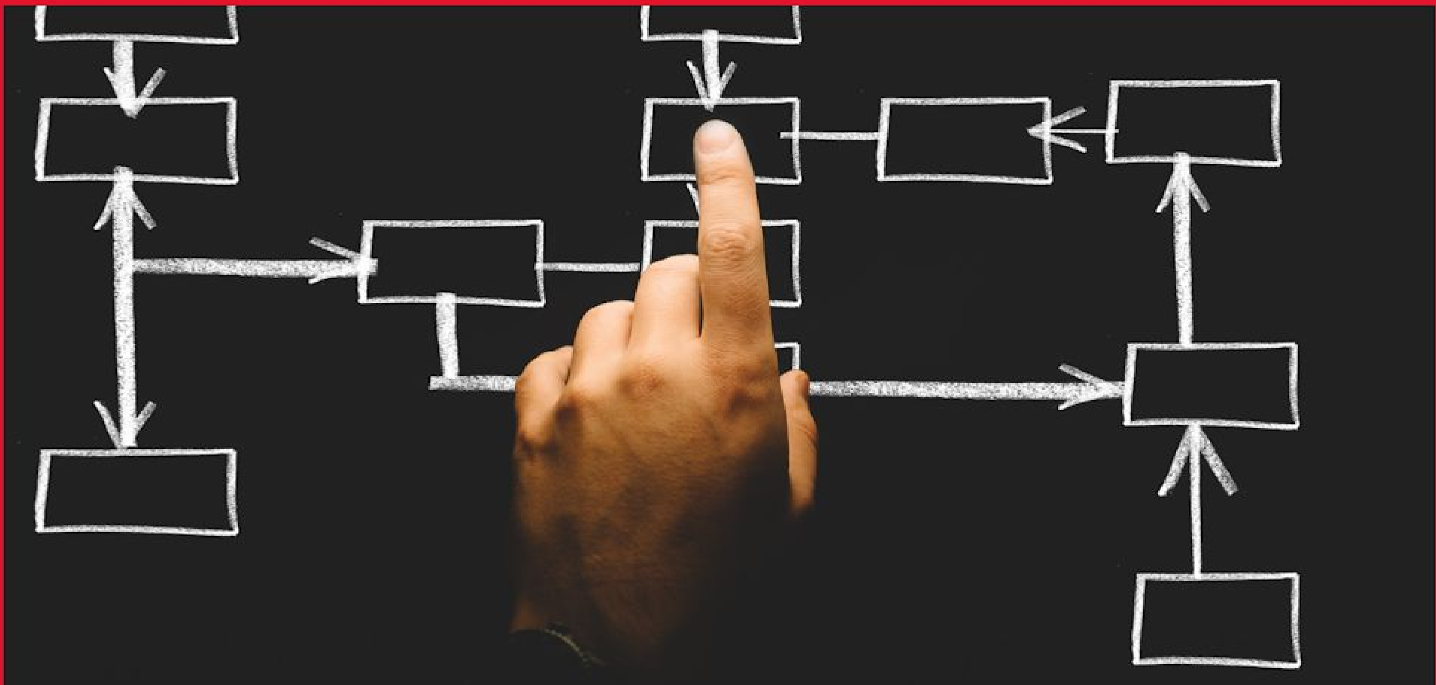

SELL OPTIONS LIKE AN ENGINEER

Place Your Trades and Operate Them

Through All Possible Outcomes

Kevin Hamilton

1. Preface

I started trading options regularly in 2017 following a substantial personal loss in an oil and gas MLP company, Breitburn Energy Partners (BBEP), which filed Chapter 11 and restructured. Following that event, I began reading books and putting together some options strategies. I watched the daily options trading educational shows hosted by market makers on the TD Ameritrade Think or Swim platform every single day. They produce daily market commentary and walk you through different trade types and strategies that people use to bet on the market in different situations. I studied the videos, took notes, and repeated their trades in both paper and real money accounts. After a while I began to develop an understanding of what was happening. These shows are very helpful in order to gain an understanding of the mechanics of the trades.

One day I sold a Put Spread on United Airlines (UAL) that expired in roughly 30 days. For a week everything was fine and then UAL plunged through both strikes in the spread. I was looking at fairly large losses, but knew that my total loss was capped by the difference in the strike prices of the spread so I wasn't too worried. One day I logged in to check my account and noticed that instead of two short Put contracts, I now owned 200 shares of UAL and 2 long Put contracts. I was assigned overnight. The person that owned the two contracts that I sold had exercised them and sold me 200 shares of UAL.

I panicked. I immediately entered a live chat with the trade desk support at Think or Swim™. The support person calmed me down by explaining what happened and that the risk profile of my account hadn't changed at all, just my cash position. As long as I was fine with owning 200 shares of the company then I could leave it alone, I was still protected from further downside by the two Put options that I had purchased. I could also just close the whole position as if the assignment never happened. Since I had already been assigned, and the stock had fallen lower than the strike price of my long Put contracts, there was also a third option.

Sell the long Puts for a profit and hold the stock. I had never really understood how powerful Put Spreads were until this moment. And this third option is the one that I chose. I closed the Put contracts for a profit a few days before they would have expired and held the 200 shares of UAL stock (at a loss). Once the stock recovered, I also sold the 200 shares for a profit. Thus I profited by selling the short Put contracts that were assigned, I profited from selling the long Put contracts, and I profited from selling the assigned shares of stock.

Amazing, I thought; and I was hooked. I wanted to sell more options. And thus began my real education into options contracts. Since then I've tried everything including backtesting options strategies for different market conditions, different company and world events and news publications. This book is the condensed result of what I have learned and is an expression of how I trade options and manage my investments today. My one true goal is to own shares in really great companies and use options to drive the cost basis of those shares to zero and lower. I hope you enjoy this book, and I hope that at a minimum, it saves you from losing too much money in the markets.

2. Introduction

If you're not a sovereign wealth fund, then you're set up to simply be crushed trading options, or stocks or really anything in the capital markets. If you are a massive fund driving the markets, then congratulations, this book is not for you. For everyone else participating in the markets, you need a plan, a strategy, guardrails; something to keep your head above water.

> "You must know which way you're going to turn
> long before you get to the intersection." - Dad

When I was learning to drive at age 15 in Austin, Texas. The real learning came after mastering the steering wheel, the clutch, the brake, the gas and the mirrors. The real learning was being prepared for what happens while driving. When I pulled up to one of the first intersections on the open road with my dad in the passenger seat I slowed the car to a stop and looked around. My dad looked at me and asked me which way I was going to turn. At that moment I had no idea and he knew it, he simply said "you must know which way you're going to turn long before you get to the intersection". Masters of the road plan for what happens next by knowing which way they're going to go when they get to the next intersection.

Knowing the terms and practicing the mechanics of the trades are just the beginning. This book assumes you've got all of that nailed down. We're not going to talk about the Greeks or explain the different types of amazing positions you can get into with options (I won't boast about the iron condor and won't talk at length about the different options positions and their pros and cons). We're not going to cover time decay or the various rates of change. No. That's all required fundamental knowledge that you can pick up on Investopedia, on the Think or Swim videos or anywhere else online. And if you haven't done that yet, please do so immediately. I also expect that you've chosen your platform already, have installed your trading software and have mastered it in paper money so that you don't end up selling 15 more calls for a total of 30 instead of buying them to close the position with only minutes remaining before the closing bell. Believe me, fat fingering trades is extremely painful.

Instead, we're going to present options trades that will bring income and your overall cost basis in that stock (not for taxes, but just for your investment knowledge). We're going to not only show you that, but also teach you how to manage the position after you've entered it, that is to answer the one question that nobody else wants to answer.

What happens next? What do I do when _____ happens?

This is the burning question. Software engineers always want to know the answer to this question and they employ algorithms to help them. Those algorithms are documented in a particular way and that's why the format of this guide borrows from the world of software specifications. We crave it, we must know what happens at every turn, at every possible outcome. It isn't enough to know how cool it is to put on a calendar spread. It is knowing how to operate the trade after it has been opened that truly matters.

I've been a software engineer for over 20 years and before that received my undergraduate degree in Mechanical Engineering from The University of Texas at Austin. Over this long period, starting back when I learned how to drive, I've learned the importance of employing algorithms. The scenarios presented in this book answer that burning question for every possible outcome of the options trades. Combining options trades to form complex positions isn't covered, but really those expand on the foundational trades described here and the possible outcomes never change, no matter how simple or complex your position.

We'll cover a few other things as well starting with a focus on selling options. This is an important thing to consider and drives at the motivation of the trade. Next, we'll cover a slew of assumptions and beliefs. In software engineering, no algorithm can be complete without first stating the preconditions, the assumptions or beliefs of the software team. Those assumptions may, at first, seem silly or naive, but over time I've learned that they clarify and remove ambiguity which leads to much better outcomes. Next we'll cover the scenarios, the meat of the trades, the algorithm, the answer to your burning question. And finally wrap with a tiny bit of clarifying information that may help make these trades more effective for you.

3. Selling Options

Buying options has its place, but in this book everything is geared toward selling options. I want you to be thinking about this as you review the scenarios in particular. All of the strategies are focused on selling and not buying options. The reason is simple: Probability. When you buy an option there is only one scenario in which you make money: The stock moves dramatically and rapidly in your favor. Compare that to making money in 4 scenarios when you sell options. Let's take a quick peek at these scenarios:

1. The stock stays the same price
2. The stock moves a little in your favor
3. The stock moves a little against you
4. The stock moves a lot in your favor
5. The stock moves a lot against you

Here are the scenarios as they play out if you purchase a call option. We're going to review these scenarios quickly from the perspective of purchasing because I think it has more of an effect on you to see all the ways in which you lose money to the person that sold the option. Then think, gosh I should be the person selling the option!

Scenario 1: The stock stays the same price
Given that you bought a 50 delta option for $1 and the stock trades at $30
When the stock closes on expiration at the same price ($30)

Then your option expires worthless
And you lose $100 ***(To the person that sold you the option!)***

Scenario 2: The stock moves a little in your favor
Given that you bought a 50 delta call option for $1 and the stock trades near $30
When the stock moves up a little, to $30.60 at expiration
Then your option expires in the money
And you lose $40 ***(To the person that sold you the option!)***

Scenario 3: The stock moves a little against you
Given that you bought a 50 delta call option for $1 and the stock trades near $30
When the stock moves down a little, to $29.50 at expiration
Then your option expires out of the money
And you lose the entire premium, $100 ***(To the person that sold you the option!)***

Scenario 4: The stock moves a lot in your favor
Given that you bought a 50 delta call option for $1 and the stock trades near $30
When the stock moves up a lot, to $35 at expiration
Then your option expires in the money
And you are paid $500. (net out $400)

Scenario 5: The stock moves a lot against you
Given that you bought a 50 delta call option for $1 and the stock trades near $30
When the stock moves down a lot, to $20 at expiration
Then your option expires out of the money
And you lose the entire premium, $100 ***(To the person that sold you the option!)***

We looked at these scenarios with call options but you could reverse it with put options and the outcomes are the same if you buy a put option. The main point here is to focus on selling options more than buying options. Only buy options to protect your positions, or reduce margin requirements. That is to prevent you from losing too much money, and not in an effort to make money in the first place. Make money by selling options.

4. Core Assumptions and Beliefs

Assumptions and beliefs in any robust system are critically important to a successful outcome. Here, we're talking about the assumptions and beliefs that govern your stock trading system, or the design of your trading practices. If you want to be successful, you've got to surface and understand them.

During my study in Mechanical Engineering I had the opportunity to work on a part of the design of a chemical agent detector for the U.S. Military. Over the course of the project, the team and I decided that it would be better if the detector was able to take in more air more quickly and that meant a bigger intake hole. So we went to work resizing the hole and redoing all of our calculations. It looked very promising, but we wanted to actually test our hypothesis. At a standard check in meeting with the lead on the project, we posed this request to change the design of the detector. Now this was before the advent of the 3D printer that you can take home with you for a few hundred dollars. But the concept that we presented, as it turns out, would have required a huge investment in machinery in order to make the change. Thus uncovering a big missed assumption, that we could conduct unlimited design modifications and test them with no real impact to the project. This failed assumption cost us quite a bit of time and actually ended up changing the way in which we went about our calculations and how we proved that they would work (which we had to do before we could get a prototype).

That was awful and had we understood that assumption early on, and more importantly invalidated that assumption early on, then we would have saved a ton of time and energy. The goal of this section is to help you prevent that kind of waste while you're designing your trading system.

To help with that, I'm going to share some of the beliefs that I hold or have held in one form or another. We all have these hidden assumptions or beliefs that drive quite a bit our behavior, our thinking, our reactions. The idea is to surface these hidden drivers, to understand them, and then work past them so that they don't obstruct our ability to operate our trading system.

Really absorb these. Understand them. Always search out your own hidden beliefs and surface them and then test them. They are cornerstones to your own trading behavior and understanding them will help keep your trades safe from your emotions and help to save you time, money and energy in the future.

A01: All Information is Baked Into The Price - I don't recommend relying much on research, or if you do research, don't bank on that keeping you out of trouble. What you can bank on, is that within seconds after new information is released about a company, professional traders and people with a lot more money than you correct the price. Researching a stock, reading too much about it, also leads to another problem: overconfidence. Your brain will use confirmation bias to seek out troves of information in support of whatever opinion you have about a stock. This is dangerous. It leads you to put on trades that you're so confident in, so invested in, that you can't let them go. Accept the price as the price and move on. All known information is baked into the price by very competent and wealthy investors that set the price and drive the market. You're simply along for the ride.

A02: You're Happy Owning The Stock at the Strike Price - In the case of selling put options, if the price goes down you may be assigned. This is a coping mechanism that keeps you from over-reacting to corrections in prices. Because one day one piece of news comes out and the price moves. Then the next day another piece of news comes out and the price moves again. You don't want to try and fight that, instead stay calm because you're perfectly okay with owning the stock.

A03: You're Happy Selling The Stock at the Strike Price - In the case of selling call options, if the price goes up you're happy and you won't try to adjust the options too much, instead you'll let the stock go through the strike and if it stays up, then your shares are called away, but you're happy with that. You made that determination before you sold the call options. This is another mechanism that keeps you from reacting to short term price changes that feel like they move against you. And your trader dashboard probably isn't helping lighting the position up in bright red indicating that you're losing a ton of money, when in reality you've made money on the trade, just not as much as you would have made had you been able to predict the stock move.

A04: You have enough money to trade with - This is important. "Enough money" is different for everybody. The idea here is that you have enough money to sell options that keep bringing in cash even when trades go against you. For example, if you sell one put option on Amazon at $3,000 strike price and you get assigned, well then you buy 100 shares at $3,000 which is, yes, $300,000. If you don't have much more than that, then that one trade causes a full stop to your trading until you're able to later sell those 100 shares for a profit. That may be immediately, or the next day or it could be awhile. Having reserve cash is also good psychologically. It will give you confidence to stick with a trade and avoid other pitfalls like panicking, toward the end of an options trade, near expiration.

A05: We're not looking to "Go All In", slow and steady income wins - The strategies presented here may seem downright boring. That's good. We'll get to some examples at the end that illustrate why you should never "YOLO". I'm all about low anxiety trading. You can follow the algorithm presented in this book without checking your portfolio every half hour or every ten minutes as is the case with some of us.

A06: Never Trade Earnings - There are no predictions in the stock market. Back testing doesn't work because the probability of future events happening is not in any way tied to the events of the past. Because of this we pay attention to the news and especially the news cycle of the stocks we trade. The most important news is earnings and we try not to make "earnings trades", that is a trade that is made solely around the earnings event. For example, backtesting buying call options on a stock 3 days before earnings because the last 6 of 7 earnings skyrocketed and owning call options for a few days through earnings paid out huge. Or putting on an iron condor to try and sell the premium from increased volatility. My opinion is to try and avoid these things generally or if you do them, do very small trades. I have to admit, one iron condor on a $20 stock through earnings is fun to do.

A07: You're able to deal with FOMO - The strategies mentioned below sound simple and easy and they are. However, operating them in practice is hard. One of the biggest hurdles is Fear Of Missing Out, or FOMO. When you own 100 shares of a stock and it jumps up 5%, then you should sell a call option if you haven't already. But at that moment, the little voice in your head is going to be whispering weird things to you, suggesting you might miss out on an even bigger upside if you sell the call option (and there are plenty of examples of just that). Don't listen to that voice.

A08: It takes exactly one trade to move the stock price - This sounds silly, but keep in mind that no matter how much volume is traded daily in a particular stock, it does NOT anchor the price. The price will shift on the very next trade even if that trade is for 1 share. Don't let volume of trades give you confidence that the price is stable or leading the price in any particular direction. The market algorithms are incentivised to execute as many trades as possible and they don't care about past volume; they're matchmakers. Find a match, make the trade.

A09: It is easier to profit from selling puts - This is due to how volatility fluctuates with price movement and how volatility subsequently affects options prices. It is the way of things, don't let it frustrate you. Call options lose value when the stock goes down, but volatility increases at the same time which raises option prices. The effect is opposite for puts.

A10: Stop Using Stop Loss Trades - I'm going to take heat for this one for sure. However, consider the change in probabilities that your stop loss ads into the equation. I can't calculate it but I can understand it intuitively. In high volatility this is much worse, the market can naturally move through your stop price multiple times over the course of the trade if not over the course of the hour. I've been stopped out so many times on what would be profitable trades that I just don't do it anymore. It is much better to set up your trades and operate them in a manner that is conducive to moving with the market, not fighting it. Let's look at a quick example:

1. Sell the 140 put on BA expiring in 38 days with Volatility of 49%.
2. The contract sells for $3.35 and has a probability of profit of 81%
3. Set a stop loss at $10.05 (3 x 3.35). Then the question is, what is the price of the stock that makes this option worth $10.05?
4. This is difficult to calculate but you can get an idea by looking at the option chain and finding how far away is the option that trades for about $10? In this case it would indicate that if the BA dropped to around $150 then our stop would get hit and we'd be out. Now this is well away from our $140 put.
5. The probability of profit for the 150 option is 74%, so by setting the stop loss, you've reduced your probability of profit by at least 7%.

In practice, you'll see options prices move extremely fast, thus setting stops on them is very difficult. That is why we have the assumption that if you sell puts, just be ok with owning the stock. That way you're able to ride the trade all the way to expiration or assignment which maximizes your probability of profit.

A11: We Like It, But We're Not Married to the Stock - I can't count the number of times I've told someone "I just bought x00 shares of ___" and in return I got gasps, sighs, huge reactions! It truly is OK to sell and buy shares in a stock multiple times per year or month or even day. So if your shares are called away, or about to be called away, it is ok. You can either roll the position to prevent them from being called away, or, you can let them be called away and just sell another put. Don't worry, you'll get your shares back. Sometimes we want to keep them to earn dividends or to support the company, and that's fine. We just want to be sure that we address any heavy feelings about buying stock; it is not a big deal to buy or sell stock. It isn't like a house, the market is completely liquid and so we assume if we're assigned 100 shares, we can just sell it immediately if we don't like it, or if our shares are called away, we can re-buy them immediately or pre-buy them in the case when we know they will be called away at the end of the day or week.

That about wraps up our assumptions. If you have or discover your own assumptions, write them down for yourself and share them in our private community at https://tiblio.com. The more clear we become about our biases in the markets, the more we'll understand our motivations and trades and the better we'll do.

5. Strategies

Trading without a predetermined strategy will feel like quicksand. Every single move you make will just get you in deeper trouble. This still happens to me more often than it should and is usually caused by moments of boredom while I'm cooking breakfast as the market opens. So there I am watching the eggs fry up in the pan and I check my phone. You know what happens next, oh look! L-Brands is up 8%! And then I think to myself, hey I was supposed to sell some puts in that, now seems like a good time! Sell puts… Two minutes later I'm losing hundreds of dollars. I'm not a momentum trader, I'm not set up for that. I know that, yet from time to time I still end up reacting to the market during volatile times.

Carefully choosing your strategies will help to reduce those reactions. And choosing them in conjunction with the particular equity will help. For example, if you know that L-Brands makes 8-12% moves fairly often, then don't buy the dip and then turn around and sell a covered call. Just buy the dip and wait for the move in the opposite direction, or sell a put or put spread. That way you don't panic when the stock shoots through your call and turn what would be a great trade into a negative.

The strategies that we'll cover are below:

1. Short Vertical Call Spread
2. Short Vertical Put Spread
3. Covered Call
4. Cash Secured Put
5. Short Covered Strangle
6. Wheel

Each strategy discussion has four main parts. First the open. This is a scenario description to open the trade, this is how you get into the trade. Second, a sample trade and third, operating the trade. The Operate section addresses each one of the five possible moves that the market could make mentioned above. Fourth, the Close section includes any additional notes on closing the trade that weren't already mentioned.

5.1. Short Vertical Call Spread

This trade profits when the underlying doesn't go up too much. You set up the trade by selling a call option and then limiting your loss by buying a further out of the money call option. Your maximum loss is the difference between the strike prices of the two options.

5.1.1. Open

Given that earnings are not within the next 4-6 weeks
When you sell a 90 delta call spread as a single trade with a 30-45 day expiration
Then the credit is applied to your account
And your margin requirement (risk) goes up by the difference between the strike prices of the two option contracts

5.1.2. Operate

S1 - The stock stays the same price - Do nothing

S2 - The stock moves a little in your favor - Do nothing

S3 - The stock moves a little against you - Monitor the trade as the stock approaches the short strike. If you're within 7 days of expiration then you begin taking on more gamma risk, meaning that the option price will fluctuate more quickly. Be mindful of the fact that the stock could jump through your strikes. At this point if you're able to close the position for any profit, then do so. If you don't, then be prepared to hold the position open until the final hours of trading which will allow you to squeeze every last dollar of premium out. Be sure to keep emotions in check during this week because it is easy to see a large negative move, panic and close the position for more than the max loss.

S4 - The stock moves a lot in your favor - Do nothing

S5 - The stock moves a lot against you - In this case the stock has moved well past the first strike and possibly the second strike. If the price has moved through both strikes then, depending on your brokerage rules, you can do nothing and let them close out the trade at expiration. This way you won't incur any losses beyond the difference in the option prices. If the stock price sits between the strike prices of the two options then you'll need to do something before expiration. You can close the trade or, if you would like to wait a little longer for a move in your favor then roll the position to the following week or month. I always recommend rolling the position using your brokerage tools because they can execute the roll as a single trade so that you don't end up losing even more in the time between you would close the spread and open the new spread. The more quickly you execute the roll, the more likely you are to be able to take in even more premium.

5.1.3. Close

As soon as you notice that there is less than $1/day of value left in the options then you should look to close. This should be somewhere between a 50-80% profit. At this point, you're not being paid for the risk that you're carrying so it is better to close the trade, wait a day and then if you still feel good about it, repeat the trade.

5.2. Short Vertical Put Spread

Opposite of the call spread, this trade profits when the underlying doesn't go down too much.

5.2.1. Open

Given that earnings are not within the next 4-6 weeks
When you sell a 90 delta put spread as a single trade with a 30-45 day expiration
Then the credit is applied to your account
And your margin requirement (risk) goes up by the difference between the strike prices of the two option contracts

5.2.2. Operate

Operate this trade in largely the same manner as the Short Vertical Call Spread. There is one difference when the stock moves a lot against you, which I'll talk about here.

S5 - The stock moves a lot against you - Selling a put is risk defined, if you're assigned then the max loss is the strike price * 100. This is different from selling a naked call, which brings with it unlimited risk. Just imagine selling a call on TSLA with an expiration of 6 months and then watching it go from $300 to $1800 against you. That would mount losses of $150,000 or more. The max loss of selling a put at a $300 strike price is $30,000 and that would only happen if the company went to 0 during the option term.

Because of this, when you sell a put spread, if you have the cash to cover a short put, then when the stock moves a lot against you, say through both strike prices, then you would be able to sell the long put option for a profit and then continue operating the trade as a Cash Secured Put (explained below).

5.2.3. Close

Close this spread the same as you would the Short Vertical Call Spread. Try to take profits early or whenever they pass the 50-80% mark.

5.3. Covered Call

5.3.1. Open

Given that earnings are at least 4-6 weeks away

And that you have 100 shares of the stock
When you sell a 90 delta call
Then the credit is applied to your account
And your margin requirement doesn’t change

5.3.2. Operate

S1 - The stock stays the same price - Do nothing

S2 - The stock moves a little in your favor - I’m going to define this as moving down in this case, which is in favor of the short call option. As the stock moves down, you should monitor it to see when you’re able to close the trade and take profits. You may be surprised at how fast option prices can deflate with small changes of the stock.

S3 - The stock moves a little against you - I’m going to define this as moving up as that is against the short option. In this case though, you’re making money on the 100 shares faster than you’re losing money on the option. Do nothing. Your ideal situation is for the stock to close just under the strike price of the option.

S4 - The stock moves a lot in your favor - If the stock is dipping rapidly (in favor of the short option), then the option price is likely to deflate and you should look to close it for very little ($.05-$.10).

S5 - The stock moves a lot against you - In this case, the stock price has risen sharply and may shoot through the strike price of the option. You should check to see if you can quickly roll the option to take more premium. If not, don’t worry, you’re making good money and don’t need to do anything. Let your shares go and wait to repeat the trade.

You should be aware of possible early exercise by the short option holder (the person that bought your option) in the event that the stock rises above the strike price + dividend the day before the ex-dividend date. In this case the option holder will want to exercise and buy the shares so that they get the high share price and the dividend. This is actually one of the best outcomes of this trade as it gets you out of the trade the fastest at your max profit.

5.3.3. Close

This is one of the best trades out there because of its low maintenance. After you open the trade, there really isn’t much you have to worry about. If the stock goes down, well at least you’re making money on the option. If the stock goes up, well you’re making more money than what you’re losing on the option and you have the premium you collected as a buffer against actual loss. The only loss over not selling the option is if the stock just takes off. When that happens you’ll be kicking yourself and never want to sell covered calls again. However, this is rare, so just let it go and move on to the next trade.

5.4. Cash Secured Put

5.4.1. Open

Given that earnings are at least 4-6 weeks away
And that you have have enough cash to buy 100 shares of the stock
When you sell a 90 delta put
Then the credit is applied to your account
And your margin requirement goes up by the strike price * 100

5.4.2. Operate

S1 - The stock stays the same price - Do nothing

S2 - The stock moves a little in your favor - This is a bullish position, you want the stock to go up. As it does two things happen simultaneously. First, the stock is moving away from the option so the option value goes down. Second, volatility goes down which also lowers the option value. You will notice that puts can deflate very rapidly because of this double effect. Close the trade out and take profits at the 50-80% level and move on to the next trade.

S3 - The stock moves a little against you - Do nothing.

S4 - The stock moves a lot in your favor - Close the position.

S5 - The stock moves a lot against you - You really have two choices once the stock price falls below the strike price of the option. Either take the assignment and own 100 shares or roll the position out to buy yourself more time for the stock to go back up. If you're good with owning another 100 shares of the stock (and you should be for good mental health when selling puts) then really the best thing to do is just let it expire and take the assignment. You don't have to do anything. The morning after option expiration (usually Saturday morning), you can check your account and you'll own 100 shares and no option.

5.4.3. Close

This is another very low maintenance trade. As long you were comfortable with owning 100 shares of the stock when you sold the option (and in fact I rarely ever buy stock directly preferring instead to sell puts until I'm assigned and then start selling covered calls until the stock is taken away and then repeat).

5.5. Short Covered Strangle

If you were to execute 5.3 and 5.4 on the same stock (a covered call and a cash secured put), you'd have a short strangle position (while owning the stock). This is a favorite position of mine because I don't pretend to know which way a stock will move and it puts a lot of premium in my pocket, especially when IV is high. Rolling with a stock like this takes a lot of discipline and over time you may find that you roll in and out of this position however the stock dictates. If you're into it, this is also the best way to leg into an iron condor. Sell the call spread when the stock jumps up, then after some time, if the stock falls sell the put spread.

You'll want to open, operate and close the legs of this position as mentioned above, so I won't repeat that here. This is a "flow with the market" strategy, so do just that; closing out legs to take profit and opening legs after the stock moves in that direction (e.g., stock dips sharply, sell the put). This works well in high volatility stocks.

5.6. Wheel

You'll notice above that I referenced "rolling" with the stock. One way to roll with the stock is to follow the wheel strategy. It doesn't really matter how you start, but it looks something like this:

1. Sell a put
2. Get assigned 100 shares
3. Sell a call
4. The shares are called away
5. Sell a put
6. ...

6. Sample Trades

Below you'll find some sample trades that I personally did along with the outcome and how I managed or operated the position after opening the trade. I find it very useful to keep a log of trades, the operation of the trade and the outcome.

Activision Blizzard (ATVI) trades for $72
Sell the $70 PUT expiring in 30 days for $120 in premium
The next day, ATVI trades up to $78 and the option value falls to $40
I decide to take risk off the table and close the trade immediately, paying $40 to close the trade resulting in an $80 gain in one day (Minus transaction fees)

Rule of Thumb: If there's less than $1/day in premium remaining, it might be a good idea to just close the position. You're assuming a lot of risk with a sudden market move for little gain.

Rule of Thumb: It is usually a good idea to close positions immediately after or during a big market move in your favor. If the market is up 2% (SPY moves up 2%) in one day, it may coincide with one of your positions making a very large (say 6+%) move. If those things correlate and you've made some money, then close the option position and wait a few days.

In the following weeks ATVI trades down to $73
Sell the $70 PUT again expiring in 30 days for $100 in premium
The stock subsequently trades down to 65

I am assigned and pay $7,000 for 100 shares of the stock now trading at $65 (I'm holding the stock at a $500 loss)

Rule of Thumb: Sometimes you'll be assigned and the stock has moved so far against you that you don't want to sell a covered call right away. In this case, I usually choose to wait it out. Remember the first rule of selling the put was that you don't mind owning the stock at the put strike price. You didn't mind owning it before, so don't panic and sell now. You might even love it enough at the new low price to sell another put and accumulate shares.

Rule of Thumb: Have in mind the maximum number of shares of this stock that you want to accumulate so that your portfolio doesn't become too heavily weighted in one security and so that in case of total disaster with the company, you'll be ok. Stick to that number and don't let yourself fall into the trap of trying to average down all the way to bankruptcy. Once you hit the number, then stop selling puts and stop buying the stock.

7. Appendix

Here are some additional bits of info on how I trade that might augment the approaches or at least the way that I look for and operate the trades. Some are nuanced but they can be beneficial.

7.1. Working Your Trades

When you go to open your trade, you'll see the bid/ask prices and your software will likely have an easy way for you to split the difference and set that as your limit price. When the bid/ask spread is tight then it isn't a big deal, but if you have 20-30 cents or more, then it makes more sense to walk your limit to the middle. Start on the outside, let your order sit for a few minutes and slowly adjust the price to get your execution.

7.2. Target stocks

I usually target companies that I have a strong belief in that won't file for bankruptcy while I have the trades open. If they pay dividends then I also believe that they aren't about to cut the dividend. Dividends tend to stabilize stock prices. You also don't want to start trading companies that are on the verge of being kicked from whatever index they're in. That's a disaster as the funds invested in the index essentially sell the stock immediately. I usually target stocks in the 20-50 dollar range that have good price movements. If a stock like KO has traded flat for the past 10 years then option premiums are going to be so low that they're just not worth it. You can't generate an income from them. At the same time, if the price jumps around too much it might cause you too much anxiety and therefore lead you to losing a lot of money.

7.3. Target option price

If I can get an option premium of say $150 and only risk $300-400, that's great. If I'm getting an option premium of $50 to risk $5000, that's not so great. You have to seek out the balance. If it is a $12 stock, this is harder to do, you'll only get it on highly volatile stocks. But if you can get $1 call prices on a stock like that, then it will only take 10-15 trades to knock your cost basis down tremendously. You'll practically own the stock for free in no time. Right now, during coronavirus, it is easy to expect a $1.50 premium on a 40-50 delta option on a $10 stock. The beauty of volatility.

7.4. Price Check: Black-Scholes

If you're curious, head over to https://tiblio.com and check the price checker. You don't need to do this too much, but if you spend some time with it you'll see that the price checker is usually extremely close to the price you see in your brokerage software. If you do this a few times, you'll develop a sense for what the price should look like for an option of a particular delta, with a particular volatility. This intuition should help trigger alarm bells when you go to place trades and things seem off. If you're ever in doubt you can get this formula in a spreadsheet and run it constantly. It isn't perfect for US options prices but it is very very close, close enough to tell you when you're about to get ripped off.

7.5. Cutting Down Margin Requirements

Depending on your brokerage and your particular account, you may have noticed that if you sell a put option on a stock trading around $100, then your margin requirement will be around $10,000. Ouch, that might limit the number of trades you can do. You can easily reduce this by half or more by buying a very far out of the money put option, say at a $50 strike price. This option should cost you $.05 or less. There may be liquidity issues here so use a limit price and don't combine it with the sale of the first option. This is technically a spread (a really really wide spread), but really the only thing we're doing is cutting margin, or protecting ourselves from only the most massive of losses.

7.6. Eating Into Profits

It would be nice to keep everything that you earn, but that's not going to happen. In fact, taxes and fees can actually put your account into the negative or reduce profits so much that it isn't even worth trading. Keep in mind that you're competing against big firms that are able to drive down their taxes and fees and thus force prices that are too tight for you, the retail investor, to make any money (even when you're right).

7.6.1. Capital Gains and Tax Consequences

Profit from stock options sales is generally counted as short term capital gains and you'll need to pay taxes on that. Short term capital gains taxes can be as much as 25-30%, generally the same as your income tax bracket.

7.6.2. Brokerage Accounts and Fees

The other things that sucks up your profit are the fees that you pay to the brokerage service. These can be incredibly destructive, so watch out!

7.6.3. Example

Sell an option contract: $100.00
Pay brokerage transaction fee: ($4.95)
Pay brokerage contract fee: ($0.60)
Buy contract to close position: ($10.00)
Pay brokerage transaction fee: ($4.95)
Pay brokerage contract fee: ($0.60)
Gross income: $78.90
Taxes: ($19.73)
Net income: $59.15

Keep this in mind as you're trading because it is unlikely that the reports from your brokerage will be so transparent. After a few trades it can seem like you're breaking even when, in fact, because of fees, you're losing quite a bit of money.

7.7. Liquidity Risk

I always walk my trades into the price that I want or the price that is shown in the middle of the bid/ask. For example if the bid is $1.45, I might start at $1.30 and move the price up by editing the order every couple of seconds. This practice helps me avoid the all too regular jerk out there with the only 10 options with an out of bounds price. The trap that you want to avoid is that someone goes in and finds a somewhat obscure option and places a buy or sell way out and just lets it sit. Then the options at the correct price get all bought up. Then you glance at the bid/ask spread and place your order for the middle and get a quick execution. A few seconds later it is reported that you lost $20. Yes, someone out there just took $20 from you, then reverse the trade at the correct price to close their position and repeat.