve this with an order called a “trailing stop loss.” Check with your broker.

Here’s an example. You sell stock synthetically for $50 so your 10% eject level is $5 higher at $55. When the stock moves to $45, then your eject level is 10% higher at $49.50. That's calculated as \([45 + (10\% \times 45)] = 49.50.\)

**Important Greeks**

The Greeks that affect this trade are straightforward.

Delta: This tactic has a negative 100 Delta for every combo just like a short stock. All the other Greeks are negated.

**Exit Steps**

When either your Eject Criteria or your Profit Goal is hit, then it is time to close the trade.

When you are ready to close this trade you will “buy the combo to close.” That means that you will buy the call to close, sell the put to close, and you do this as a spread trade. The resulting debit or credit determines your final profit or loss.

If you decide that you want to take a short position in the stock, you can do that at expiration. If the put is in the money, then it will automatically exercise and you’ll sell the stock at the strike price. If this is your choice, then make sure to buy the call to close to eliminate that risk. If the put is out of the money, then that means the call is in the money and you can simply let it expire and you'll be assigned the short stock at the strike price.

One final note, since you’re short the call option, you can be assigned on the call at any time during the life of the option. If you are assigned, your risk does not increase because the synthetic short stock position already has the same risk as an actual short stock position. If this happens, then simply manage the stock position as you would manage the synthetic stock position.

Let’s pick a stock and build a trade plan.
American Tower Group Synthetic Short Stock

American Tower Group (AMT) operates a wireless and broadcast communications infrastructure company. AMT is aggressively expanding globally and has run up nicely in the last year. There is some concern with the availability of communication towers and the ability to keep up with demand. Given its nice run to a new 52 week high, this could lead to some profit taking based on some uncertainty to sustain its rapid growth. See chart below:

We think the run up might be a bit early, so we want to take a position to profit from a minor pullback in the stock.
The two strikes that look interesting are the October 45 and 47.5 strikes. Looking at the ask for the calls and the bids for the puts, we can see that we can open a synthetic short stock position with the 45 strike for a net credit. We will receive a net credit of 85 cents, which means are synthetic short stock price is $45.85, more than the current price of the stock. So, let’s build a trade plan for an October 45 synthetic short stock.
Strategic Mindset:  BEARISH
Target:  AMT currently trading at 46.00

Commit Criteria:
Think AMT is poised to give some back due to profit taking and some uncertainty on the supply of communication towers. AMT is trading around its 52 week high on weaker than normal volume and might be out of gas for the short term.

Tactic: 45 Strike Synthetic Short Stock

Tactical Employment:
Leg Set up:  Buy 1 October 45 Strike Put@ 2.45
Sell 1 October 45 Strike Call@ 3.30
Net Credit: 85 cents per share

Max Profit:  45.85, based on AMT
Max Risk:  Unlimited
Breakeven:  45.85

The Greeks:
Delta: Delta is 1.0; position will act exactly like a short stock after it is open.

Mid-Course Guidance:
Profit Target: 10% move down in AMT to $41.40

Threats to success:
Earning release July 26.

Eject Criteria/Contingency Plan:
- Commit Criteria no longer valid.
- Max allowable loss of 10%, a move up to $50.60
- Stock not moving as desired 45 days to expiration.

Exit Plan
1. Profit Target Reached.
2. Eject Criteria Reached.
3. To Close Position,
   a. Sell to close 1 Oct 45 put.
   b. Buy to close 1 Oct 45 call.

Planning Thoughts:
Remember why we plan. The plan lays the foundation for Discipline, it lays out our risk parameter and tells us what to do when they are threatened and when we stick to our plan we have Superior Execution. The bullet points below outline some of our thought with this trade plan.

1. We are mildly bearish in the short term on AMT.
2. Our Commit Criteria are stated simply and summarizes our thoughts when entering the trade.
3. Tactic is simply the option position we are opening.
   a. Remember our objective...Make Money, Don't Lose It!
   b. Our strategy is to use options to support our objective.
   c. And our tactic is the options position.
4. Our Tactical Employment is simply the trade set up and the performance parameters for the trade.
   a. Profit is dependent on AMT.
5. Mid-Course Guidance:
   a. We define our price target on stock movement for a synthetic call. Normally a 10% move down in the stock.
   b. We will keep an eye on earnings when they come out in July and be ready to exit if positive.
   c. Eject Criteria:
      i. If our bearishness on AMT can no longer be supported.
      ii. Max allowable loss is also based on a movement in the stock. Normally a 10% upward move.
Wrap Up

A synthetic short stock allows you to enter a position that acts exactly like shorting the underlying equity at a much lower price than actually borrowing the stock. It also gives you the same risk exposure as shorting the stock (check with your broker for margin requirements). Next we will look into the selling of options.
Lesson 2 Quiz

1. What is the set up for a synthetic short stock?
   a. Buy 1 put and sell 1 call.
   b. Buy 1 call and sell 1 put.
   c. Buy 1 call and buy 1 put.
   d. Sell 1 call and sell 1 put.

2. What is the max gain of a synthetic short stock?
   a. Unlimited.
   b. The premium paid.
   c. The premium received.
   d. The strike price minus the premium paid or plus the credit received.

3. What is the breakeven of a synthetic short stock?
   a. The strike price minus the net debit.
   b. The current stock price plus the premium paid.
   c. The strike price plus the net credit.
   d. Both a and c.

4. What is the max loss of a synthetic short stock?
   a. Unlimited.
   b. The premium paid.
   c. The premium received.
   d. The strike price minus the premium paid or plus the credit received.

Use the Cisco Systems (CSCO) option chain above to answer the following questions.
Assumptions:

- Bearish on CSCO.
- Market order and transaction costs excluded.
5. What is the net debit or net credit per share to open a synthetic short stock with the October 22 strike?
   b. Net credit of 62 cents.
   c. Net credit of 36 cents.
   d. Net debit of 36 cents.

6. Picking the Oct 22 strike, what is our break even share price?
   a. $22.26
   b. $21.48
   c. $22.62
   d. $23.50

7. What is the max risk per share of 1 synthetic short stock opened with the Oct 22 strike?
   a. Unlimited.
   b. $23.37
   c. $22.62
   d. $23.00

8. What is the max profit per share of the Oct 22 strike synthetic short stock?
   a. $18.00
   b. Unlimited.
   c. $22.00
   d. $22.62

9. If AMT goes up by $4.00, how much will our 22 strike synthetic short stock decrease in value per share?
   a. $100.00
   b. $22.63
   c. $4.00
   d. $3.38

10. If AMT goes down by $4.00, how much will our synthetic short stock increase in value per share?
    a. $4.00
    b. $22.63
    c. $100.00
    d. $3.38
Introduction

Trading stock and synthetic stock obviously have their advantages of profiting from the Delta as the stock changes price. But there are other Greeks you can use to make money: Theta and Vega. Time decay and volatility changes can also produce profits when traded correctly. These additional avenues for profit can help you build upon a directional position so that it’s possible to profit from direction, time and volatility all at the same time.

This is the idea behind “writing” options. Writing options simply means “to sell options to open.” The idea behind these tactics is to collect the premium in the option as the option drops in value from stock movement, the passage of time, and/or a drop in the implied volatility of the options. The trade off is that the risk of loss may substantially outweigh the potential profit.

This tactic involves selling options without buying other options or stock to limit or reduce the risk. So these should only be entered into under the conditions that you have the cash or stock to cover the risk and that you’re comfortable with the level of risk you’re taking. If you’re comfortable with this, then we’ll look at selling call options.

A couple of general rules of trading:

1. Anything you buy, you want the premium to go up in value.
2. Anything you sell, you want the premium to go down in value.

So when you sell a call option you profit by having the call go down in value. You can then buy the call at the lower price and close your position. If the call is out of the money at expiration, then the call will be worthless and you’ll keep the entire credit. How do call options drop in value? By having the stock go down, through the passage of time (time decay), and/or when volatility drops.

Commit Criteria

When you find a stock that has bearish Commit Criteria supported by your analysis, then your next move is to select the most appropriate tactic. If you don’t know already, you’ll soon see that there are multiple tactics that you could choose if you’re bullish, bearish or neutral on a stock. The tactic to choose comes down to selecting the one that most closely matches your outlook and risk tolerance for both the stock and the implied volatility.

Fox3 Trade Principles
The call option that you sell should be ATM or OTM so that the option is made up solely of the time value and no real value.

Since the benefit of time decay is one of the main reasons you might select a short call, you want to limit yourself to selling options that have less than 45 days left until expiration. The greatest acceleration in the decay of an option occurs in the last 30-45 days so you want to avoid going out in time any further than you think you need to. Also, on the other side of the coin, you need to be very careful in selling options in the last week of expiration. Typically, by that time, the vast majority of the premium has eroded away already. And if you sell the option you’re taking a lot of risk without receiving much of a credit.

Due to the unlimited risk of selling a call option you will need to have the cash or stock to cover the position if it starts to move against you.

**Leg Set Up**

![Short Call Diagram]

- **Maximum Gain** = Limited to the Premium Received
- **Max Loss** = Unlimited
- **Break even** = Strike Price + Premium

Since this tactic is only comprised of one option simply select the strike that provides you enough premium to be comfortable with the risk associated with the stock moving higher. Let’s look at an example. Assume that IBM is currently trading at $120 and you think that
the stock will either not go any higher or that it will go down. The 125 strike call in June is trading for $2 and there are only 30 days left before expiration.

<table>
<thead>
<tr>
<th>Stock Price</th>
<th>Call Price</th>
<th>Profit/Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>$115</td>
<td>$0</td>
<td>$2</td>
</tr>
<tr>
<td>$120</td>
<td>$0</td>
<td>$2</td>
</tr>
<tr>
<td>$125</td>
<td>$0</td>
<td>$2</td>
</tr>
<tr>
<td>$127</td>
<td>$2</td>
<td>$0</td>
</tr>
<tr>
<td>$130</td>
<td>$5</td>
<td>-$3</td>
</tr>
<tr>
<td>$150</td>
<td>$25</td>
<td>-$23</td>
</tr>
</tbody>
</table>

Notice the limited reward of $2, that’s the premium of the call. But the losses mount up quickly if the stock moves higher.

**Selling Call Options to Open**

<table>
<thead>
<tr>
<th>Strike Price</th>
<th>Call Bid Ask</th>
</tr>
</thead>
<tbody>
<tr>
<td>115</td>
<td>$3.80 - $3.90</td>
</tr>
</tbody>
</table>

If you want to sell the 115 call to open a short call position, you would “sell the option to open.” But what price would you receive by trading on the natural price? The natural price for you to sell would be the $3.80 bid price. You don’t have to trade on the natural prices; you can enter an order with any price you want. But for purposes of this lesson we’ll look at selling options on the bid price and buying options on the asking price.

**Maximum Risk**

Just as with short stock your maximum risk is unlimited.

**Maximum Reward**

Your maximum reward is limited to the premium from the sale of the call. In order for you to keep the entire amount of the premium the option needs to expire worthless at expiration. In this example the max reward is $380 per option contract (100 x 3.80).

**Break Even**

The breakeven price for a short call is calculated by adding the premium to the strike price
of the call. At expiration this is the stock price above which you would see losses above and beyond the amount of premium you collected. In this above example, by selling the 115 call for a credit of $3.80 the breakeven is $118.80.

Please note, however, that if the stock moves higher prior, then the call option will go higher in value and you can have losses before the stock reaches the breakeven point. That occurs because the time value in the call will increase as the stock moves closer to the strike price.

Here are some examples of profits and losses in the 115 call that was sold at $3.80.

**Pricing A Short Call Prior to Expiration**

<table>
<thead>
<tr>
<th>Strike Price</th>
<th>Call Bid Ask</th>
</tr>
</thead>
<tbody>
<tr>
<td>115</td>
<td>$4.40 - $4.60</td>
</tr>
</tbody>
</table>

To calculate the profit or loss from your short call just look at what it would cost you to close the trade. To close a short call you will buy the call back on the ask price. If you can buy the call back for less than what you sold it for, then you have a profit. If it costs you more to buy it back, then you have a loss.

So, if you sold the call for $3.80, what is your current profit or loss based on the bid ask in the table above? Because it would cost you $4.60 to buy back the option to close (which is also called "buying to cover") the net loss in this trade would be $0.80.

Here’s another example:

<table>
<thead>
<tr>
<th>Strike Price</th>
<th>Call Bid Ask</th>
</tr>
</thead>
<tbody>
<tr>
<td>115</td>
<td>$0.60 - $0.75</td>
</tr>
</tbody>
</table>

Closing the trade now would lock in your profit. Since the call if offered at $0.75 you could buy to cover the option for $3.05 cheaper than the price you initially sold, and that $3.05 represents your profit in the trade. After the trade has been closed, you don’t have any more risk in the trade.

**Mid-Course Guidance**

When would you close the short call position?

Eject Criteria: If your initial reasons for being bearish on the stock have changed or no longer exist, then close the trade regardless of profit or loss.

Or if the position loses 50% of the premium received, then close the trade by buying the
Another trigger for you to close the position is if the option is ATM or ITM 15 days prior to expiration and the stock is not moving as desired. If this is the case, just close the trade to avoid any further risk.

Finally, if the option is OTM, but you have not yet reached your profit level (see below), manage the trade until expiration by re-setting the loss limit to protect what gains you do have.

Profit Goal: You initially want to reach a profit on the trade of 50% of your initial credit. For instance, if you sell a call for $2.00, then when the option drops down to a price of $1.00, you've made 50% of your potential $2.00 profit.

Once the trade gets to that point of profitability, then reset your exit level to 25%. In this last example that means you would close the trade if the option price went back to $1.50 because that's the point where you would only have 25% of your potential profit. You may be able to manage this exit by using a stop-loss, or trailing stop-loss order. Check with your individual broker.

**Important Greeks**

The Greeks all play a part in this tactic, but the important Greek to look at is Theta. Since the options we're selling are short term, these options will begin to decay very quickly.

**Delta:** Short calls have negative Deltas. A drop in the stock will cause the calls to lose value, and this is profitable for a short call. If the stock goes up, the call will increase in value thus giving you a loss.

**Gamma:** Short calls have negative Gamma. The important thing to understand about this is that your losses will begin to accelerate as the stock goes up. As the stock goes up in value, the Delta of the call will start to go up. Therefore the option that you are short will be increasing in value at an increasing rate.

The opposite is also true. As the stock drops your profits will slowly taper off as the option price approaches zero.

**Theta:** Time decay is definitely your friend. Short calls have positive Theta which means every day that passes by lowers the price of the option and that puts money in your pocket.

Vega is negative for short calls. Therefore an increase in the implied volatility will hurt this position because increases in volatility raise option prices. You want the option price to go down. A decrease in volatility will help this tactic profit.
Exit Steps

When either your Eject Criteria or your Profit Goal is hit, then it is time to close the trade.

Buying the call option to close your position:

When you are ready to close this trade you will “buy the call to close.” After the trade is closed, you will use the closing price to tally your profit or loss in the trade. And once the trade is closed there is no more risk in the trade.

If your option is OTM at expiration, then you can let the option expire worthless without having to buy the option to close. Many smart traders, however, adhere to a policy of closing all short options when the options decrease in value by a substantial amount and therefore don’t carry short option positions into expiration.

One reason for doing this is to avoid any time bombs sitting around that might explode back to value if the stock has a big move. A second reason is that buying to close the first short option gives you the freedom to go and sell another option short if it fits into your trade plan.

Wrap up

Short call options are a bearish tactic that profit from time decay, a drop in the stock price, and a drop in volatility. The profit potential is limited to the sale price and the risk is unlimited. If the option drops in price, then you’ll profit. But if it goes higher, you’ll lose. In the next lesson we’ll take a look at selling put options on stocks that you don’t think will go down in value.

Let’s pick a stock and build a trade plan.
**Best Buy Short Call**

Best Buy (BBY) is a consumer electronics store that I am sure we are all familiar with. BBY is a solid company but has missed on earnings recently and was followed by a steep slide in prices. Top that with a few recent downgrades and a not too rosy profit outlook for the current and next quarter.

Looking at the chart below, there has been a significant drop, but considering the outlook we are thinking the BBY will trade sideways at best and likely decline some as investors look for better places to find returns.
Writing a call on this stock we want to look at the OTM strikes. The 35 will give us 3.4% return on capital at risk and the 36 a 2.2% return on risk. The 35 strike does not give us as much room as we would like, so we will pick the 36 strike and build a trade plan to sell five contracts.

--------------------------------

BBY Trade Plan
July 6, 2010

Strategic Mindset:  NEUTRAL to BEARISH
Target:  BBY currently trading at 34.37

Commit Criteria:

Don’t think there is any upside in BBY for a few quarters. Recent downgrades and earnings reports have been negative and consumers are shying away from purchasing the high end electronics in the current economic climate.

Tactic:

36 Strike Short Call

Tactical Employment:
Leg Set up:  Sell 5 August 36 Strike Calls @ 0.80
Net Credit: 80 cents per share / $400 total

Max Profit: 80 cents per share
Max Risk: Unlimited
Breakeven: 36.80

The Greeks:

Theta: Theta is our friend.

Vega: An increase in IV will hurt our option value, but increase the chances of BBY decreasing. A decrease in IV will help our position, but could signal that investors are getting comfortable and buyers may step in.

Mid-Course Guidance:

Profit Target: 50% of premium received. If 40% is achieved, reset max allowable loss to 60% and manage trade.

Threats to Success:
- Broader market rally could bring buyers into BBY.

Eject Criteria/Contingency Plan:
- Commit Criteria no longer valid.
- Max allowable loss of 50% of premium, $1.20.

Exit Plan
1. Profit Target Reached.
2. Eject Criteria Reached.
3. To close position:
   a. Buy to close 5 Aug 36 calls.

Planning Thoughts:

1. Strategic Mindset is based on our outlook for BBY.
2. Our Commit Criteria are stated simply and summarizes our thoughts when entering the trade.
3. Tactic is simply the option position we are opening.
   a. Remember our objective...Make Money, Don’t Lose It!
   b. Our strategy is to use options to support our objective.
   c. And our tactic is the options position.
4. Our Tactical Employment is simply the trade set up and the performance parameters for the trade.
5. Mid-Course Guidance:
   a. We define our profit target in terms of the premium; our goal is to make a minimum of 50% of the premium taken in.
   b. A broad market rally could lead to some buying across the market and possibly BBY.
   c. Eject Criteria:
      i. If our Commit Criteria can no longer be supported, we get out.
      ii. Max allowable loss is based on the premium, and we do not want to lose more than 50% of the amount of the premium.


Reminder

A short call should not be opened unless you are covered by cash or the stock. If you choose to open based on margin alone, you are open to substantial risk and we do not recommend this at Fox3 Options.
Lesson 3 Quiz

1. What is the max loss for a short call?
   a. Unlimited.
   b. Premium paid.
   c. Premium received.
   d. Strike minus current stock price.

2. What is the max gain of a short call?
   a. Unlimited.
   b. The premium paid.
   c. The premium received.
   d. The strike price plus the credit received.

3. What is the breakeven of a short call?
   a. The strike price minus the net debit.
   b. The current stock price plus the premium paid.
   c. The strike price plus the net credit.
   d. Current stock price.

4. What is the strategic mindset for a short call?
   a. Bullish to neutral.
   b. Neutral to bearish.
   c. Bullish.
   d. Volatile.

Use the British Petroleum (BP) option chain above to answer the following questions. Assumptions:
• Bearish on BP.
• Market order and transaction costs excluded.

5. What is the net credit per share to open a short call with the BP Aug 36 strike?
   a. $2.14
   b. $2.17
   c. $2.56
   d. $2.60

6. Writing the Aug 36 strike call, what is our break even?
   a. $33.26
   b. $33.86
   c. $36.00
   d. $38.14

7. What is the max risk per share of if we short the Aug 36 call?
   a. Unlimited.
   b. $33.37
   c. $32.26
   d. $33.00

8. What is the max profit per share if we short the Aug 36 strike call?
   a. $36.00
   b. Unlimited.
   c. $2.14
   d. $2.17
Lesson Four
Short Put Option

Introduction

In the previous chapter we looked at selling calls short as a bearish tactic to help you profit from direction, time and volatility all at the same time. But what if you're bullish on a stock, or least don't think that the stock can go lower by very much? Then you can look at selling a put option.

Just like in the last lesson, this tactic involves selling options without buying other options to limit or reduce the risk. And part of the risk involves being forced to buy the stock. So this tactic should only be entered into under the conditions that you have the cash to buy the stock, you would be happy to own the stock and that you're comfortable with the level of risk you're taking. Remember rule number 1 when selling puts:

**Do NOT Sell a Put on a Stock You Do Not Want to OWN!**

If you're comfortable with this, then we'll look at selling put options.

A couple of general rules of trading are these:
- Anything you buy, you want the premium to go up in value.
- Anything you sell, you want the premium to go down in value.

So when you sell a put option you profit by having the put go down in value. You can then buy the put at the lower price and close your position. If the put is OTM at expiration, then the put will be worthless and you'll keep the entire credit. How do put options drop in value? Several things can occur: The stock goes up through the passage of time (time decay) and when volatility drops.

Commit Criteria

When you find a stock that has bullish criteria supported by your analysis, then your next move is to select the most appropriate tactic. This tactic works best in situations where you're confident that the stock won't drop very much in price and when the broader market is moving higher and supporting your outlook for the stock. So a great situation for this would be positive indications both fundamentally and technically in the individual stock as well as the market as a whole.

If you don't know already, you'll soon see that there are multiple tactics that you could choose depending on your outlook for the target stock. Which tactic to choose comes down to selecting the one that most closely matches your outlook for stock direction, risk
tolerance and the implied volatility.

**Fox3 Options’ Trade Principles**

The put option that you sell should be ATM or OTM so that the option is made up solely of the time value and no real value.

Since the benefit of time decay is one of the main reasons you might select a short put, you want to limit yourself to selling options that have no more than 30-45 days left until expiration. The greatest acceleration in the decay of an option begins in the last 30-45 days, so you want to avoid going out in time any further than you think you need to. Also, on the other side of the coin, you need to be very careful in selling options in the last week of expiration. Typically, by that time, the vast majority of the premium has already eroded away. And if you sell the option with such little time left you’re taking a lot of risk without receiving much of a credit.

Due to the substantial risk of selling a put option you will want to have the cash to buy the stock if it starts to move against you.
**Leg Set Up**
Since this tactic is only comprised of one option, simply select the strike that provides you enough premium to be comfortable with the risk associated with the stock moving lower. Let’s look at an example. Assume that IBM is currently trading at $125 and you think that the stock will either not go any lower or that it will go up. The 125 strike put in June is trading for $2 and there are only 30 days left before expiration. If you sell that put, then this is your potential profit at expiration:

<table>
<thead>
<tr>
<th>Stock Price</th>
<th>Put Price</th>
<th>Profit/Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100</td>
<td>$20</td>
<td>-$18</td>
</tr>
<tr>
<td>$105</td>
<td>$15</td>
<td>-$13</td>
</tr>
<tr>
<td>$110</td>
<td>$10</td>
<td>-$8</td>
</tr>
<tr>
<td>$115</td>
<td>$5</td>
<td>-$3</td>
</tr>
<tr>
<td>$120</td>
<td>$0</td>
<td>$2</td>
</tr>
<tr>
<td>$125</td>
<td>$0</td>
<td>$2</td>
</tr>
</tbody>
</table>

**Maximum Gain = Premium Received**
**Max loss = Strike price - Premium**
**Break even = Strike Price - Premium**
Notice the limited reward of $2, that’s the premium of the put. But the losses mount up quickly if the stock moves lower.

**Selling Put Options to Open**

If you want to sell the 115 put to open a short put position, you would “sell the option to open.” But what price would you receive by trading on the natural price? In the table below the natural price for you to sell would be the $3.80 bid price. You don’t have to trade on the natural prices; you can enter an order with any price you want. But for purposes of this text we’ll look at selling options on the bid price and buying options on the asking price.

<table>
<thead>
<tr>
<th>Strike Price</th>
<th>Put Bid Ask</th>
</tr>
</thead>
<tbody>
<tr>
<td>115</td>
<td>$3.80 - $3.90</td>
</tr>
</tbody>
</table>

**Maximum Risk**

Put options go up in value when the stock drops, and if you sold the put, that means you’re losing money as the stock drops. You’re losing money because it would cost you more to buy back the put than what you originally collected from the sale. And the higher the put goes, the more it’s going to cost you.

Since stock prices can only drop to zero (which can still be an incredible amount of risk!) this means that put prices have a cap on how high they can go. Therefore, put options cannot trade for more than the value of their strike price. If you subtract from the strike price the amount of premium you collect from the sale, then you have your maximum risk.

Strike Price - Premium = Max risk

In this example above where the 115 put is sold for a credit of $3.80, the max risk is $111.20, which for one contract is $11,120.

**Maximum Reward**

Your maximum reward is limited to the premium from the sale of the put. In order for you to keep the entire amount of the premium the option needs to expire worthless at expiration. In this example the max reward is $3.80, which is $380 per option contract.

**Break Even**
The breakeven price for a short put is calculated by subtracting the premium from the strike price of the put. At expiration, this is the stock price below which you would see losses. If the stock is above this price, then you will have at least some profit. In this above example, by selling the 115 put for a credit of $3.80 the break even is $111.20.

Where does the stock have to be for you to keep the full credit of the sale as profit? You’ll only get to keep the full credit when the option is worthless at expiration. That means that the stock has to be above $115, and you would have to let the option go to expiration without closing the trade.

Please note, however, that if the stock moves lower prior to expiration, then the put option will go higher in value and you can have losses even before the stock reaches the breakeven point. That occurs because the time value in the put will increase as the stock moves closer to the strike price.

**Pricing your Short Put Prior to Expiration**

Here are some examples of calculating profits and losses in the 115 put that was sold at $3.80.

<table>
<thead>
<tr>
<th>Strike Price</th>
<th>Put Bid Ask</th>
</tr>
</thead>
<tbody>
<tr>
<td>115</td>
<td>$4.40 - $4.60</td>
</tr>
</tbody>
</table>

To calculate the profit or loss from your short put just look at what it would cost you to close the trade. To close a short put you will buy the put back on the ask price. If you can buy the put back for less than what you sold it for, then you have a profit. If it costs you more to buy it back, then you have a loss.

So, if you sold the put for $3.80, what is your current profit or loss based on the bid ask in the table above? Because it would cost you $4.60 to buy back the option to close (which is also called “buying to cover”) the net loss in this trade would be $0.80.

Here’s another example:

<table>
<thead>
<tr>
<th>Strike Price</th>
<th>Put Bid Ask</th>
</tr>
</thead>
<tbody>
<tr>
<td>115</td>
<td>$0.60 - $0.75</td>
</tr>
</tbody>
</table>

Closing the trade now would lock in your profit. Since the put is offered at $0.75 you could buy to cover the option for that price, which is $3.05 cheaper than the price you initially sold. That $3.05 represents your profit in the trade. After the trade has been closed you
have no more risk in the trade.

**Mid-Course Guidance**

When would you close the short put position?

Eject Criteria: If your initial reasons for being bullish on the stock have changed or no longer exist, then close the trade regardless of profit or loss. This is true of any trade where your initial Commit Criteria have changed. Always better to bail out of the trade and live to trade another day.

Or if the position loses 50% of the initial premium, then close the trade by buying the put to cover the position. Here’s an example of how that works. Let’s assume you sell a 100 strike put and collect a premium of $2.50. One-half of this amount is $1.25. In order for you to lose $1.25 on this put it would have to increase by $1.25 up to a price of $3.75. So if the put gets to that value, you will close the position to prevent any further loss to the position.

Another trigger for you to close the position is if the option is ATM or ITM 15 days prior to expiration and the stock is not doing what we intended. What does that mean?

Let’s say that your option has gone into the money, but because the option has been dropping in value from the time decay, it could be that you haven’t yet hit the Eject Criteria. But if the stock is drifting lower and it looks like the option will remain ITM, then buy the option to close.

If the option is ITM and the stock is moving as intended, that is, it’s at least drifting higher, then manage according to the profit exit.

Finally, if the option is OTM but you have not yet reached your profit level (see below); manage the trade until expiration by re-setting the loss limit to protect what gains you do have.

**Profit Goal:** You initially want to reach a profit on the trade of 50% of your initial credit. For instance, if you sell a put for $2.00, then when the option drops down to a price of $1.00, you’ve made 50% of your potential $2.00 profit.

Once the trade gets to that point of profitability, then reset your exit level to 25%. In this last example that means you would close the trade if the option price went back to $1.50 because that’s the point where you would only have 25% of your potential profit. You may be able to manage this to exit by using a stop-loss, or trailing stop-loss order. Check with your individual broker.

**Important Greeks**
The Greeks all play a part in this tactic, but the important Greek to look at is Theta. Since the options we’re selling are short term, these options will begin to decay very quickly.

**Delta:** Short puts have positive Deltas. A rise in the stock will cause the puts to lose value and this is profitable for a short put. If the stock goes down, the put will increase in value thus giving you a loss.

**Gamma:** Short puts have negative Gamma. The important thing to understand about this is that your losses will begin to accelerate as the stock goes down. As the stock goes down in value, the Delta of the put will start to go up. Therefore the option that you are short will be increasing in value at an increasing rate.

The opposite is also true. As the stock moves higher your profits will slowly taper off as the option price approaches zero.

**Theta:** Time decay is definitely your friend. Short puts have positive Theta which means every day that passes lowers the price of the option and that puts money in your pocket.

**Vega:** Vega is negative for short puts. Therefore an increase in the implied volatility will hurt this position because increases in volatility raise option prices. You want the option price to go down. A decrease in volatility will help this tactic profit.

**Exit Steps**

When either your Eject Criteria or your Profit Goal is hit, then it is time to close the trade.

When you are ready to close this trade you will “buy the put to close.” After the trade is closed, you will use the closing price to tally your profit or loss in the trade. And once the trade is closed there is no more risk in the trade.

If your option is OTM at expiration, then you can let the option expire worthless without having to buy the option to close. Many smart traders, however, adhere to a policy of closing all short options when the option decreases in value by a substantial amount, and therefore they don’t carry short option positions into expiration.

One reason for doing this is to avoid any time bombs sitting around that might explode back to value if the stock has a big move. A second reason is that buying to close the short option gives you the freedom to go and sell another option short if it fits into your trade strategy.

**Wrap Up**

Short put options are a bullish tactic that profits from time decay, a rise or stagnation in the stock price, and a drop in volatility. The profit potential is limited to the sale price, and the
risk is substantial. If the option drops in price, then you’ll profit. But if it goes higher, you’ll lose. In the next lesson we’ll start to put different options to work in tandem with one another, much like having a wingman to help offset the risk.

So, let’s pick a stock and build a trade plan.
The Q's (QQQQ) Short Put

Although we focus primarily on options traded on equities of publicly traded companies in Top Gun Options, these are not the only optionable assets we can target. There are several optionable Exchange Traded Funds (ETF’s) that can be targeted. Through ETF’s we can target several different classes of assets. The PowerShares QQQ (QQQQ) is an ETF that seeks to replicate the performance of the NASDAQ-100 Index, which includes 100 of the largest tech companies in the world such as Apple (AAPL), Microsoft (MSFT) and Google (GOOG) are among the top holdings. ETF’s offer a broad market exposure and can diversify risk nicely, certainly a consideration when writing a put.

Looking at the chart of the Q’s below, we can see that since the high in late April the Q’s have been beat up a bit. Plus, many of the stock in the portfolio are looking pretty oversold. The Q’s have bounced solidly after hitting support in the beginning of July and they, as well as the rest of the market, look poised for a bullish move. Given the diversification of the Q’s and their recent bounce off support, this seems like a reasonable target for a short put. Plus, if we end up getting assigned the Q’s around 42 or 43, we would be ok with that. Don’t forget rule number 1 when selling puts!
The option chain for an ETF is identical to a stock option. When writing an option we want to look at the OTM or ATM strikes. We would rather not be assigned so we will look at the OTM strikes. We will consider the 42 or 43 strikes to get us a little more OTM. The 42 strike gives us a 1.5% return on capital at risk and the 43 gives us 2% return. So we will choose the 43 strike and build a trade plan to sell five put contracts.

QQQQ Trade Plan
July 7, 2010

**Strategic Mindset:** BULLISH

**Target:** QQQQ currently trading at 44.62

**Commit Criteria:**
We think tech is oversold and poised for a rebound. The Q's just bounced solidly of support at 42 and the broader market appear to be rebounding.

**Tactic:** 43 Strike Short Put
**Tactical Employment:**

Leg Set up:  *Sell 5 August 43 Put @ 0.89*

*Net Credit: 89 cents per share / $445T total*

Max Profit:  

89 cents per share

Max Risk:  

42.11

Breakeven:  

42.11

**The Greeks:**

*Theta:* Theta is our friend.

*Vega:* An increase in IV will hurt our option value plus increase the chances of the Q’s decreasing. A decrease in IV will help our position and could signal that investors are getting comfortable and buyers may step in. This is good.

**Mid-Course Guidance:**

*Profit Target:* 50% of premium received. If 50% is achieved, reset max allowable loss to 25% and manage trade.

**Threats to success:**

- *Broader market decline could lead to selling in the tech sector hurting the Q’s.*
- *Negative economic reports.*

**Eject Criteria/Contingency Plan:**

DISCIPLINE | RISK MANAGEMENT | SUPERIOR EXECUTION
Commit Criteria no longer valid.
Max allowable loss of 50% of premium, $1.33.

Exit Plan
1. Profit Target Reached.
2. Eject Criteria Reached.
3. To close position:
   a. Buy to close 5 Aug 43 calls.

Planning Thoughts:
1. Strategic Mindset is based on a sector and market outlook.
2. Our Commit Criteria are stated simply and summarizes our thoughts when entering the trade.
3. Tactic is simply the option position we are opening.
   a. Remember our objective...Make Money, Don't Lose It!
   b. Our strategy is to use options to support our objective.
   c. And our tactic is the options position.
4. Our Tactical Employment is simply the trade set up and the performance parameters for the trade.
5. Mid-Course Guidance:
   a. We define our profit target in terms of the premium, our goal is to make a minimum of 50% of the premium taken.
   b. A broad market decline could lead to some selling across the market.
   c. A negative economic report could be a catalyst for a sell off.
   d. Eject Criteria:
      i. If our Commit Criteria can no longer be supported we get out.
      ii. Max allowable loss is based on the premium, and we do not want to lose more than 50% of the amount of the premium.

Reminder
A short put should not be opened unless you are covered by cash. If you choose to open based on margin alone, you are open to substantial risk and we do not recommend this at Fox3 Options.
Lesson 4 Quiz

1. What is the max loss for a short put?
   a. Unlimited.
   b. Premium paid.
   c. Premium received.
   d. Strike minus premium received.

2. What is the max gain of a short put?
   a. Unlimited.
   b. The premium paid.
   c. The premium received.
   d. The strike price plus the credit received.

3. What is the breakeven of a short put?
   a. The strike price minus the premium received.
   b. The current stock price plus the premium paid.
   c. The strike price plus the net credit.
   d. Current stock price.

4. What is the strategic mindset for a short call?
   a. Neutral to bullish.
   b. Neutral to bearish.
   c. Bullish.
   d. Volatile.

Use the Deere (DE) option chain above to answer the following questions.
Assumptions:

<table>
<thead>
<tr>
<th>STRIKES</th>
<th>Bid</th>
<th>Ask</th>
<th>Mark</th>
<th>Open Interest</th>
<th>Ask Size</th>
<th>Bid Size</th>
<th>Imp Vol</th>
<th>Imp Vol Chg</th>
</tr>
</thead>
<tbody>
<tr>
<td>52.5</td>
<td>1.16</td>
<td>1.19</td>
<td>1.175</td>
<td>656</td>
<td>0</td>
<td>0</td>
<td>42.84%</td>
<td>+3.47%</td>
</tr>
<tr>
<td>55</td>
<td>1.78</td>
<td>1.82</td>
<td>1.80</td>
<td>829</td>
<td>0</td>
<td>0</td>
<td>40.03%</td>
<td>+4.22%</td>
</tr>
<tr>
<td>57.5</td>
<td>2.68</td>
<td>2.73</td>
<td>2.705</td>
<td>1,618</td>
<td>0</td>
<td>0</td>
<td>37.41%</td>
<td>+5.16%</td>
</tr>
<tr>
<td>60</td>
<td>3.90</td>
<td>4.00</td>
<td>3.95</td>
<td>718</td>
<td>0</td>
<td>0</td>
<td>34.97%</td>
<td>+6.84%</td>
</tr>
<tr>
<td>62.5</td>
<td>5.50</td>
<td>5.60</td>
<td>5.55</td>
<td>83</td>
<td>0</td>
<td>0</td>
<td>32.31%</td>
<td>-1.06%</td>
</tr>
<tr>
<td>65</td>
<td>7.45</td>
<td>7.60</td>
<td>7.525</td>
<td>2</td>
<td>0</td>
<td>0</td>
<td>30.56%</td>
<td>-1.31%</td>
</tr>
</tbody>
</table>
• Bullish on Deere (DE)
• Market order and transaction costs excluded.

5. What is the net credit per share to open a short put with the DE Aug 55 strike put?
   a. $1.82
   b. $2.68
   c. $1.78
   d. $2.73

6. Writing the Aug 55 strike put, what is our break even?
   a. $53.22
   b. $56.78
   c. $55.00
   d. $58.01

7. What is the max risk per share of if we short the Aug 36 call?
   a. Unlimited.
   b. $53.22
   c. $55.00
   d. $58.01

8. What is the max profit per share of the short Aug 36 strike call?
   a. $55.00
   b. Unlimited.
   c. $1.78
   d. $1.82

9. If we wrote 5 DE Aug 57.5 put contracts and were assigned the shares, what would be our cost basis for DE?
   a. $57.50
   b. $58.01
   c. $60.18
   d. $54.82

10. What is the number one rule for selling puts?
    a. Don’t sell a put on a stock you do not want to own!
    b. Don’t sell a put on a stock you do not want to own!
    c. Don’t sell a put on a stock you do not want to own!
    d. All of the above.
Lesson Five
Bull Call Spreads

Introduction

Spreads are tactics that involve the use of more than one kind of option. Even though there are multiple option components to the trade (with each component being called a “leg”) the options are executed simultaneously for one net price.

There are many types of spreads. Some take advantage of stock movements while others are set up to take advantage of movements in implied volatility and even time decay. There are calendar or time spreads, diagonal spreads, ratio spreads and also vertical spreads, which we will discuss in depth here. Vertical spreads can provide large percentage returns with low risk and can be entered into with small capital outlay. A vertical involves the purchase of one option in conjunction with the sale of another option.

Spreads are more advanced and sophisticated than the tactics discussed thus far. While vertical spreads can be less risky than a covered call, there are more variables to consider and control which makes trading the spread more complicated.

When you trade a spread you are dealing with three elements: the spread as a whole (which you can buy or sell) and its component parts – the option you buy and the option you sell.

Although the cost of most spreads is relatively inexpensive to initiate, they can provide a large percentage return and there is protection (limits) to both sides of the trade. Therefore, even experienced investors can profit from learning about spreads and their investment potential.

There are two types of vertical spreads: the vertical call spread and the vertical put spread. Each spread allows you to do two things. First, you can buy it, making you long the vertical spread. Second, you can sell it making you short the vertical spread. Both can be employed to take advantage of directional stock plays. When we use the term “directional stock play,” we refer to using vertical spreads to capitalize on anticipated stock movements either up or down.

Commit Criteria
A bullish spread is used when the investor feels that a stock is most likely to go up. As we recall, “bullish” means to have a positive outlook on a stock’s future movement. In this case, a bullish investor would buy a Bull Call Spread. The investor is said to “be long the call spread”. Buying a call with a lower strike price and selling a call with a higher strike price in the same expiration month accomplishes this.
The spread is chosen when the trader wishes to hedge the downside risk of the trade by selling the higher strike option. The trade can still profit with the stock moving higher, but the spread hedges the volatility risk in the trade as well as lowering the cost of the trade.

**Fox3 Options’ Trade Principles**

To begin creating a long call spread trade, let’s first look at the time frame. Which expiration month should you choose? When buying call spreads we want to keep the time frame to 2 months or less before expiration. If you trade spreads further out in time, then the spread will not change value very quickly. A general rule of thumb is that shorter term options and spreads move quicker than longer term options and spreads. Keep this in mind when you’re deciding on which month to choose. And simply match up your time frame for how quickly you think the stock will be making its move higher.

Once you’ve chosen the expiration month in which you want to target, we then need to choose the right strikes. When we look at the Leg Set Up just below you’ll see that this trade has two legs (two different strike price options). You want to start the trade with the stock price above Leg 1. Let’s look at that now.

**Leg Set Up**

A long call spread (bull call spread) is constructed by buying a lower strike call (1) and selling a higher strike call (2) in the same stock and in the same month. For instance, you can buy a call spread by buying the IBM June 55 call while selling the June IBM 60 call. This

**Bull Call Spread**

\[
\text{Maximum Gain} = \text{difference between strikes} - \text{debit} \\
\text{Max loss} = \text{debit} \\
\text{Breakeven} = \text{lower strike} + \text{debit}
\]

A long call spread (bull call spread) is constructed by buying a lower strike call (1) and selling a higher strike call (2) in the same stock and in the same month. For instance, you can buy a call spread by buying the IBM June 55 call while selling the June IBM 60 call. This
trade would be called the IBM June 55 - 60 call spread. In our example we want the stock to be trading at a higher price than the strike of Leg 1. So here the stock could be trading at $57, $2 higher than the low strike of 55.

A vertical spread's maximum value is the difference between the two strikes. For example, the maximum value of the June 55 – 60 call spread is $5.00. \[72x666\)\[269x680\)\[276x680\] = $5.

<table>
<thead>
<tr>
<th>Spread</th>
<th>Difference between Strikes</th>
<th>Spreads Maximum Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>August 35 - 40 call</td>
<td>5</td>
<td>$5.00</td>
</tr>
<tr>
<td>April 70 – 85 put</td>
<td>15</td>
<td>$15.00</td>
</tr>
<tr>
<td>Nov. 20 – 22.5 call</td>
<td>2.5</td>
<td>$2.50</td>
</tr>
<tr>
<td>Dec. 40 – 50 put</td>
<td>10</td>
<td>$10.00</td>
</tr>
<tr>
<td>Jan 60 – 80 call</td>
<td>20</td>
<td>$20.00</td>
</tr>
</tbody>
</table>

Using the June 55 – 60 call spread example, we will set the date to June expiration on Friday. On that day, all the June options will expire and all of the time value will have eroded away.

Where does the spread get its value? Basically, from its two components - the call you buy and the call you sell. Let's look at the spread’s value with a couple of different closing stock prices. If the stock closes at $55, then both the 55 strike and the 60 strike will be worthless. The value of the spread will be zero as both options are worth $0. If the stock closes at $57.50, the June 55 calls will be worth $2.50. The June 60 calls will be out of the money and thus worthless, therefore the spread will be worth $2.50 (June 55 call $ 2.50 - June 60 call $0).

If the stock closes at $60.00, then the June 55 calls will be worth $5.00. Meanwhile, the June 60 calls will be worth $0. This means that the spread will be worth $5.00 (June 55 call $ 5.00 - June 60 call $0). This is the maximum value of the spread. Note that the maximum value is identical to the difference between the strikes.

As the stock goes higher, the June 60 call becomes ITM and gains real value. Now, for every penny that the stock increases in value, the June 55 calls and June 60 calls gain value equally, keeping the $5.00 spread between the two strikes constant. To see this, refer to the Table below.
The difference between the strikes is the maximum value of all vertical spreads regardless of the distance between the two strikes. It does not matter whether the spread is $5.00 wide, $10.00 wide, $20.00 wide, or even $50.00 wide; its maximum value is the difference between the two strikes.

Prior to expiration, a vertical spread is simply priced by taking the current market value of each option and deriving the net price for the spread. If the current net value of the spread is more than what you paid for it, then you have a profit. If the current value of the spread is less than what you paid, then you have a losing trade. Let’s look at an example.

<table>
<thead>
<tr>
<th>Stock Price</th>
<th>June 55 call Value</th>
<th>June 60 call value</th>
<th>Spread</th>
</tr>
</thead>
<tbody>
<tr>
<td>55</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>56</td>
<td>1</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>57</td>
<td>2</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>58</td>
<td>3</td>
<td>0</td>
<td>3</td>
</tr>
<tr>
<td>59</td>
<td>4</td>
<td>0</td>
<td>4</td>
</tr>
<tr>
<td>60</td>
<td>5</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>61</td>
<td>6</td>
<td>1</td>
<td>5</td>
</tr>
<tr>
<td>62</td>
<td>7</td>
<td>2</td>
<td>5</td>
</tr>
<tr>
<td>65</td>
<td>10</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>70</td>
<td>15</td>
<td>10</td>
<td>5</td>
</tr>
<tr>
<td>100</td>
<td>45</td>
<td>40</td>
<td>5</td>
</tr>
</tbody>
</table>

The difference between the strikes is the maximum value of all vertical spreads regardless of the distance between the two strikes. It does not matter whether the spread is $5.00 wide, $10.00 wide, $20.00 wide, or even $50.00 wide; its maximum value is the difference between the two strikes.

Prior to expiration, a vertical spread is simply priced by taking the current market value of each option and deriving the net price for the spread. If the current net value of the spread is more than what you paid for it, then you have a profit. If the current value of the spread is less than what you paid, then you have a losing trade. Let’s look at an example.

<table>
<thead>
<tr>
<th>Strike Price</th>
<th>Bid</th>
<th>Ask</th>
</tr>
</thead>
<tbody>
<tr>
<td>55</td>
<td>$3.80</td>
<td>$3.90</td>
</tr>
<tr>
<td>60</td>
<td>$2.90</td>
<td>$3.05</td>
</tr>
</tbody>
</table>

**Buying a Call Spread to Open**

Trading on the natural prices means buying an option on the asking price and/or selling an option on the bid price. Basically, it’s trading at the worst price currently displayed. If you were to buy this call spread on the natural prices, you would pay $3.90 for the 55 call and collect $2.90 by selling the 60 call on the bid price. Therefore, the net price that you’re paying for the spread is the difference between the two options: $1.00.

**Maximum Risk**

The maximum risk on this trade is $1.00, and this would be completely lost at expiration if the stock is at $55 or lower. In that case, both options would be worthless and the spread would also be worth zero.
**Maximum Reward**

The maximum potential reward would be $4.00. Since this is a $5 spread, and you paid $1.00 for it, if the stock is above $60 at expiration, then the spread would be worth its full $5 value. That leaves you with a $4.00 profit.

**Break Even**

The break even for a call spread if you hold it until expiration is the lower strike price plus the debit. The stock would have to be above this price at expiration for the spread to be worth more than you paid for it.

Prior to expiration, however, the price of the spread is going to change as the market moves. You’ll make money if the value of the call spread goes up in value. Since call spreads increase in value when the stock goes up long call spreads are sometimes referred to as “bull call spreads.” But to keep everything as simple as possible just remember that you want your long spreads to go up in value, and short spreads to go down in value. If the stock goes lower in price, then the call spread will drop in price and you will lose money.

**Pricing your Spread Prior to Expiration**

The current profit or loss can be taken straight from the option chains. Just look at the current values of the two options. If you paid $1.00 for the spread, what would the current profit or loss be with these natural prices?

<table>
<thead>
<tr>
<th>Strike Price</th>
<th>Bid</th>
<th>Ask</th>
</tr>
</thead>
<tbody>
<tr>
<td>55</td>
<td>$4.35</td>
<td>$4.50</td>
</tr>
<tr>
<td>60</td>
<td>$1.60</td>
<td>$1.70</td>
</tr>
</tbody>
</table>

Since you own the 55 call, then you would need to sell it to close. Therefore, look at the bid price. And you’re short the 60 call, so you would need to buy it. Therefore, look at the ask price. Together this equates to the natural bid price for the spread. If you bought the spread for $1.00, and now you see that you can sell the spread on the natural prices for $2.65 ($4.35-$1.70), then you have a current profit of $1.65. That’s a net profit of 165%.

**Mid-Course Guidance**

When would we close the spread?

Eject Criteria: If the spread loses 50% of your initial debit, then sell the spread to close the trade and limit your losses. Also, if your reasons for being bullish on the stock have changed or no longer exist, then close the trade regardless of profit or loss.
Profit Goal: Once the spread reaches a profit level of 50%, then manage the trade actively by setting your Eject Criteria to the 25% profit level. Continue to raise your Eject Criteria as the spread moves higher in value. Depending on your particular broker, you might be able to achieve this with an order called a “trailing stop loss.” Check with your broker.
**Important Greeks**

Let’s look at the Greeks that affect the long call spread.

**Delta:** A long call spread as positive Deltas.

**Gamma:** Although the spread offsets much of the Gamma, there is still an effect. Take a look at the midpoint between the two strikes of your spread. Gamma will affect the spread differently depending on where the stock is relative to the strikes of the spread. In an earlier example we looked at the 55-60 call spread. The midpoint for that spread would be $57.50.

With the stock below the midpoint the spread has a small amount of positive Gamma. The spread has a small amount of negative Gamma with the stock above the midpoint.

**Theta:** Like Gamma, the spread offsets much of the time decay. But there is still an effect.

If the stock is below that midpoint, then the spread has negative Theta and will lose money from the passage of time. And if the stock is below the lower strike (leg 1), then the spread will decay to zero by expiration giving you the full loss on the trade.

If the stock is above the midpoint, then the spread has a positive Theta. If the stock is above the higher strike call (leg 2), then the spread continue to increase in value until it reaches its full value at expiration, at which time you will have achieved max profit.

**Vega** is essentially neutralized by the spread.

**Exit Steps**

When either your Eject Criteria or your Profit Goal is hit, then it is time to close the spread.

When you are ready to close your position you will “sell your call spread to close.” As mentioned earlier, if you can sell your spread for more than you originally paid, then you have a profit. If you sell it for less than you paid, you have a loss - just like when trading stock. The only difference here is that you are trading two different options as a package for the net price of the spread.

To sell the spread you will sell to close the option you own (leg 1) and buy to close the option you’re short (leg 2). These trades are executed simultaneously by selling the spread using a spread order with your broker.

As an alternative, if your spread is completely ITM, that is, with the stock safely above your short strike (leg 2), then you can let the position go to expiration. At that point both options will automatically go through the exercise/assignment process and you’ll be left
with the full value of the spread minus any commissions or fees.

Wrap Up

Vertical spreads are an excellent way to enter a directional position on an underlying. The Bull Call Spread is a bullish tactic that allows a trader to control risk and offset the cost of simply buying a long call. It puts a floor on losses, but also caps the upside potential. Depending on the price of the underlying when open, this tactic can produce profits if the stock trades sideways or climbs. So the Bull Call Spread gives a trader some additional versatility in their arsenal of option tactics.

So, let’s pick a stock and build a trade plan.
Google Bull Call Spread

Google (GOOG) is the king of online advertising and search engines. Every one reading this lesson has probably done more than one Google search today. But 2010 has beaten up the stock pretty good. An attempt to enter the mobile phone business and taking on China, albeit for good reasons, GOOG has taken it on the chin.

Looking at GOOG’s chart below, the stock is down 25% from its highs in January in the face of blowing earnings away on the upside and continued dominance in its market. The stock is coming off a near 1 year low and looks to be reversing its down trend.

If you are thinking the downside is overdone, this may be a good time to jump in with a bull Put Spread. We want to keep our trade timeframe to less than two months, so we will look at the August strikes.
We want to make sure the stock price is greater than our lower strike price so we can buy any of the ITM calls and sell a call above the lower strike to set the spread. We could actually buy the 440/450 Bull Call Spread giving us some downside room to $447.40, but if GOOG nose dives we have $7.40 per share at risk. Since we are feeling pretty bullish, we will pick the 460 and 470 strikes and build a trade plan.

GOOG Trade Plan
July 9, 2010

Strategic Mindset: BULLISH
Target: GOOG currently trading at 467.49

Commit Criteria:
Think GOOG is oversold and this is a good time to jump in. GOOG has given up almost all of its past years gains and appears to be reversing the downtrend.

Tactic: Bull Call Spread
Tactical Employment:

Leg Set up: Buy 1 August 460 Strike Call@ 24.00
Sell 1 August 470 Strike Call@ 18.30
Net Debit: 5.70 per share

Max Profit: 4.30
Max Risk: 5.70 /570.00
Breakeven: 465.70

The Greeks:

Theta and Vega: Both are essentially neutralized by the spread

Mid-Course Guidance:

Profit Target: 50% of max profit: premium of 7.85. If reached reset max loss to 25% profit to ensure a profit, premium of 6.78.

Threats to success:

• Earning release July 15.

Eject Criteria/Contingency Plan:

• Commit Criteria no longer valid.
• Max allowable loss of 50% of premium paid: out at premium of 2.85.

Exit Plan

1. Profit Target Reached.
2. Eject Criteria Reached.
3. To close position:
   a. Sell to close 1 August 460 call.
   b. Buy to close 1 August 470 call.
Planning Thoughts:

1. We are bullish on GOOG at these levels.
2. Our Commit Criteria is stated simply and summarizes our thoughts when entering the trade.
3. Tactic is simply the option position we are opening.
   a. Remember our objective...Make Money, Don’t Lose It!
   b. Our strategy is to use options to support our objective.
   c. And our tactic is the options position.
4. Our Tactical Employment is simply the trade set up and the performance parameters for the trade.
   a. Difference between strikes minus premium paid.
5. Mid-Course Guidance:
   a. We define our price target as a percentage of max profit. We would like to get the max profit, but set our target at 50% of max. Once reached, we reset our loss limit to ensure profits to the 25% profit point then actively monitor trade to see if it has the potential to yield the max profit. If we hit 50% then position retracts to a 25% profit we simply close the trade. We are not looking for home runs, base hits are good and add up fast.
   b. We will keep an eye on earnings when they come out in July and be ready to exit if negative.
   c. Eject Criteria:
      i. If our bullishness on GOOG can no longer be supported.
      ii. Max allowable loss is also based on the premium and do not want to lose more than 50% of our premium.
Lesson 5 Quiz

1. What is the set up for a Bull Call Spread?
   a. Buy 1 put and sell 1 higher strike call.
   b. Buy 1 call and sell 1 higher strike call.
   c. Buy 1 call and buy 1 higher strike put.
   d. Sell 1 call and sell 1 lower strike put.

2. What is the max gain of a Bull Call Spread?
   a. Premium paid.
   b. Debit paid.
   c. Difference between strikes plus premium paid.
   d. Difference between strikes minus premium paid.

3. What is the breakeven of a Bull Call Spread?
   a. Difference between strikes plus premium paid.
   b. Lower strike minus premium paid.
   c. Lower strike plus premium paid.
   d. Upper strike minus premium paid.

4. What is the max loss of a Bull Call Spread?
   a. Net premium paid.
   b. Net debit paid.
   c. Difference between strikes plus premium paid.
   d. Difference between strikes minus premium paid.

Use the Potash Corporation (POT) option chain above to answer the following questions.
Assumptions:

DISCIPLINE | RISK MANAGEMENT | SUPERIOR EXECUTION
Bullish on POT.
Market order and transaction costs excluded.

5. What is the cost per share to open the POT August 90/95 Bull Call Spread?
   a. $2.50
   b. $3.95
   c. $2.70
   d. $6.65

6. What is the Breakeven of the POT August 90/95 Bull Call Spread?
   a. $92.50
   b. $92.30
   c. $96.65
   d. $92.70

7. What is the max risk per share of the POT August 90/95 Bull Call Spread?
   a. $2.70
   b. $3.95
   c. $2.50
   d. $6.65

8. What is the max profit per share of the POT August 90/95 Bull Call Spread?
   a. $2.50
   b. $3.95
   c. $2.70
   d. $2.30

9. At or above what price does the POT August 90/95 Bull Call Spread achieve max profit?
   a. $90.00
   b. $95.00
   c. $100.00
   d. $96.00

10. At or below what price does the POT August 90/95 Bull Call Spread achieve max loss?
    a. $90.00
    b. $95.00
    c. $100.00
    d. $96.00
Lesson Six
Bear Call Spreads

Introduction

Now that you understand what it means to buy a call spread, we’ll now look at the opposite side of this trade. There are always two parties to every trade, and the profits from one side of the trade equal the losses on the other side of the trade.

If you buy a $5-wide call spread for a net debit of $1, what’s your risk in the trade? Your risk is $1, and you would lose that $1 if your spread is worth zero at expiration. So who gets your $1? The seller of the spread does. Since your maximum risk as the buyer is the amount you pay for the spread, the amount received by the seller represents his maximum possible return. If you sell a spread, your max profit is the amount of the credit received. That would occur if the spread expires worthless.

If you buy the spread, then what is your potential profit? Since you paid $1 for a $5 spread you could profit by as much as $4. This represents the risk to the seller.

So getting back the basics of buying and selling, if you buy something, you want it to go up in value. If you sell something, then you want it to go down in value. Here, call spreads go down in value when the stock goes down in value. So if you are bearish on the stock, you can sell a call spread to someone else and profit when the call spread drops in value. This is why these spreads are referred to as “bear call spreads.”

Commit Criteria

A bearish spread is used when the investor feels that a stock is most likely to go down. In this case, a bearish investor could sell a vertical call spread (bear call spread). The investor is said to “be short the call spread”. Selling a call with a lower strike price and buying a call with a higher strike price in the same expiration month is the way you would enter such a spread.

The spread is chosen when the trader wishes to hedge against the risk of unlimited loss should the stock go higher in price. The trade can still profit with the stock moving lower because the spread price will drop in value, but the spread hedges the volatility risk and unlimited risk potential of a short naked call option.

Fox3 Options’ Trade Principles

To begin creating a short call spread trade, let’s first look again at the time frame. When selling call spreads we still want to keep the time frame to two months or less before expiration. If you sell spreads further out in time, then the spread will not change value

DISCIPLINE | RISK MANAGEMENT | SUPERIOR EXECUTION
very quickly. We're trying to take advantage of both a downward move in the stock as well as time decay.

Once you've chosen the expiration month, then we need to choose the appropriate strikes. You want to start the trade with stock price above Leg 1. Let’s look at that now.

**Leg Set Up**

A Bear Call Spread is constructed by selling a lower strike call (1) and buying a higher strike call (2) in the same stock and in the same month.

As an example, you can sell a call spread by selling the Medtronic (MDT) June 55 call while buying the June 60 call. This trade is still the MDT June 55 - 60 call spread; it’s just that you sold it instead of buying it. We want the stock to be trading at a higher price than the strike of Leg 1. So here the stock could be trading at $57, for example, $2 higher than the low

**Bear Call Spread**

Maximum Gain = credit received
Max loss = difference between strike prices minus credit
Break even = lower strike plus credit

![Bear Call Spread Diagram](image-url)
strike of 55.

A vertical spread’s maximum value is the difference between the two strikes regardless of whether you buy it or sell it. Understanding this helps you calculate your profit and loss potential.

Using the June 55 – 60 call spread example, we will set the date to June expiration on Friday. On that day, all the June options will expire and all of the time value will have eroded away.

Where does the spread get its value? Basically, from its two components - the call you buy and the call you sell. Let's look at the spread’s value with a couple of different closing stock prices. If the stock closes at $55, then both the 55 strike and the 60 strike will be worthless. The value of the spread will be zero as both options are worth $0.

If you sold the spread, and then the spread turns out to be worth zero at expiration, then you have made the full profit because you keep 100% of the credit that you brought in by selling the spread.

If the stock closes at $57.50, the June 55 calls will be worth $2.50. The June 60 calls will be out of the money and thus worthless, therefore the spread will be worth $2.50 (June 55 call $2.50 – June 60 call $0).

If the stock closes at $60.00, then the June 55 calls will be worth $5.00. Meanwhile, the June 60 calls will be worth $0. This means that the spread will be worth $5.00 (June 55 call $5.00 - June 60 call $0). This is the maximum value of the spread. Note that the maximum value is identical to the difference between the strikes. If the spread reaches its maximum value, then you, as the seller, have incurred your full loss on the trade.

As the stock goes higher, the June 60 call becomes in-the-money and gains real value. Now, for every penny that the stock increases in value, the June 55 calls and June 60 calls gain value equally, keeping the $5.00 spread between the two strikes constant. To see this, refer to the Table below.

<table>
<thead>
<tr>
<th>Stock Price</th>
<th>June 55 call Value</th>
<th>June 60 call Value</th>
<th>Spread</th>
</tr>
</thead>
<tbody>
<tr>
<td>55</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>56</td>
<td>1</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>57</td>
<td>2</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>58</td>
<td>3</td>
<td>0</td>
<td>3</td>
</tr>
<tr>
<td>59</td>
<td>4</td>
<td>0</td>
<td>4</td>
</tr>
<tr>
<td>60</td>
<td>5</td>
<td>0</td>
<td>5</td>
</tr>
</tbody>
</table>
The difference between the strikes is the maximum value of all vertical spreads regardless of the distance between the two strikes. It does not matter whether the spread is $5.00 wide, $10.00 wide, $20.00 wide, or even $50.00 wide; its maximum value is the difference between the two strikes.

Prior to expiration, a vertical spread is simply priced by taking the current market value of each option and deriving the net price for the spread. If the current net value of the spread is less than what you sold it for, then you have a profit. If the current value of the spread is more than what you sold it for, then you have a losing trade. Let’s look at an example.

<table>
<thead>
<tr>
<th>Strike Price</th>
<th>Bid</th>
<th>Ask</th>
</tr>
</thead>
<tbody>
<tr>
<td>55</td>
<td>$3.80</td>
<td>$3.90</td>
</tr>
<tr>
<td>60</td>
<td>$2.90</td>
<td>$3.05</td>
</tr>
</tbody>
</table>

**Selling a Call Spread to Open**

Trading on the natural prices means buying an option on the asking price and/or selling an option on the bid price. Basically, it’s trading at the worst price currently displayed. If you were to sell this call spread on the natural prices, you would sell the 55 call at $3.80 and pay $3.05 by for the 60 call by buying it on the ask price. Therefore, the net credit that you’re collecting for the spread is the difference between the two options: $0.75.

**Maximum Risk**
The maximum risk on this trade is $4.25, and this would be completely lost at expiration if the stock is at $60 or higher. In that case, the spread would be worth its full $5 value.

**Maximum Reward**
The maximum potential reward is limited to the entry credit of $0.75. If the stock closes below $55, then both options are worthless, which makes the spread worthless. And you then get to keep the full credit you received for selling the spread.

**Break Even**
The break even for a call spread if you hold it until expiration is the lower strike price plus the credit. The stock would have to be below $55.75 at expiration for this trade to be
profitable.

Prior to expiration, however, the price of the spread is going to change as the market moves. You’ll make money if the value of the call spread goes down in value. You’ll lose if the spread goes up in value. But to keep everything as simple as possible just remember that you want your long spreads to go up in value, and short spreads to go down in value.

**Pricing your Spread Prior to Expiration**

The current profit or loss can be taken straight from the option chains. Just look at the current values of the two options. If you paid $1.00 for the spread, what would the current profit or loss be with these natural prices?

<table>
<thead>
<tr>
<th>Strike Price</th>
<th>Bid</th>
<th>Ask</th>
</tr>
</thead>
<tbody>
<tr>
<td>55</td>
<td>$0.35</td>
<td>$0.40</td>
</tr>
<tr>
<td>60</td>
<td>$0.15</td>
<td>$0.20</td>
</tr>
</tbody>
</table>

Since you’re short the 55 call, then you would need to buy it to close. Therefore, look at the ask price. And you’re long the 60 call, so you would need to sell it. Therefore, look at the bid price. Together this equates to the natural asking price for the spread. If you sold the spread for $0.75, and now you see that you can buy the spread on the natural prices for $0.25 ($0.40-$0.15), then you have a current profit of $0.50. That’s a net profit of 12% which is calculated by taking the profit of $0.50 and dividing it by the total risk of $4.25.

**Mid-Course Guidance**

When would we close the spread?

Eject Criteria: If your losses reach 50% of your initial credit, then buy the spread to close the trade and limit your losses. For instance, if you sell a spread and collect $1.20, if the spread moves higher in value by $0.60, then you will have lost $0.60 and you should close your trade.

Also, if your reasons for being bearish on the stock have changed or no longer exist, then close the trade regardless of profit or loss.

Profit Goal: Once you have achieved a profit level equal to 50% of your credit, then manage the trade actively by setting your Eject Criteria to 25% of your initial credit. Depending on your particular broker, you might be able to achieve this with an order called a “trailing stop loss” that would trigger when the spread goes higher in value. Check with your broker.

**Important Greeks**
Let’s look at the Greeks that affect the Bear Call Spread. These are all going to be just the opposite of the long call spread.

**Delta:** A short call spread has negative Deltas.

**Gamma:** Although the spread offsets much of the Gamma, there is still an effect. Take a look at the midpoint between the two strikes of your spread. Gamma will affect the spread differently depending on where the stock is relative to the strikes of the spread. In an earlier example we looked at the 55-60 call spread. The midpoint for that spread would be $57.50.

With the stock below the midpoint the spread has a small amount of negative Gamma. The spread has a small amount of positive Gamma with the stock above the midpoint.

**Theta:** Like Gamma, the spread offsets much of the time decay. But there is still an effect.

If the stock is below that midpoint, then the spread has positive Theta and will make money from the passage of time. And if the stock is below the lower strike (leg 1), then the spread will decay to zero by expiration giving you the full profit of the credit.

If the stock is above the midpoint, then the spread has a negative Theta. If the stock is above the higher strike call (leg 2), then the spread continue to increase in value until it reaches its full value at expiration, at which time you will have lost your maximum risk.

**Vega:** Vega is essentially neutralized by the spread.

### Exit Steps

When either your Eject Criteria or your Profit Goal is hit, then it is time to close the spread.

When you are ready to close your position you will “buy the call spread to close.” As mentioned earlier, if you can buy your spread for less than you originally paid, then you have a profit. If you have to buy it for more than your original credit, you have a loss - just like when trading stock. The only difference here is that you are trading two different options as a package for the net price of the spread.

To buy the spread you will buy to close the option you're short (leg 1) and sell to close the option you're long (leg 2). These trades are executed simultaneously by buying the spread using a spread order with your broker.

If you haven’t been triggered out of your trade by your Eject Criteria, and the spread remains out of the money at expiration, then you do not have to do anything. Simply let both options expire worthless and the options will disappear after expiration.
Wrap Up

Vertical spreads are an excellent way to enter a directional position on an underlying. The Bear Call Spread is a bearish tactic that allows a trader to control risk and collect premium vice paying for the position. It puts a floor on losses, but also caps the upside potential. Depending on the price of the underlying when open, this tactic can produce profits if the stock trades sideways or climbs. So the Bear Call Spread gives a trader some additional versatility in their arsenal of option tactics.

So, let’s pick a stock and build a trade plan.

DVN Bear Call Spread

Devon Energy Corporation is a leading independent natual gas and oil exploration and production company. Recently DVN divested all of its offshore assets in favor of onshore drilling and exploration. However, with all of the uncertainty around the oil and gas market and questions still surrounding the decision to exit offshore drilling, DVN has been beat up with the rest of the energy market.

Looking at the DVN chart below, the stock is down significantly from its 52-week highs and has entered a fairly volatile downtrend. It recently bounced off apparent support and appears to be stalling and stands a chance of retesting support again. It could also keep going up, so we would need to limit our risk a bit more.
If you are thinking it could retest support, selling a Bear Call Spread would limit our losses over buying a put and still give us some exposure to the downside to play our strategic mindset.

We want to make sure the stock price is less than our higher strike price so we can buy an

DISCIPLINE | RISK MANAGEMENT | SUPERIOR EXECUTION
OTM call and sell a lower strike a call to set the spread. Looking at the August options, buying the 65 call and selling the 62.5 call offers a nice balance of risk vs. reward, so let’s build a DVN 62.5/65 Bear Call Spread.
DISCIPLINE | RISK MANAGEMENT | SUPERIOR EXECUTION

DVN Trade Plan
July 10, 2010

Strategic Mindset: BEARISH
Target: DVN currently trading at 63.35

Commit Criteria:
Still think there is some downside to DVN. With the uncertainty in the industry and lack of resolution to recent change in business model we think some more downside exists.

Tactic: Bear Call Spread

Tactical Employment:
Leg Set up: Sell 1 August 62.5 Strike Call@ 3.40
Buy 1 August 65 Strike Call@ 2.18
Net Credit: 1.22 per share

Max Profit: 1.22
Max Risk: 1.28
Breakeven: 63.72

The Greeks:
Theta and Vega: Both are essentially neutralized by the spread

Mid-Course Guidance:
Profit Target: 50% of max profit: premium of 0.61. If reached reset max loss to 25% profit to ensure a profit, premium of 6.78.

Threats to success:
Spike in oil or natural gas prices.

Eject Criteria/Contingency Plan:
- Commit Criteria no longer valid.
- Max allowable loss of 50% of premium received: out at premium of 1.83.

Exit Plan
1. Profit Target Reached.
2. Eject Criteria Reached.
3. To close position:
   a. Buy to close 1 August 62.5 call.
   b. Sell to close 1 August 65 call.

Planning Thoughts:
1. We are bearish on DVN.
2. Our Commit Criteria are stated simply and summarizes our thoughts when entering the trade.
3. Tactic is simply the option position we are opening.
   a. Remember our objective...Make Money, Don’t Lose It!
   b. Our strategy is to use options to support our objective.
   c. And our tactic is the options position.
4. Our Tactical Employment is simply the trade set up and the performance parameters for the trade.
5. Mid-Course Guidance:
   a. We define our price target as a percentage of max profit. We would like to get the max profit, but set our target at 50% of max. Once reached, we reset our loss limit to ensure profits to the 25% profit point then actively monitor trade to see if it has the potential to yield the max profit. If we hit 50% the position retraces to a 25% profit we simply close the trade. We are not looking for home runs every time, base hits are good and add up fast.
   b. We will keep an eye on oil and gas prices, a spike in prices would be bad for this position.
   c. Eject Criteria:
      i. If our bearishness on DVN can no longer be supported.
      ii. Max allowable loss is also based on the premium and do not want to lose more than 50% of our premium.
Lesson 6 Quiz

1. What is the set up for a Bear Call Spread?
   a. Buy 1 put and sell 1 higher strike call.
   b. Buy 1 call and sell 1 lower strike call.
   c. Buy 1 call and buy 1 higher strike put.
   d. Sell 1 call and sell 1 lower strike put.

2. What is the max gain of a Bear Call Spread?
   a. Premium received.
   b. Debit paid.
   c. Difference between strikes plus premium paid.
   d. Difference between strikes minus premium paid.

3. What is the breakeven of a Bear Call Spread?
   a. Difference between strikes plus premium received.
   b. Lower strike minus premium received.
   c. Lower strike plus premium received.
   d. Upper strike minus premium received.

4. What is the max loss of a Bear Call Spread?
   a. Premium received.
   b. Debit paid.
   c. Difference between strikes plus premium received.
   d. Difference between strikes minus premium received.

Use the Potash Corporation (POT) option chain above to answer the following questions.

Assumptions:
• Bearish on POT.
• Market order and transaction costs excluded.
5. What is the premium received per share to open the POT August 90/95 Bear Call Spread?
   a. $2.50
   b. $3.95
   c. $2.70
   d. $6.65
6. What is the Breakeven of the POT August 90/95 Bear Call Spread?
   a. $92.50
   b. $92.30
   c. $96.65
   d. $92.70
7. What is the max risk per share of the POT August 90/95 Bear Call Spread?
   a. $2.70
   b. $3.95
   c. $2.50
   d. $6.65
8. What is the max profit per share of the POT August 90/95 Bear Call Spread?
   a. $2.50
   b. $3.95
   c. $2.70
   d. $2.30
9. At or above what price does the POT August 90/95 Bear Call Spread achieve max loss?
   a. $90.00
   b. $95.00
   c. $100.00
   d. $96.00
10. At or below what price does the POT August 90/95 Bear Call Spread achieve max profit?
    a. $90.00
    b. $95.00
    c. $100.00
    d. $96.00
Lesson Seven
Bear Put Spreads

Introduction

Just like with the call spreads you can buy or sell put spreads depending on whether you’re bullish or bearish on the stock. Put spreads increase in value when a stock drops, and they go down in value when a stock rallies. So your outlook for the stock tells you whether to buy or sell the put spread.

If you think a stock is going down, then you buy the put spread and profit as the spread increases in value as the stock drops.

Commit Criteria

After analyzing a stock and developing a bearish sentiment, you next select your tactic. In the case of a bearish outlook on the stock you could buy a Bear Put Spread. Buying the put spread would mean that you are “long the put spread”. And since you’re long the put spread you want the put spread to increase in value.

Buying a put spread is accomplished by buying to open a put option and simultaneously selling to open a put with a lower strike price. Both options are in the same expiration month.

Since spreading the options helps protect you from a drop in the volatility, choose this tactic instead of a straight put purchase when the volatility is high. The trade can still profit with the stock moving lower, but the spread hedges the volatility risk in the trade as well as lowering the cost of the trade.

Fox3 Options’ Trade Principles

To begin creating a Bear Put Spread trade, let’s first look at the time frame. Which expiration month should you choose? When buying put spreads you want to keep the time frame to two months or less before expiration. If you trade spreads further out in time, then the spread will not change value very quickly. A general rule of thumb is that shorter term options and spreads move quicker than longer term options and spreads. Keep this in mind when you’re deciding on which month to choose. And simply match up your time frame for how quickly you think the stock will be making its move higher.

Once you’ve chosen the expiration month you want to trade, then you need to choose the right strikes. When you look at the Leg Set Up below, you’ll see that this trade has two legs (two different strike price options). You want to start the trade with the stock price above
Leg 1 and below Leg 2.
**Leg Set Up**

A Bear Put Spread is constructed by buying a put (2) and selling a put with a lower strike price (1) in the same stock and in the same month. For instance, you can buy a put spread by buying the IBM June 60 put while selling the June IBM 55 put. This trade would be called the IBM June 60-55 put spread. In our example you want the stock to be trading at a higher price than the strike of Leg 1, but lower than Leg 2. So here the stock could be trading at $57, $2 higher than the low strike of 55.

A vertical spread's maximum value is the difference between the two strikes. For example, the maximum value of the June 55 – 60 put spread is $5.00. \( [60 - 55] = 5 \).

<table>
<thead>
<tr>
<th>Spread</th>
<th>Difference between Strikes</th>
<th>Spreads Maximum Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>August 35 - 40 put</td>
<td>5</td>
<td>$5.00</td>
</tr>
<tr>
<td>April 70 – 85 put</td>
<td>15</td>
<td>$15.00</td>
</tr>
<tr>
<td>Nov. 20 – 22.5 put</td>
<td>2.5</td>
<td>$2.50</td>
</tr>
<tr>
<td>Dec. 40 – 50 put</td>
<td>10</td>
<td>$10.00</td>
</tr>
</tbody>
</table>
Using the June 60-55 put spread example, you will set the date to June expiration on Friday. On that day, all the June options will expire and all of the time value will have eroded away.

Like all spreads, this tactic gets its value from its components - the put you buy and the put you sell. Let’s look at the spread’s value with a couple of different closing stock prices. If the stock closes at $60, then both the 55 strike and the 60 strike will be worthless. The value of the spread will be zero as both options are worth $0. If the stock closes at $57.50, the June 60 puts will be worth $2.50. The June 55 puts will be out of the money and thus worthless, therefore the spread will be worth $2.50 (June 60 put $ 2.50 – June 55 put $0).

If the stock closes at $55.00, then the June 60 puts will be worth $5.00. Meanwhile, the June 55 puts will be worth $0. This means that the spread will be worth $5.00 (June 60 put $ 5.00 - June 55 put $0). This is the maximum value of the spread. Note that the maximum value is identical to the difference between the strikes.

As the stock goes lower, the June 55 put becomes ITM and gains real value. Now, for every penny that the stock increases in value, the June 55 puts and June 60 puts gain value equally, keeping the $5.00 spread between the two strikes constant. To see this, refer to the Table below.

<table>
<thead>
<tr>
<th>Stock Price</th>
<th>June 60 put Value</th>
<th>June 55 put value</th>
<th>Spread</th>
</tr>
</thead>
<tbody>
<tr>
<td>65</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>60</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>59</td>
<td>1</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>58</td>
<td>2</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>57</td>
<td>3</td>
<td>0</td>
<td>3</td>
</tr>
<tr>
<td>56</td>
<td>4</td>
<td>0</td>
<td>4</td>
</tr>
<tr>
<td>55</td>
<td>5</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>54</td>
<td>6</td>
<td>1</td>
<td>5</td>
</tr>
<tr>
<td>50</td>
<td>10</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>40</td>
<td>20</td>
<td>15</td>
<td>5</td>
</tr>
<tr>
<td>30</td>
<td>30</td>
<td>25</td>
<td>5</td>
</tr>
</tbody>
</table>

Prior to expiration, a vertical spread is simply priced by taking the current market value of each option and deriving the net price for the spread. If the current net value of the spread is more than what you paid for it, then you have a profit. If the current value of the spread is less than what you paid, then you have a losing trade. Let’s look at an example.

**DISCIPLINE | RISK MANAGEMENT | SUPERIOR EXECUTION**
Buying a Put Spread to Open

If you want to buy this put spread on the natural prices, you would pay $6.40 for the 60 put and collect $4.90 by selling the 55 put on the bid price. Therefore, the net price that you’re paying for the spread is the difference between the two options: $1.50.

Maximum Risk

The maximum risk on this trade is $1.50, and this would be completely lost at expiration if the stock is at $60 or higher. In that case, both options would be worthless and the spread would also be worth zero.

Maximum Reward

The maximum potential reward would be $3.50. Since this is a $5 spread, and you paid $1.50 for it, if the stock is at or below $55 at expiration, then the spread would be worth its full $5 value. That leaves you with a $3.50 profit.

Break Even

The break even for a put spread if you hold it until expiration is the higher strike price minus the debit. The stock would have to be at this price at expiration for the spread to be worth the same value that you paid for it.

Prior to expiration, however, the price of the spread is going to change as the market moves. You’ll make money if the value of the put spread goes up in value. And since put spreads increase in value when the stock goes down, long put spreads are referred to as “Bear Put Spreads.” But to keep everything as simple as possible just remember that you want your Bull spreads to go up in value, and Bear spreads to go down in value. If the stock goes higher in price, then the Bear spread will decrease in price and you will lose money.

Pricing your Spread Prior to Expiration

The current profit or loss can be taken straight from the option chains. Just look at the current values of the two options. If you paid $1.50 for the spread, what would the current profit or loss be with these natural prices:

<table>
<thead>
<tr>
<th>Strike Price</th>
<th>Bid</th>
<th>Ask</th>
</tr>
</thead>
<tbody>
<tr>
<td>60</td>
<td>$4.15</td>
<td>$4.25</td>
</tr>
<tr>
<td>55</td>
<td>$0.60</td>
<td>$0.70</td>
</tr>
</tbody>
</table>

Since you own the 60 put, then you would need to sell it to close. Therefore, look at the bid price. And you’re short the 55 put, so you would need to buy it. Therefore, look at the ask price. Together this equates to the natural bid price for the spread, the price at which you’ll
sell your spread. If you bought the spread for $1.50, and now you see that you can sell the spread on the natural prices for $3.45 ($4.15-$0.70), then you have a current profit of $1.95. That’s a net profit of 130%.

**Mid-Course Guidance**

When would you close the spread?

Eject Criteria: If the spread loses 50% of your initial debit, then sell the spread to close the trade and limit your losses. Also, if your reasons for being bearish on the stock have changed or no longer exist, then close the trade regardless of profit or loss.

Profit Goal: Once the spread reaches a profit level of 50%, then manage the trade actively by setting your Eject Criteria to the 25% profit level. Continue to raise your Eject Criteria as the spread moves higher in value. Depending on your particular broker, you might be able to achieve this with an order called a “trailing stop loss.” Check with your broker.

**Important Greeks**

Let’s look at the Greeks that affect the Bear Put Spread.

**Delta:** A Bear Put Spread as negative Deltas.

**Gamma:** Although the spread offsets much of the Gamma, there is still an effect. Take a look at the midpoint between the two strikes of your spread. Gamma will affect the spread differently depending on where the stock is relative to the strikes of the spread. In an earlier example we looked at the 60-55 put spread. The midpoint for that spread would be $57.50.

With the stock above the midpoint the spread has a small amount of positive Gamma. The spread has a small amount of negative Gamma with the stock below the midpoint.

**Theta:** Like Gamma, the spread offsets much of the time decay effect. But there is still an effect.

If the stock is above that midpoint, then the spread has negative Theta and will lose money from the passage of time. And if the stock is above the higher strike (Leg 2), then the spread will decay to zero by expiration giving you the full loss on the trade.

If the stock is below the midpoint, then the spread has a positive Theta. If the stock is below the lower strike put (Leg 1), then the spread will continue to increase in value until it reaches its full value at expiration, at which time you will have achieved max profit.

**Vega:** Vega is essentially neutralized by the spread.
Exit Steps

When either your Eject Criteria or your Profit Goal is hit, then it is time to close the spread.

Selling a put spread to close your position.

When you are ready to close your position you will “sell your put spread to close.” As mentioned earlier, if you can sell your spread for more than you originally paid, then you have a profit. If you sell it for less than you paid, you have a loss - just like when trading stock. The only difference here is that you are trading two different options as a package for the net price of the spread.

To sell the spread you will sell to close the option you own (Leg 2) and buy to close the option you’re short (Leg 1). These trades are executed simultaneously by selling the spread using a spread order with your broker.

As an alternative, if your spread is completely in the money, that is, with the stock safely below your short strike (Leg 1), then you can let the position go to expiration. At that point both options will automatically go through the exercise/assignment process and you’ll be left with the full value of the spread minus any commissions or fees.

Wrap Up

Vertical spreads are an excellent way to enter a directional position on an underlying. The Bear Put Spread is a bearish tactic that allows a trader to control risk and collect premium vise paying for the position. It puts a floor on losses, but also caps the upside potential. Depending on the price of the underlying when open, this tactic can produce profits if the stock trades sideways or climbs. So the Bear Put Spread gives a trader some additional versatility in their arsenal of option tactics.

So, let’s pick a stock and build a trade plan.
Family Dollar Bear Put Spread

Family Dollar Stores, Inc. (FDO) operates a chain of self service retail discount stores throughout the United States. They offer the standard fare of consumable goods similar to any small grocery store and cater to lower income families. Despite being a winning stock for investors for several years, FDO recently reported earnings and an outlook that disappointed Wall Street.

Looking at the FDO chart below, the stock has recently hit 52 week high, but then gapped down and traded sideways for a while. The stock gapped down again after an earnings report and guidance that disappointed the street.

If you are thinking there is more downside going forward due to the guidance then opening a Bear Put Spread would be a good way to play your strategic mindset.
With FDO trading at $35.95 we will look to open the August FDO 36/35 Bear Put Spread for $0.55 a contract. Our max profit is $0.45 per contract giving us a play with a pretty nice return on risk.
FDO Trade Plan
July 10, 2010

Strategic Mindset: BEARISH
Target: FDO currently trading at 35.95

Commit Criteria:
After negative guidance from FDO we think there is some downside in the near future. FDO is also coming off it recent 52 week high and this guidance will likely lead investors to take profits.

Tactic: Bear Put Spread

Tactical Employment:
Leg Set up: Sell 1 August 35 Strike Put@ 0.85
Buy 1 August 36 Strike Put@ 1.40
Net Debit: 55 cents per share

Max Profit: 0.45
Max Risk: 0.55
Breakeven: 35.45

The Greeks:
Theta and Vega: Both are essentially neutralized by the spread.

Mid-Course Guidance:
Profit Target: 50% of max profit: premium of 0.68. If reached reset max loss to 25% profit to ensure a profit, premium of 0.56.

Threats to success:
**Broad Market Rally.**

**Eject Criteria/Contingency Plan:**
- *Commit Criteria no longer valid.*
- *Max allowable loss of 50% of premium received: out at premium of 0.23*

**Exit Plan**
1. *Profit Target Reached.*
2. *Eject Criteria Reached.*
3. *To close position:*
   a. *Buy to close 1 August 35 Put.*
   b. *Sell to close 1 August 36 Put.*

**Planning Thoughts:**

1. We are bearish on FDO.
2. Our Commit Criteria are stated simply and summarizes our thoughts when entering the trade.
3. Tactic is simply the option position we are opening.
   a. Remember our objective...Make Money, Don't Lose It!
   b. Our strategy is to use options to support our objective.
   c. And our tactic is the options position.
4. Our Tactical Employment is simply the trade set up and the performance parameters for the trade.
5. Mid-Course Guidance:
   a. We define our price target as a percentage of max profit. We would like to get the max profit, but set our target at 50% of max. Once reached, we reset our loss limit to ensure profits to the 25% profit point then actively monitor trade to see if it has the potential to yield the max profit. If we hit 50% then position retraces to a 25% profit we simply close the trade. We are not looking for home runs every time, base hits are good and add up fast.
   b. A broad market rally could bring buyers in to FDO.
   c. *Eject Criteria:*
      i. If our bearishness on FDO can no longer be supported.
      ii. Max allowable loss is also based on the premium and do not want to lose more than 50% of our premium.
Lesson 7 Quiz

1. What is the set up for a Bear Put Spread?
   a. Buy 1 put and sell 1 higher strike call.
   b. Buy 1 put and sell 1 lower strike call.
   c. Buy 1 call and buy 1 higher strike put
   d. Buy 1 put and sell 1 lower strike put.

2. What is the max gain of a Bear Put Spread?
   a. Premium received.
   b. Debit paid.
   c. Difference between strikes plus premium paid.
   d. Difference between strikes minus premium paid.

3. What is the breakeven of a Bear Put Spread?
   a. Difference between strikes plus premium paid.
   b. Lower strike minus premium paid.
   c. Lower strike plus premium paid.
   d. Upper strike minus premium paid.

4. What is the max loss of a Bear Put Spread?
   a. Premium received.
   b. Debit paid.
   c. Difference between strikes plus premium paid.
   d. Difference between strikes minus premium paid.

Use the United Airlines (UAUA) option chain above to answer the following questions. Assumptions:
• Bearish on UAUA.
• Market order and transaction costs excluded.

5. What is the premium per share to open the UAUA August 22/21 Bear Put Spread?
   a. $0.55
   b. $0.45
   c. $1.56
   d. $2.11

6. What is the Break-even of the UAUA August 22/21 Bear Put Spread?
   a. $21.55
   b. $22.55
   c. $21.45
   d. $20.45

7. What is the max risk per share of the UAUA August 22/21 Bear Put Spread?
   a. $21.55
   b. $21.45
   c. $0.45
   d. $0.55

8. What is the max profit per share of the UAUA 22/21 Bear Put Spread?
   a. $21.55
   b. $21.45
   c. $0.45
   d. $0.55

9. At or above what price does the UAUA Bear Put Spread achieve max loss?
   a. $22.00
   b. $21.00
   c. $21.45
   d. $21.55

10. At or below what price does the UAUA Bear Put Spread achieve max profit?
    a. $22.00
    b. $21.00
    c. $21.45
    d. $21.55
Lesson Eight
Bull Put Spreads

Introduction

The final vertical spread is the called the Bull Put Spread because this tactic makes money when a stock goes up.

Commit Criteria

After analyzing a stock and developing a bullish sentiment, you next select your tactic. In the case of a bullish outlook on the stock you could buy a call spread, but you could also sell a Bull Put Spread as an alternative tactic. Selling the put spread would mean that you are “short the put spread”. And since you're short the put spread you want the put spread to decrease in value.

From the previous lesson you know that put spreads go up when stocks go down and vice versa. So if you sell a put spread because you think the stock is moving higher, then you will make money as your short spread drops in value.

Selling a put spread is accomplished by selling to open a put option and simultaneously buying to open a put with a lower strike price. Both options are in the same expiration month.

The spread is chosen instead of just selling a naked put to cut down the risk of excessive loss if the stock drops dramatically. But the trade can still profit with the stock moving higher.

Fox3 Options’ Trade Principles

As with the other vertical spread tactics, when selling put spreads you want to keep the time frame to two months or less before expiration.

Once you've chosen the expiration month you want to trade, then you need to choose the right strikes. When you look at the Leg Set Up below you’ll see that this trade has two legs (two different strike price options). You want to start the trade with the stock price above Leg 1 and below Leg 2.
**Leg Set Up**

A Bull Put Spread is constructed by selling a higher strike put (Leg 2) and buying a lower strike put (Leg 1) on the same stock and in the same month. For instance, you can sell a put spread by selling the IBM June 60 put while buying the June IBM 55 put. This trade would be called the “short IBM June 60-55 put spread”. In our example you want the stock to be trading at a higher price than the strike of Leg 1, but lower than Leg 2. So here the stock could be trading at $56, $1 higher than the low strike of 55.

Using the June 60-55 put spread example, set the date to June expiration on Friday. On that day, all the June options will expire and all of the time value will have eroded away.

Let’s look at the spread’s value with a couple of different closing stock prices. If the stock closes at $60, then both the 55 strike and the 60 strike will be worthless. The value of the spread will be zero as both options are worth $0. If the stock closes at $57.50, the June 60 puts will be worth $2.50. The June 55 puts will be out of the money and thus worthless, therefore the spread will be worth $2.50 (June 60 put $ 2.50 – June 55 put $0).
If the stock closes at $55.00, then the June 60 puts will be worth $5.00. Meanwhile, the June 55 puts will be worth $0. This means that the spread will be worth $5.00 (June 60 put $ 5.00 - June 55 put $0). This is the maximum value of the spread. Note that the maximum value is identical to the difference between the strikes.

As the stock goes lower, the June 55 put becomes in-the-money and gains real value. Now, for every penny that the stock increases in value, the June 55 puts and June 60 puts gain value equally, keeping the $5.00 spread between the two strikes constant. To see this, refer to the Table below.

<table>
<thead>
<tr>
<th>Stock Price</th>
<th>June 60 Put Value</th>
<th>June 55 Put Value</th>
<th>Spread</th>
</tr>
</thead>
<tbody>
<tr>
<td>65</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>60</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>59</td>
<td>1</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>58</td>
<td>2</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>57</td>
<td>3</td>
<td>0</td>
<td>3</td>
</tr>
<tr>
<td>56</td>
<td>4</td>
<td>0</td>
<td>4</td>
</tr>
<tr>
<td>55</td>
<td>5</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>54</td>
<td>6</td>
<td>1</td>
<td>5</td>
</tr>
<tr>
<td>50</td>
<td>10</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>40</td>
<td>20</td>
<td>15</td>
<td>5</td>
</tr>
<tr>
<td>30</td>
<td>30</td>
<td>25</td>
<td>5</td>
</tr>
</tbody>
</table>

But now, since you’ve sold the spread you’ll want the value of the spread to drop so that you can buy it back for a cheaper price than what you collected in a credit. This spread goes down in value when the stock moves higher in price.

Prior to expiration, a vertical spread is simply priced by taking the current market value of each option and deriving the net price for the spread. If the current net value of the spread is more than what you paid for it, then you have a profit. If the current value of the spread is less than what you paid, then you have a losing trade. Let’s look at an example.

<table>
<thead>
<tr>
<th>Strike Price</th>
<th>Bid</th>
<th>Ask</th>
</tr>
</thead>
<tbody>
<tr>
<td>60</td>
<td>$4.90</td>
<td>$5.10</td>
</tr>
<tr>
<td>55</td>
<td>$2.40</td>
<td>$2.60</td>
</tr>
</tbody>
</table>

**Selling a Put Spread to Open**

If you want to sell this put spread on the natural prices, you would collect $4.90 for the 60 put and pay $2.60 for the 55 put on the ask price. Therefore, the net price that you’re collecting for the spread is the difference between the two options: $2.30.
**Maximum Risk**
The maximum risk on this trade is $2.70, and this would be completely lost at expiration if the stock is at $55 or lower. In that case, both options would be worth their real values and the spread would be worth $5. Since you collected $2.30 up front, you’ve lost the balance of $2.70.

**Maximum Reward**
The maximum potential reward would be $2.30. That’s the credit received for the sale of the spread. If the stock goes above $60 at expiration, then the spread would be worth zero, and you’d keep the full credit.

**Break Even**
The break even for a Bull Put Spread if you hold it until expiration is the higher strike price minus the credit. The stock would have to be at this price at expiration for the spread to be worth the same value that you collected for it.

Prior to expiration, however, the price of the spread is going to change as the market moves. You’ll make money if the value of the put spread goes down in value. If the put spread increases in price, then you will lose money.

**Pricing your Spread Prior to Expiration**
The current profit or loss can be taken straight from the option chains. Just look at the current values of the two options. If you collected $2.30 for the spread, how much would you have to pay in order to buy back the spread:

<table>
<thead>
<tr>
<th>Strike Price</th>
<th>Bid</th>
<th>Ask</th>
</tr>
</thead>
<tbody>
<tr>
<td>60</td>
<td>$4.15</td>
<td>$4.25</td>
</tr>
<tr>
<td>55</td>
<td>$0.60</td>
<td>$0.70</td>
</tr>
</tbody>
</table>

Since you’re short the 60 put, then you would need to buy it to close. Therefore, look at the ask price. And you’re long the 55 put, so you would need to sell it. Therefore, look at the bid price. Together this equates to the natural bid price for the spread, the price at which you’ll buy your spread. If you sold the spread for $2.30, and now you see that you can buy the spread on the natural prices for $3.65 ($4.25-$0.60), then you have a current loss of $1.35. That’s a net loss of 50%. That’s calculated by taking the net return of minus $1.35 and dividing it by the total risk in the trade of $2.70.

If you could buy back the spread for a net price that’s lower than your initial credit, then you would have a profitable trade.

**Mid-Course Guidance**
When would you close the spread?

Eject Criteria: If your losses reach 50% of your initial credit, then buy the spread to close the trade and limit your losses. For instance, if you sell a spread and collect $1.20, if the spread moves higher in value by $0.60, then you will have lost $0.60 and you should close your trade.

Also, if your reasons for being bullish on the stock have changed or no longer exist, then close the trade regardless of profit or loss.

Profit Goal: Once you have achieved a profit level equal to 50% of your credit, then manage the trade actively by setting your Eject Criteria to 25% of your initial credit. Depending on your particular broker, you might be able to achieve this with an order called a “trailing stop loss” that would trigger when the spread goes HIGHER in value. Check with your broker.

**Important Greeks**

Let’s look at the Greeks that affect the Bull Put Spread.

**Delta:** A Bull Put Spread as positive Deltas.

**Gamma:** Although the spread offsets much of the Gamma, there is still an effect. Take a look at the midpoint between the two strikes of your spread. Gamma will affect the spread differently depending on where the stock is relative to the strikes of the spread. In an earlier example we looked at the 60-55 put spread. The midpoint for that spread would be $57.50.

With the stock above the midpoint the spread has a small amount of negative Gamma. The spread has a small amount of positive Gamma with the stock below the midpoint.

**Theta:** Like Gamma, the spread offsets much of the time decay effect. But there is still an effect.

If the stock is above that midpoint, then the spread has positive Theta and will make money from the passage of time. And if the stock is above the higher strike (Leg 2), then the spread will decay to zero by expiration giving you the full profit on the trade.

If the stock is below the midpoint, then the spread has a negative Theta and will continue to lose money as the spread increases in value. If the stock is below the lower strike put (Leg 1), then the spread will continue to increase in value until it reaches its full value at expiration, at which time you will have incurred your max loss.

Vega is essentially neutralized by the spread.
Exit Steps

When either your Eject Criteria or your Profit Goal is hit, then it is time to close the spread.

Buying a put spread to close your position.

When you are ready to close your position you will “buy your put spread to close.” As mentioned earlier, if you can buy your spread for less than you originally collected, then you have a profit. If you buy it for more than you collected, you have a loss - just like when trading short stock. The only difference here is that you are trading two different options as a package for the net price of the spread.

To buy the spread you will buy to close the option you are short (Leg 2) and sell to close the option you’re long (Leg 1). These trades are executed simultaneously by buying the spread using a spread order with your broker.

As an alternative, if your spread is completely out of the money, that is, with the stock safely above your short strike (Leg 2), then you can let the position go to expiration. At that point both options will expire worthless.

Wrap Up

Vertical spreads are an excellent way to enter a directional position on an underlying. The Bull Put Spread is a bullish tactic that allows a trader to control risk and offset the cost of simply buying a long call. It puts a floor on losses, but also caps the upside potential. Depending on the price of the underlying when open, this tactic can produce profits if the stock trades sideways or climbs. So the Bull Put Spread gives a trader some additional versatility in their arsenal of option tactics.

So, let’s pick a stock and build a trade plan.
Freeport McMoRan Spread

Freeport McMoRan (FCX) is the world’s largest publicly traded copper and gold company. Though a very well run company, they have been victim to slowing demand for copper and a rapid decline in copper prices. They have been riding the wave of China growth for the past few years, and with the uncertainty in China FCX has been taking a hit.

Looking at FCX’s chart below, the stock is well off its highs in January and has been hit hard by macroeconomic uncertainty for copper demand.

If you are thinking the downside is overdone, opening Bull Put Spread is a good tactic to limit your downside risk.
Looking at the August strike opening the 65/62.5 Bull Put Spread look to be a good play to take advantage of our strategic mindset.
**Strategic Mindset:** BULLISH

**Target:** FCX currently trading at 63.20

**Commit Criteria:**
Think FCX is oversold and this is a good time to jump in. FCX has given up almost all of its past years gains and appears to be reversing the downtrend and appears poised to rebound.

---

**Tactic:** Bull Put Spread

**Tactical Employment:**
- Leg Set up: Buy 1 August 62.5 Strike Put@ 4.10  
  Sell 1 August 65 Strike Call@ 5.30  
  Net Credit: 1.20 per share

- **Max Profit:** 1.20
- **Max Risk:** 1.30
- **Breakeven:** 63.80

**The Greeks:**
- Theta and Vega: Both are essentially neutralized by the spread
**Mid-Course Guidance:**

**Profit Target:** 50% of max profit; premium of 0.60. If reached reset max loss to 25% profit to ensure a profit, premium of 0.90.

**Threats to success:**
- Further decrease in copper Prices.
- Bad news out of China.

**Eject Criteria/Contingency Plan:**
- Commit Criteria no longer valid.
- Max allowable loss of 50% of premium paid: out at premium of 1.80

**Exit Plan**
1. Profit Target Reached.
2. Eject Criteria Reached.
3. To close position:
   a. Sell to close 1 August 62.5 Put.
   b. Buy to close 1 August 65 Put.

**Planning Thoughts:**
1. We are bullish on FCX at these levels.
2. Our Commit Criteria are stated simply and summarizes our thoughts when entering the trade.
3. Tactic is simply the option position we are opening.
   a. Remember our objective...Make Money, Don’t Lose It!
   b. Our strategy is to use options to support our objective.
   c. And our tactic is the options position.
4. Our Tactical Employment is simply the trade set up and the performance parameters for the trade.
   a. Difference between strikes minus premium paid.
5. Mid-Course Guidance:
   a. We define our price target as a percentage of max profit. We would like to get the max profit, but set our target at 50% of max. Once reached, we reset our loss limit to ensure profits to the 25% profit point then actively monitor trade to see if it has the potential to yield the max profit. If we hit 50% then position retraces to a 25% profit we simply close the trade. We are not looking for homeruns, base hits are good and add up fast.
   b. We will keep an eye on earnings when they come out in July and be ready to exit if negative.
   c. Eject Criteria:
      i. If our bullishness on FCX can no longer be supported.
ii. Max allowable loss is also based on the premium and do not want to lose more than 50% of our premium.

Lesson 8 Quiz

1. What is the set up for a Bull Put Spread?
   a. Buy 1 put and sell 1 higher strike put.
   b. Buy 1 call and sell 1 higher strike call.
   c. Buy 1 call and buy 1 higher strike put
   d. Sell 1 call and sell 1 lower strike put.

2. What is the max gain of a Bull Put Spread?
   a. Premium paid.
   b. Premium received.
   c. Difference between strikes plus premium received.
   d. Difference between strikes minus premium received.

3. What is the breakeven of a Bull Put Spread?
   a. Difference between strikes plus premium paid.
   b. Lower strike minus premium received.
   c. Lower strike plus premium paid.
   d. Upper strike minus premium received.

4. What is the max loss of a Bull Put Spread?
   a. Premium received.
   b. Debit received.
   c. Difference between strikes plus premium received.
   d. Difference between strikes minus premium received.

Use the JP Morgan chase (JPM) option chain above to answer the following questions.
Assumptions:

<table>
<thead>
<tr>
<th>STRIKES</th>
<th>Bid</th>
<th>Ask</th>
<th>Mark</th>
<th>Open Interest</th>
<th>Ask Size</th>
<th>Bid Size</th>
<th>Imp Vol</th>
<th>Imp Vol Chg</th>
</tr>
</thead>
<tbody>
<tr>
<td>36</td>
<td>0.88</td>
<td>0.90</td>
<td>0.89</td>
<td>3,279</td>
<td>3,498</td>
<td>401</td>
<td>41.19%</td>
<td>+1.44%</td>
</tr>
<tr>
<td>37</td>
<td>1.15</td>
<td>1.17</td>
<td>1.16</td>
<td>2,436</td>
<td>1,529</td>
<td>352</td>
<td>39.50%</td>
<td>+1.25%</td>
</tr>
<tr>
<td>38</td>
<td>1.49</td>
<td>1.51</td>
<td>1.50</td>
<td>4,319</td>
<td>218</td>
<td>2,004</td>
<td>38.00%</td>
<td>+1.25%</td>
</tr>
<tr>
<td>39</td>
<td>1.92</td>
<td>1.94</td>
<td>1.93</td>
<td>1,266</td>
<td>2,415</td>
<td>70</td>
<td>36.75%</td>
<td>+1.13%</td>
</tr>
<tr>
<td>40</td>
<td>2.43</td>
<td>2.45</td>
<td>2.44</td>
<td>1,123</td>
<td>92</td>
<td>131</td>
<td>35.50%</td>
<td>+1.00%</td>
</tr>
<tr>
<td>41</td>
<td>3.00</td>
<td>3.10</td>
<td>3.05</td>
<td>695</td>
<td>6,132</td>
<td>10,373</td>
<td>34.25%</td>
<td>-8.87%</td>
</tr>
</tbody>
</table>

DISCIPLINE | RISK MANAGEMENT | SUPERIOR EXECUTION
- Bullish on JPM.
- Market order and transaction costs excluded.

5. What is the premium received to open the JPM August 39/38 Bull Put Spread?
   a. $0.41
   b. $1.92
   c. $1.51
   d. $0.45

6. What is the Breakeven of the JPM August 39/38 Bull Put Spread?
   a. $39.41
   b. $37.41
   c. $37.65
   d. $38.59

7. What is the max risk per share of the JPM August 39/38 Bull Put Spread?
   a. $0.59
   b. $1.92
   c. $1.51
   d. $0.45

8. What is the max profit per share of the JPM August 39/38 Bull Put Spread?
   a. $0.59
   b. $1.92
   c. $0.41
   d. $0.45

9. At or above what price does the JPM August 39/38 Bull Put Spread achieve max profit?
   a. $39.41
   b. $39.00
   c. $38.00
   d. $38.59

10. At or below what price does the JPM August 39/38 Bull Put Spread achieve max loss?
    a. $39.41
    b. $39.00
    c. $38.00
    d. $38.59
Introduction

One of the biggest advantages that option traders have over stock traders is the ability to make money when a stock doesn’t move. And unlike the short calls and short puts that profit if the stock doesn’t move, calendar spreads profit from non-movement and are limited in their risk. Calendar spreads harness the power of time decay by selling options short, but the tactic involves buying other options to protect from the unlimited risk of the short option. Basically, the long option is being used as insurance against a big move in the underlying stock.

If options are both sold and bought, how does the tactic profit from time decay? It seems that the time decay from the long option would offset the time decay from the short option. But the profit potential in the trade comes from the fact that options across different expiration periods have different rates of decay.

Calendar spreads are created by buying a longer term option and selling a shorter term option at the same strike price. And since there are calls and puts, you can trade call calendars or put calendars. In order to cover the risk you have to buy a call to cover the risk in a short call; or buy a put to cover the risk in a short put. You can’t cover the risk in a short call by buying a put, and vice versa.

Call calendars and put calendars are virtually identical trades. Both trades reach maximum profit if the stock closes at the strike price on expiration of the shorter term option. Both trades lose their maximum if the stock moves too far away from the strike in either direction. And call calendars and put calendars that share the same strike prices and expirations are going to be similarly priced. There will be price discrepancies, but generally these price differences do not indicate any advantage to the retail trader.

As such we’re going to focus on put calendars because this will keep you from any early exercise considerations that sometimes arise with call calendars. The calculations for early exercise are something that every trader should know and will be covered in later lessons.

Here’s an example of a put calendar: buy the June 50 put and sell the May 50 put for $1.00.

Because the long option is further out in time than the short option, the “right” covers the risk in the short option. And since both options share the same strike price the real value (if any) of both options is offset. As the stock moves higher or lower, the long real value of the June option completely offsets the short real value in the May option and therefore doesn’t contribute to profit or loss.
The only thing that’s left in this trade is the fact that you’re buying the time value of the June option and selling the time value of the May option. And this is how the trade profits. An option that has fewer days to expiration is going to decay at a faster rate than an option that has more days until expiration. This means that even though you own the June option and it’s decaying, you’re profiting from the decay that is occurring at a faster rate in the May option.

**Commit Criteria**

Since calendar trades profit the most when the stock doesn't move, your target is a stock that is moving minimally within a channel or range. And you anticipate that the stock will remain within this range until the short option expires. Therefore, you need to avoid trading this tactic if there are known news announcements that could cause the stock to suddenly move. Known news announcements include earnings reports, FDA reports for biotech and drug stocks and court rulings to name a few.

Events that are expected to happen after the short term option expires are not really a concern since the trade will be closed by the time the event occurs. In case some unexpected event does take place, simply follow your eject criteria and profit goal.

**Fox3 Options’ Trade Principles**

With the stock in a range, begin your calendar spread by choosing the options that are closest to ATM. This will equally distribute the range in which the stock can be for the trade to be profitable at expiration. Any movement outside of this range at expiration, the calendar will begin to lose money. Too much movement and the calendar will lose its full value.

Here’s how that works. Remember that the real value of each option doesn’t matter, since the real values of the long and short options will always offset. So the only thing that’s left is the time value. If the stock moves so that the calendar trade is completely out of the money, then both options will have no time value, and hence the calendar spread will be worth zero. If the stock moves so that the calendar spread is so deep in the money, the same thing occurs. The time value disappears and the spread is once again worth nothing.

But if the stock settles right at the strike price of the calendar, on the expiration of the short option, then the short option is worthless, yet the long option is still worth a lot of money. Hence the spread has value. Depending on the stock and option pricing calendar returns can range from 50%-200% in a month. We'll look closer at some examples below.
To keep with the standard definition of a calendar spread, you create the trade by buying a longer term option and selling a shorter term option. Also the strike price needs to be the same. To trade time spreads that can generate the highest return on investment (ROI) sell the front month option (also called the current month) and buy the next month out.

Recall why you’re buying the longer term option; for the insurance. If you go further out in time to buy your insurance, the trade will become more expensive. That lowers your ROI, but also exposes you to more volatility risk. We’ll address that later in the Greeks section below.

Take a look at the calendar trade in the table below assuming that the stock is right at $50. If you buy the calendar, what price are you paying, and what is your maximum risk on the trade?
Buying the calendar means buying the June put for $3 and selling the May put for $2. The net debit on the trade is $1, and that’s the maximum risk in this trade.

Now assume that 30 days have gone by, the stock is still sitting right at $50 and all other variables remain unchanged. What’s the value of the calendar at this point in time? The way to answer that is to look at each individual option and figure out what that option will be worth 30 days after inception of the trade.

Since the May option had 30 days until expiration, and then 30 days passed, that put expires worthless with the stock at $50.

The June option had 60 days until expiration and 30 days passed, which leaves June with 30 days until it expires. What value is the June put going to have when it’s a 30-day option? Since all other variable remain unchanged the June put is going to be worth $2; the same value May had when it was a 30-day option.

So now, with the May put worthless and the June put worth $2, the calendar spread is worth $2. That’s twice what you paid for it. A 100% return on your risk. This is how professionals analyze calendar spreads.

Another way of looking at it is this: You profited $2 by selling May, and lost $1 by buying June, for a net profit of $1. Why? Because May decayed at a faster rate than June.

### Buying Put Calendars to Open

<table>
<thead>
<tr>
<th>Strike Price</th>
<th>May Put (30 days)</th>
<th>June Put (60 days)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$50</td>
<td>$2</td>
<td>$3</td>
</tr>
</tbody>
</table>

When you are ready to use this tactic you will “buy the June-May 50 put calendar to open”. With regard to the specific language used, many traders and brokers adhere to a standard of quoting the longer term option first, but the key here is that you are buying the calendar. “Buying the calendar” always means that you buy the longer term option regardless of how the months are quoted.

How much would the calendar in this table cost? To buy the calendar on the natural prices you would buy to open June at $2.55 and sell to open May at $1.75. Net price for the trade
is $0.80, and that’s the max risk.

If the stock plummets and both puts go deep into the money, then they’ll be trading for nearly identical prices and the spread will be worth zero since the options will only have real value. Same thing occurs if the stock skyrockets and both options are worthless and OTM.

**Maximum Risk**

The maximum risk on a calendar trade is the debit. That’s true even if you get assigned on your short option. For instance, with the last example of buying the June-May 50 put calendar for $0.80, if you’re assigned on the May put, which means you’re forced to buy stock at $50. But you can exercise your June 50 put which allows you to sell that stock at the same price you were forced to buy it. So the stock is gone from your account, and all you’ve lost is the net time value in the trade which was $0.80.

**Maximum Reward and Break Even**

The calendar trade is worth its maximum value if the stock settles exactly at the strike price of the calendar on the expiration of the short option. But, calculating the maximum potential reward and the break even points are more difficult than they are with the other strategies. The reason is that we’re dealing with two time frames instead of one, and the implied volatility of the longer term option can change as the trade progresses. Nonetheless, your option broker should have tools available to you that will generate the break even points and potential returns based on your assumption of volatility.

**Pricing your short put prior to expiration**

Let’s assume that you bought the June-May 50 put calendar for $0.80. Fifteen days later the option quotes show this:

<table>
<thead>
<tr>
<th>Strike Price</th>
<th>May Put (15 days)</th>
<th>June Put (45 days)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$50</td>
<td>$1.05 - $1.10</td>
<td>$2.05 - $2.20</td>
</tr>
</tbody>
</table>

To price the profit or loss in your spread you can look at the option chains to sell how much you could collect in a credit by selling the calendar to close. Since your long the June put, you would sell the put on the bid and collect $2.05. You’re short the May put so you would buy it to close on the asking price of $1.10. With these prices, the calendar can be sold for a net credit of $0.95.

Here’s another look at the trade with only 2 days left:
What’s the profit or loss on the trade now? The calendar can be sold on the natural price of $1.60 ($2.30 - $0.70). That represents a 100% profit on the $0.80 entry price.

Closing the trade now would lock in your profit. And here is how you’ll manage the trade once you have opened the position.

**Mid-Course Guidance**

When would you close the calendar trade?

Eject Criteria: Several reasons could trigger you out of this trade. If a previously unknown news event is scheduled to occur during the life of the short option, close the trade if you believe that the event is something that could drive the stock out of your break even points.

If the stock starts to move outside the break even points regardless of the news, then consider closing the trade. Your calendar will quickly lose if the stock starts trending away from the strike price of your calendar.

If the calendar loses 50% of the initial debit, close the trade and preserve your capital.

Profit Goal: Initial goal is to obtain 50% of the maximum potential gain. Again, your broker should have tools to generate this number.

Once the trade gets to that point of profitability, then reset your exit level to 25%. For instance, you buy a calendar for $1 knowing that you can make a 100% profit. When your calendar is worth $1.50 that means you have achieved 50% of that profit potential. Now you set your exit level to $1.25 if the calendar starts to go down in price. That will preserve at least some profit if the trade starts to go the wrong way. You may be able to manage this exit by using a stop-loss, or trailing stop-loss, order. Check with your individual broker.

Continue to squeeze the profits out and raise your exit level as the price of the calendar increases.

**Important Greeks**

The Greeks all play a part in this tactic, but the important Greek to look at is Theta. Since the options we’re selling are short term, these options will begin to decay very quickly.

Delta: Calendars are Delta neutral when the stock is at the strike price.
Gamma: Long calendars have short Gamma, but that’s the reason that we trade them. Short Gamma means long Theta.

Theta: Time decay is definitely your friend. The short option has more Theta than the long option, so the spread has a net short Theta that profits from the passage of time.

Vega: Calendar spreads have positive Vega. The calendar is positive Vega because the longer term option has a bigger Vega than the shorter term option, and this can be a problem for the calendar.

If the implied volatility is high, your calendar can lose money if the volatility drops during the life of your trade. So you may want to avoid calendars in high volatility environments. But if you buy the calendar when volatility is low, and then the volatility goes up, this can lead to profits for the trade.

**Exit Steps**

When either your Eject Criteria or your Profit Goal is hit, then it is time to close the trade.

Selling the calendar to close your position:

When you are ready to close this trade you will “sell the calendar to close.” After the trade is closed you will use the closing price of your spread to tally your profit or loss in the trade. And once the trade is closed there is no more risk in the trade.

The trade is closed by selling the longer term option to close and buying the shorter term option to close, as a spread. If you sell the calendar for more than you paid for it, you have a profit. If you sell the calendar for less than you paid for it, you have a loss.

**Wrap Up**

Calendar spreads are a tactic that profit from time decay if the underlying stock stays near the strike price of the calendar. The risk is limited to the purchase price, but returns can range from 50%-200% per month for example depending on the stock and option pricing. The short option drives the profits in this trade as the time decay you collect outweighs the time decay you lose from the longer term insurance option.

In the final lesson of the Intermediate Tactics we’ll move into a spread called a collar, which is used to protect an underlying stock position that you hold.
McDonald’s Put Calendar

McDonald’s (MCD) needs no introduction. The company is as solid as it gets and has provided nice returns for investors for many years. Its stock price has had a nice run over the past year and appears to be entering a nice trading range.

This range bound price action offers a nice opportunity to some sideways tactics. Exploiting Theta we will open an Aug/Sep Put Calendar.
Looking at the chart, MCD the 67.5 Strike looks the proper price target for our Put Calendar Spread, so we will build a trade plan for the Sep/Aug 67.5 Put Calendar.
MCD Trade Plan
July 9, 2010

**Strategic Mindset:** Neutral

**Target:** MCD currently trading at 69.70

**Commit Criteria:**
*MCD is settling into a nice trading range and there are no events on the horizon that appear to threaten the range.*

**Tactic:** 67.5 Put calendar Spread

---

**Tactical Employment:**

- **Leg Set up:**
  - Sell 1 August 67.5 Strike Put @ 0.95
  - Buy 1 September 67.5 Strike Put @ 1.62
  - Net Debit: 69 cents per share

- **Max Profit:** Estimated 95 Cents
- **Max Risk:** 69 Cents
- **Breakeven:** Estimated, 64.90 / 69.70

**The Greeks:**

- **Theta:** Time decay is our friend.
- **Vega:** We would like IV to stay low, if it increases it will decrease the value of the position.
Mid-Course Guidance:

**Profit Target:** 50% of the premium paid, 0.35. If reached, reset max loss to 25% profit level, 0.52.

**Threats to success:**
- Broader Market volatility.

**Eject Criteria/Contingency Plan:**
- Commit Criteria no longer valid.
- Max allowable loss of 50% of premium paid, 0.35

**Exit Plan**
1. Profit Target Reached.
2. Eject Criteria Reached.
3. To close position:
   a. Buy to close 1 Aug 67.5 Put.
   b. Sell to close 1 Aug 67.5 Put.

---

**Planning Thoughts:**

1. We are neutral on MCD.
2. Our Commit Criteria are stated simply and summarizes our thoughts when entering the trade.
3. Tactic is simply the option position we are opening.
   a. Remember our objective...Make Money, Don’t Lose It!
   b. Our strategy is to use options to support our objective.
   c. And our tactic is the options position.
4. Our Tactical Employment is simply the trade set up and the performance parameters for the trade.
   a. There are too many variables to put an accurate number on max profit, estimate is based on front month premium.
   b. There are too many variables to accurately calculate Breakevens. Your broker should have tools to allow an estimate these estimates are form a brokerage account.
5. Mid-Course Guidance:
   a. We define our price target as a percentage of max profit. We would like to get the max profit, but set our target at 50% of max. Once reached, we reset our loss limit to ensure profits to the 25% profit point then actively monitor trade to see if it has the potential to yield the max profit. If we hit 50% then
position retraces to a 25% profit we simply close the trade. Broad market volatility will be in our scan during this trade.

b. Eject Criteria:
   i. If our Neutral outlook can no longer be supported.
   ii. Max allowable loss is also based on the premium and do not want to lose more than 50% of our premium.

Lesson 9 Quiz

1. What is the set up for a Put Calendar Spread?
   a. Buy 1 front month put and 1 next month put at the same strike.
   b. Sell 1 front month put and buy 1 next month put at the same strike.
   c. Buy 1 call and buy 1 put at the same strike.
   d. Sell 1 call and sell 1 put at the same strike.

2. When does the max gain of a Calendar Spread occur?
   a. Back month expires at the money.
   b. Front month expires at the strike price.
   c. Front month expires above the strike price.
   d. Front month expires below the strike price.

3. Why do you buy the back month strike?
   a. To collect the premium.
   b. To profit from an increase in IV.
   c. To hedge the front month option.
   d. To profit from Delta.

4. What is the max loss of A Calendar Spread?
   a. The Premium paid.
   b. The current stock price plus the premium paid
   c. The strike price minus the net credit.
   d. The strike price of the front month put or call.
Use the Johnson & Johnson (JNJ) option chain above to answer the following questions. Assumptions:

- Neutral on JNJ.
- Market order and transaction costs excluded.

5. What is the cost to open an Aug / Oct 60 Strike Put Calendar Spread?
   a. $1.02
   b. $1.29
   c. $1.06
   d. $2.35

6. Picking the 60 strike, what is our break even share price?
   a. $60.00
   b. $62.00
   c. $59.00
   d. Not enough info to calculate.

7. What is the max risk per share of 1 Aug / Oct 60 Strike Put Calendar?
   a. $1.06
   b. $1.29
   c. $1.02
   d. $2.35
8. What is the estimated max profit of 1 Aug / Oct 60 Strike Put Calendar?
   a. $1.06
   b. $1.29
   c. $1.02
   d. $2.35

9. When does the 1 Aug / Oct 60 Strike Put Calendar achieve max profit?
   a. Expiration of the front month option at the strike price.
   b. Expiration of the back month option at the strike price.
   c. With JNJ at 61.06 at expiration of the front month.
   d. With JNJ at 58.84 at expiration.

10. What is the strategic mindset for a Calendar spread?
    a. Bullish
    b. Bearish
    c. Neutral
    d. Volatile
Lesson Ten
The Collar

Introduction

Before moving into the Advanced Tactics we’ll finish the Intermediate level by looking a combination of two options in addition to a stock position. A collar trade is a tactic used by many professionals to protect stock positions, either because the stock has had a good run or they want to lock in some profits, or because of a general bearish outlook on the market without the desire or ability to sell the stock.

Once the option positions are in place the stock is going to have a “floor” underneath is which means that stock is going to be protected from excessive loss. Basically the stock is going to be insured through the purchase of a put option. If the stock goes down in price, then the put goes up in price and this will offset some of the losses in the stock. This allows you to precisely calculate your total risk in the position.

Buying the put option, however, means you incur a capital outlay for the insurance. To help offset the cost of the put option we’ll introduce the second part of the strategy which is to sell a call with a higher strike price than the put strike. The premium collected from the short call offsets the cost of the put. The OTM call works just like a covered call, and in so doing it imposes a ceiling, or a cap, on your potential profit from the stock. If the stock is above the strike price at expiration, then you will be forced to sell your stock at the higher strike price while the put will expire worthless.

When all three positions are in place you will have a long stock position, protected by a long OTM put, which is financed by a short OTM call. This position is called a Collar.

Commit Criteria

The heart of this tactic is a long stock position. The call and put option can be added to a current stock position to lock in profits, but an advanced method of trading this tactic is to open all three positions together and then actively manage the options as the stock moves. For now we’ll stick with using the options to protect a stock position that you already own and in which you have profits that you want to protect from a market downturn.

So for stocks that you own, and want to protect profits, let’s look at turning the position into a collar by simultaneously buying the protective put OTM and offsetting its cost by selling an OTM call option.

Fox3 Options’ Trade Principles
The idea behind this tactic is to preserve profits in a stock that has had a good run. Buying the puts OTM instead of ATM lowers the cost of the insurance to the point where most, if not all, of that cost can by covered by selling an OTM call. Although the put is OTM and doesn’t completely remove the risk of having the stock go down, the risk reduction is substantial. And selling the OTM call not only reduces the cost of the put, it also gives the stock room to appreciate further before potentially being forced to sell your stock at the call strike price.

**Note:** For the purpose of definitions and calculations contained in this section the term “Stock Price” is referring to the current stock price. You could also use the purchased stock price in the calculations if you wanted to base the maximum reward, maximum losses and break even off of your original investment in the stock. However, we are applying this tactic in this lesson on the basis that you are protecting the profit you have already earned. Therefore, we will calculate from the current price of the stock.

**Leg Set Up**

When turning your long stock position into a collar you would buy an OTM put option (Leg 1) while simultaneously selling an OTM call (Leg 2). As such the stock price is going to be between the two strike prices. This trade is created on a 1-1-1 ratio which means one call and one put option for every 100 shares of stock.

Maximum Gain = Call strike minus stock price, minus debit or plus credit
Max Loss = Stock price minus put strike, plus debit or minus credit
Break Even = Stock price, minus debit or plus credit

When turning your long stock position into a collar you would buy an OTM put option (Leg 1) while simultaneously selling an OTM call (Leg 2). As such the stock price is going to be between the two strike prices. This trade is created on a 1-1-1 ratio which means one call and one put option for every 100 shares of stock.

For instance, if the stock is trading at $125, then you could buy the 120 puts and sell the
130 calls. Typically speaking, selling a call that is the same distance OTM as the put will result in the call paying for most, if not all, of the put option’s price. Depending on where the stock is actually trading you’ll find that sometimes you’ll enter the trade for a credit and sometimes debit.

The time frame that you choose should be tailored to how long you want to have protection for the stock. If you just want a quick tactic for curbing most of the risk in a stock position, then look to use front month options with around 30 days until expiration.

When you are ready to put the collar to work you will “collar your stock.” Let’s look at how a collared stock position will profit or lose as the stock moves through different prices at expiration. Assume that the stock is trading at $125, the 120 put is bought for $2, and the 130 call is sold for $2. When trading just the options component of the collar different brokers may have different names for the type of order you can use. Here we’ll use a combo to trade these options. It’s very similar to when we looked at trading synthetic stock through the use of a long call and short put (or vice versa). Here we’re buying a put and selling a call, but all we’re doing different now is changing the strike prices.

If you buy the put for $2 and sell the call for $2, then you’ve entered that trade for “even money.” With the stock at $125 the entire position is worth $125.

<table>
<thead>
<tr>
<th>Stock Price</th>
<th>Stock P/L</th>
<th>Put P/L</th>
<th>Call P/L</th>
<th>Net P/L</th>
</tr>
</thead>
<tbody>
<tr>
<td>$115</td>
<td>-$10</td>
<td>$3</td>
<td>$2</td>
<td>-$5</td>
</tr>
<tr>
<td>$120</td>
<td>-$5</td>
<td>$0</td>
<td>$2</td>
<td>-$3</td>
</tr>
<tr>
<td>$123</td>
<td>-$2</td>
<td>-$2</td>
<td>$2</td>
<td>-$2</td>
</tr>
<tr>
<td>$125</td>
<td>$0</td>
<td>-$2</td>
<td>$2</td>
<td>$0</td>
</tr>
<tr>
<td>$127</td>
<td>$2</td>
<td>-$2</td>
<td>$2</td>
<td>$2</td>
</tr>
<tr>
<td>$130</td>
<td>$5</td>
<td>-$2</td>
<td>$2</td>
<td>$5</td>
</tr>
<tr>
<td>$135</td>
<td>$10</td>
<td>-$2</td>
<td>-$3</td>
<td>$5</td>
</tr>
</tbody>
</table>

As the stock drops remember that the put is going to increase in value and offset your losses below the strike price (taking into account the effect of the net entry debit or credit of the options). So once the options are in place you can calculate with perfect precision the downside risk in the trade.

Which strikes should you choose? The put you choose will depend on how much risk you’re willing to take in the trade. The closer the options are to where the stock is trading, the less risk and less reward the trade will have. The put option will protect the stock more effectively because it’s closer to the money, but the call you’ll have to sell will also be
closer to the money, and that will more strictly limit the upside potential.

If you move the put further OTM, then you can sell a call option that is also further OTM. This increases both the risk and the reward. Depending on current market conditions and your outlook for the stock you can decide how tightly to collar the stock.

Assuming in this next example that the stock is currently trading at $75 calculate the total risk in a 200-share collar stock position using the prices in the table below:

<table>
<thead>
<tr>
<th>Stock Price</th>
<th>85 Call Option</th>
<th>65 Put Option</th>
</tr>
</thead>
<tbody>
<tr>
<td>$75</td>
<td>$2.50</td>
<td>$3.20</td>
</tr>
</tbody>
</table>

To collar the stock at $75 you could buy two 65 put options for $3.20 and pay for most of that premium by selling two 85 calls and collecting $2.50 for both. The net price for the options is just the difference between the two prices: a net debit of $0.70. That’s a total premium of $70/combo which comes to $140 for the entire position.

With the put option $10 OTM the stock can fall $10. On 200 shares that’s a total risk of $2,000. Adding together the stock risk with the total premium on this trade, the risk in this trade is $10.70 when pricing the trades on a per-share basis, so for a 200-share position the total risk is $2,140.

Without the collar the total risk in the stock is $15,000 so you can see that there is a substantial reduction in risk when the stock is collared.

If you look at strike prices closer to the money, then what would the total risk be with these option prices:

<table>
<thead>
<tr>
<th>Stock Price</th>
<th>80 Call Option</th>
<th>70 Put Option</th>
</tr>
</thead>
<tbody>
<tr>
<td>$75</td>
<td>$4.25</td>
<td>$4.50</td>
</tr>
</tbody>
</table>

By changing the strikes prices to $5 closer to where the stock is trading the risk has been cut dramatically. The net cost of the combo is a net debit of $0.25 by paying $4.50 for the put and collecting $4.25 for the call. Adding this to the $5 difference between the stock price and the put strike, the total risk is $5.25.

On 200 shares the net risk in this example is only $1050.

**Trading the Combo to Collar Your Stock**

Let’s assume that your stock is trading at $93 after you bought it $80 and you're nervous that the market is starting to turn around and head lower. With these options how would
you collar your stock and what would be your resulting risk and risk?

<table>
<thead>
<tr>
<th>Stock Price</th>
<th>95 Call Bid Ask</th>
<th>90 Put Bid Ask</th>
</tr>
</thead>
<tbody>
<tr>
<td>$93</td>
<td>$4.05 - $4.15</td>
<td>$3.00 - $3.10</td>
</tr>
</tbody>
</table>

To collar the stock based on the natural prices you would buy the 90 put on the asking price for $3.10 and sell the 95 call on the bid price of $4.05. That would be traded as a spread for a net credit of $0.95.

What’s the total risk in the position now? The stock can drop $3 to the 90 strike put, but after taking into account the $0.95 credit the total risk is only $2.05.

But what if the stock goes up? How do you figure the potential reward? Calculating the potential reward is very similar to looking at covered calls. The stock can profit all the way up to the strike price of the call, and then you figure in the debit or credit. If the net cost of the options is a debit, then subtract it from the profit potential. If it’s a credit, then add it.

Here the stock can go from $93 to $95, and then adding in the $0.95 credit brings the total potential reward to $2.95.

**Maximum Risk**

When calculating maximum risk, focus first on the difference between the current stock price and the put strike. If the options are traded for “even money”, then this difference between the stock and put strike represents the total risk. Then you add to the risk the debit cost of the option trade, or subtract it if it’s a net credit.

The maximum risk is incurred if the stock is anywhere below the strike price at expiration, or, if before expiration, the stock drops far below the strike price.

**Maximum Reward**

Maximum reward is calculated by taking the difference between the stock price and the call option strike. Once that number is calculated, then subtract out the net debit, or add in the net credit.

You’ll receive the maximum reward at expiration if the stock is above the strike price. In that case the short call, which is now ITM, will automatically assign and you will sell your stock position at the price of your call strike. And with call ITM that means that the put option is OTM and will expire worthless. Nothing has to be done with the put option when it expires.

Prior to expiration you may also receive the maximum reward (or close to it) if the stock
moves far above the call option. And this can be true even if you do not get assigned. Just because a short option goes into the money doesn’t mean that it will be exercised by the option owner. There are very precise calculations for when an option should be exercised and that is something that you learn in more Advanced Level classes with Top Gun Options.

**Break Even**

The break even calculation is straight forward: the stock price plus the debit of the combo or minus the credit.

**Pricing your spread prior to expiration**

Let’s assume that you initiated a collar for a $0.95 credit with the stock at $93. Based on the current prices what is your profit of loss on the total position? The current profit or loss can be taken straight from the option chains.

<table>
<thead>
<tr>
<th>Stock Price</th>
<th>95 Call Bid Ask</th>
<th>90 Put Bid Ask</th>
</tr>
</thead>
<tbody>
<tr>
<td>$81.50</td>
<td>$0.05 - $0.10</td>
<td>$9.00 - $9.20</td>
</tr>
</tbody>
</table>

The total profit or loss of the position is just the combination of each leg. After the stock drops from $93 to $81.50 the stock has lost $11.50. Remember, as traders, we’re not deriving our P/L from our stock “basis” price which is used for tax purposes; rather our P/L is determined by the day to day changes in the portfolio.

The profit from the options can either be figured by looking at the combo price or the individual options. We’ll look at both. Since you own the put you would sell it at $9.00 giving you a profit of $5.90 from the $3.10 purchase price.

The call option you sold at $4.05 can be bought back for $0.10 netting a profit of $3.95. Putting that all together yields a loss of only $1.65.

How about pricing the combo itself? You sold the combo originally by selling the call and buying the put for a net credit of $0.95. Now, to reverse that, you would buy the call and sell the put, again for a credit. This time the credit is $8.90. So to open and close that position you collected $9.85. Offsetting your stock loss of $11.50 leaves you with a net loss of $1.65.

Either way you look at it, your stock loss is a fraction of what it would have been otherwise if you did not collar the position.

**Mid-Course Guidance**

When would we close the collar?
Eject Criteria: Once the trade is in place the risk is greatly reduced and you can let the stock either be sold out by the long puts if the market drops or by the short calls if the market rallies.

If the stock is still between the strike prices going into expiration, then you can simply close the entire position by selling the stock, buying the call to close, and selling the put if still retains any value.

Profit Goal: With the collar there isn’t going to be a profit goal. The collar is a fire and forget tactic. But if you want to remain in the stock you can simply open another collar to keep the stock protected.

**Important Greeks**

Let’s look at the Greeks that affect the collar. The collar and the long call spread are synthetic equivalents so their Greek profiles will be similar.

Delta: A collar has positive Deltas, but much less than unprotected stock.

Gamma: The Gamma will be similar to that of a call spread.

Theta: Similar to a call spread.

Vega: Vega is essentially neutralized by the spread.

**Exit Steps**

Selling a collar to close your position:

When you are ready to close your position you will “sell your collar to close.” If either leg of the collar is ITM, then that option will automatically exercise or assign and the stock position will go away. Either the puts are exercised and you sell the stock at the put stock price, or the calls are assigned and you sell the stock at the higher call strike.

If the stock is between the two strikes, then sell the stock to close, buy the call to close, and sell the put to close if there is any value in it. Trade this as a spread.

This completes the Intermediate Tactics section. By now you understand a myriad of professional level option tactics for attacking any market condition. As we move into the Advanced Tactics section we’ll continue to groom you for some of the more sophisticated weapons an options trader can use.
**SanDisk Collar**

SanDisk Corporation designs, develops, manufactures and markets flash storage devices. SNDK is considered a best in class company. However, techs have been getting beat up lately and investors who sat through the most recent gains are considering exiting the position after its recent brief rally.

Looking at SNDK’s chart below, the sharp pullback likely caught many investors off guard and they are looking to protect their gains in the small comeback or just get out of the stock.

If you happen to be one of the lucky stock holders who got in SNDK at the beginning of the year, putting a collar on your stock would be a good way to protect your gains at a low price and still play in a bit of upside.

So, we are at a point where we would want to protect our gains, but we want a little upside
exposure. So, we decide to collar our stock with a 44 long put and the short 48 call.
Strategic Mindset: Neutral to Bearish
Target: SNDK currently trading at 45.74

Commit Criteria:
Want to protect and/or sell our 100 shares of SNDK with a collar.

Tactic: Collar

Tactical Employment:
Leg Set up: Buy 1 August 44 Strike Put @ 2.76
Sell 1 August 48 Strike Call @ 2.50
Net Debit: 0.26 per share

Max Profit: 2.00
Max Risk: 2.00
Breakeven: 46.00

The Greeks:
Theta and Vega: Both are essentially neutralized by the spread

Mid-Course Guidance:
Profit Target: None, we want to protect stock.

Eject Criteria/Contingency Plan:
Exit Plan

To close position:

Sell to close 1 August 44 put.
Buy to close 1 August 48 call.

Planning Thoughts:

1. We are Neutral to Bearish on SNDK at these levels.
2. Our Commit Criteria are stated simply and summarizes our thoughts when entering the trade.
3. Tactic is simply the option position we are opening.
   a. Remember our objective...Make Money, Don't Lose It!
   b. Our strategy is to use options to support our objective.
   c. And our tactic is the options position.
4. Our Tactical Employment is simply the trade set up and the performance parameters for the trade.
5. Mid-Course Guidance:
   a. There is no price target with a collar, if the premiums work where we can possibly get upside we may pick a couple of strike OTM with the call.
   b. Eject Criteria: Depends on what you want do with the stock, keep it or get rid of it.
Lesson 10 Quiz

1. What is the set up for a Collar?
   a. Own stock, buy 1 OTM put and sell 1 OTM call.
   b. Own stock, buy 1 ITM put and sell 1 OTM call.
   c. Own stock, buy 1 OTM put and sell 1 ITM call.
   d. Own stock, buy 1 ITM put and sell 1 ITM call.

2. What is the max gain of a Collar?
   a. Premium received.
   b. High strike price minus stock price minus net debit.
   c. High strike price minus stock price plus net credit.
   d. Both b and c.

3. From the point it is established what is the breakeven of a Collar?
   a. Difference between strikes plus premium paid.
   b. Opening stock price plus net credit or minus net debit.
   c. Opening stock price minus net credit or plus net debit.
   d. Upper strike minus premium paid.

4. What is the max loss of a Collar?
   a. Premium paid.
   b. Opening stock price minus the put strike, plus the net debit paid or minus the credit.
   c. Difference between strikes plus premium paid.
   d. Difference between strikes minus premium paid.

Use the IBM option chain above to answer the following questions.
Assumptions:
- Neutral to Bearish on IBM.
- Own 100 shares of IBM.

<table>
<thead>
<tr>
<th>Strike</th>
<th>Call Bid</th>
<th>Call Ask</th>
<th>Call Mark</th>
<th>Call Open Interest</th>
<th>Call Ask Size</th>
<th>Call Bid Size</th>
<th>Put Bid</th>
<th>Put Ask</th>
<th>Put Mark</th>
<th>Put Open Interest</th>
<th>Put Ask Size</th>
<th>Put Bid Size</th>
</tr>
</thead>
<tbody>
<tr>
<td>115</td>
<td>0.74</td>
<td>0.78</td>
<td>0.76</td>
<td>3,202</td>
<td>1,017</td>
<td>127</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>120</td>
<td>1.32</td>
<td>1.36</td>
<td>1.34</td>
<td>4,886</td>
<td>180</td>
<td>210</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>125</td>
<td>2.48</td>
<td>2.52</td>
<td>2.50</td>
<td>2,850</td>
<td>171</td>
<td>103</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>130</td>
<td>4.60</td>
<td>4.65</td>
<td>4.625</td>
<td>3,632</td>
<td>691</td>
<td>30</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>135</td>
<td>7.90</td>
<td>7.95</td>
<td>7.925</td>
<td>557</td>
<td>153</td>
<td>40</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>140</td>
<td>12.15</td>
<td>12.35</td>
<td>12.25</td>
<td>82</td>
<td>514</td>
<td>63</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

DISCIPLINE | RISK MANAGEMENT | SUPERIOR EXECUTION
• Market order and transaction costs excluded.
5. What is the cost per share to open the IBM AUG 125/135 Collar?
   a. $1.54
   b. $2.52
   c. $0.98
   d. $2.48

6. What is the Breakeven of the IBM AUG 125/135 Collar?
   a. $125.00
   b. $130.00
   c. $127.14
   d. $130.21

7. What is the max risk per share of the IBM AUG 125/135 Collar?
   a. $5.21
   b. $1.54
   c. $2.50
   d. $6.65

8. What is the max profit per share of the IBM AUG 125/135 Collar?
   a. $2.14
   b. $3.95
   c. $4.79
   d. $2.30

9. At or above what strike price can you expect to have your stock called away with the IBM AUG 125/135 Collar?
   a. $135.00
   b. $125.00
   c. $130.00
   d. $140.00
Out Brief

Congratulations! You have just completed the next step on your journey to becoming a combat tested options trader! The Intermediate Phase was designed to step up the information and provide you with the tools to become a successful trader. What you do with these tools is up to you! Remember that you have to practice these skills over and over again. Use the paper-trading accounts we talked about in the Primary Stage. Practice on a daily basis! We did not learn to become fighter pilots overnight or by reading some publication. We practiced over and over!

The next stage of your training is the Advanced Options Stage. In this stage we turn up the volume and introduce you to much more complex tactics. You will learn multi-leg tactics and we will show you when and how you will be applying these tactics in this ever-changing financial environment. We cannot stress enough that you need to be studying the material we have provided for you. Attend the Live Webinars and apply what you have learned via the Top Gun Trade Alerts to your paper accounts.

Again, Nice Job on completing this workbook! Stay focused, study, practice and we will see you again in the Top Gun Options Advanced Stage!

The Fox3 Options’ Team
**Fox3 Terms Glossary**

**Big Picture:** The “Big Picture” is our analysis of the current investing landscape. Having the “Big Picture” means we have a solid understanding of both the global and domestic financial situation.

**Commit Criteria:** “Commit Criteria” is the justification for engaging a target in a trade. “Commit Criteria” should be easily understood and explained in 1 – 3 sentences and be supported by the “Big Picture” and our fundamental, technical analysis and volatility of the Target.

**Contingency Plan:** Pre-planned actions within a Trade Plan if our trading target becomes “Non-cooperative”.

**Cooperative/Non-Cooperative:** If a target is “Cooperative” it is performing as expected with our “Commit Criteria”: If not, then the target in “Non-cooperative”.

**Discipline:** The art of executing according to plan, leaving emotion and irrational thought of our profit or cash preservation goals out of our decision making. For instance, if a trade triggers a trade plans Eject Criteria we get out, we do not ask questions or let the irrational thought of, “it might come back tomorrow”, affect are decision making. Without sound justification for change, we stick to the plan.

**Eject Criteria:** eject Criteria are pre-determined parameters within a Trade Plan us to get out of the trade immediately and preserve capital to trade another day.

**Fox 3:** A term used by fighter pilots when shooting the AIM-120 Advanced Medium Range Air-to-Air Missile (AMRAAM). The AMRAAM is a missile that is initially guided from the launch aircraft. After it has received enough information about the target it then becomes self-directed to target intercept. This is what Top Gun Options is about, providing enough knowledge and information to traders so they too, can become self-directed in their trading targets.

**Investment Radar Scope:** The “Investment Radar Scope” is our eyes, ears and mind. Once we have the “Big Picture” and have established our “Strategic Mindset” we can employ our “Investment Radar Scope” to find “Targets” that meet our “Commit Criteria”.

**Mid-Course Guidance:** Mid-Course Guidance is trade management. It includes contingency plan, profit target and eject criteria.

**Re-attack:** Refers to engaging a target after ejecting from a trade or after a successful or unsuccessful trade. If adjusting our “Strategic Mindset” and applying a different “Tactic” meets our “Commit Criteria” we can “Re-attack.”
**Risk Management:** The active mindset of identifying, assessing and implementing appropriate risk controls into a trade plan. Included is having the Discipline to make the hard decision when risk parameters or contingency plan triggers are reached to execute unemotionally.

**SA - Situational Awareness:** In terms of a trader, “Situational Awareness”/”SA” refers to the level of how one’s perception of reality mirrors actual reality. Example: If an options trader buys a call going into earnings and volatility is coincidentally at all time highs then ends up losing in the trade, the trader had low “SA” in entering this trade. Experience, training, analysis and a good wingman add to a trader’s ability to achieve and maintain a high level of “SA”.

**Strategic Mindset:** A trader’s “Strategic Mindset” is gained by developing a Big Picture and is applied to Markets, Sectors and individual stocks. A “Strategic Mindset” can be Bullish, Bearish, Neutral or Volatile. For instance, a trader may have a bearish “Strategic Mindset” for the domestic markets, but maintain a bullish “Strategic Mindset” within the energy sector.

**Strategy:** Strategy refers to a plan of action to achieve investment goals. For instance, a trader’s “Strategy” may be to attain more income from their stock portfolio and their plan may be to employ the covered call tactic to collect premium.

**Superior Execution:** The end result of effective Discipline and Risk Management in Top Gun Option Trading practices.

**Tactic:** A “Tactic” is the option or option spread used to support the trader’s strategy. For instance: If a trader has a speculative strategy, they could employ Deep in the Money Calls on a target that meets the Commit Criteria to achieve their profit goals.

**Tactical Employment:** This is the leg set-up for the option tactic chosen to support a trader’s strategy.

**Target:** Target and underlying are the same. At Fox 3 we choose our targets based on our Big Picture, Strategic Mindset, Strategy and probability of success with our chosen Tactic.

**Trade Debrief:** Is conducted after closing every trade. It determines what went right, what went wrong and how can we execute our next trade more profitably. We look at all aspects of our Trade Plan. A Trade Debrief generally takes less than 5 minutes and is how we rapidly improve our trading skills.

**Trade Plan:** A trade Plan consists of: Target, Commit Criteria, Tactic, Tactical Employment, Mid-Course Guidance and Exit Plan.
## Intermediate Lesson Answer Key

<table>
<thead>
<tr>
<th>Lesson</th>
<th>Question</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td>b</td>
<td>a</td>
<td>a</td>
<td>d</td>
<td>b</td>
<td>b</td>
<td>d</td>
<td>a</td>
<td>b</td>
<td>a</td>
</tr>
<tr>
<td>2</td>
<td></td>
<td>a</td>
<td>d</td>
<td>c</td>
<td>c</td>
<td>d</td>
<td>a</td>
<td>d</td>
<td>b</td>
<td>b</td>
<td>d</td>
</tr>
<tr>
<td>3</td>
<td></td>
<td>a</td>
<td>d</td>
<td>c</td>
<td>a</td>
<td>c</td>
<td>c</td>
<td>d</td>
<td>d</td>
<td>c</td>
<td>b</td>
</tr>
<tr>
<td>4</td>
<td></td>
<td>d</td>
<td>a</td>
<td>b</td>
<td>a</td>
<td>a</td>
<td>d</td>
<td>b</td>
<td>d</td>
<td>a</td>
<td>b</td>
</tr>
<tr>
<td>5</td>
<td></td>
<td>d</td>
<td>b</td>
<td>a</td>
<td>c</td>
<td>c</td>
<td>a</td>
<td>a</td>
<td>a</td>
<td>c</td>
<td>a</td>
</tr>
<tr>
<td>6</td>
<td></td>
<td>c</td>
<td>c</td>
<td>d</td>
<td>a</td>
<td>d</td>
<td>a</td>
<td>c</td>
<td>d</td>
<td>d</td>
<td>d</td>
</tr>
<tr>
<td>7</td>
<td></td>
<td>a</td>
<td>a</td>
<td>a</td>
<td>b</td>
<td>a</td>
<td>c</td>
<td>d</td>
<td>a</td>
<td>a</td>
<td>a</td>
</tr>
<tr>
<td>8</td>
<td></td>
<td>c</td>
<td>d</td>
<td>c</td>
<td>c</td>
<td>d</td>
<td>a</td>
<td>c</td>
<td>c</td>
<td>b</td>
<td>c</td>
</tr>
<tr>
<td>9</td>
<td></td>
<td>b</td>
<td>c</td>
<td>d</td>
<td>b</td>
<td>b</td>
<td>a</td>
<td>b</td>
<td>a</td>
<td>a</td>
<td>a</td>
</tr>
<tr>
<td>10</td>
<td></td>
<td>c</td>
<td>a</td>
<td>d</td>
<td>a</td>
<td>a</td>
<td>b</td>
<td>c</td>
<td>c</td>
<td>c</td>
<td>c</td>
</tr>
</tbody>
</table>