TRADE LIKE THE PROS



A STEP-BY-STEP GUIDE TO MAKING MONEY, TRADING EQUITIES, ETFS AND OPTIONS

STEVEN SITKOWSKI

Preface
My Story

I grew up in Orange County, California before it morphed into nothing but houses, streets, buildings and non-stop traffic jams. My childhood was, by and large, unremarkable. My dad was a banker, and my mom was a homemaker. Our family home was about 1,110 square feet and it accommodated our brood of five quite sufficiently. I think it would be accurate to say that we had enough to get by but very little extra.

Orange County is the epitome of the 'haves' and the 'have-nots' coexisting in close proximity. In my neighborhood, it was not unusual for people to park their vehicles on the front lawn, while ten miles away the kids were going to private schools and being chauffeured by their nannies. Fortunately for me, I did not understand class structure until I became an adult.

Attending the University of Southern California on a scholarship, I was ready for a life of learning, social relationships and partying. As it turned out, I experienced only the educational facet of college life. My three hour round trip commutes between home and school canceled out my social plans. My plan to study law was nixed when I found that there were no scholarships available to me for law school. After two years of college, I dropped out.

At the age of 19, I decided to get my real estate license. I was little more than a child trying to sell houses to adults whose first question was, "How old are you?" I actually did okay. I just outworked my peers and became a student of the business. The best part of being in the real estate industry is that it exposed me to a number of fantastic motivational trainers. I would go listen to people like Zig Ziglar and Jim Rohn and put into practice their notion that your attitude controls your altitude. I was also a regular at the Crystal Cathedral where every Sunday Dr. Robert Schuller would preach on possibility thinking. The messages simply resonated with me and continue to do so to this very day.

After a few years listing and selling properties, I discovered that the financial services industry was emerging with the creation of the College of Financial Planning and their new designation, the *Certified Financial Planner*. I love giving helpful advice. It makes me feel useful. I felt it would be an honor to help people improve their standard of living by helping them get their finances in order, and teaching them to make better investment decisions.. So, I enrolled in the two year course of study.

To earn the *Certified Financial Planner* designation, I mastered around 100 topics related to integrated financial planning. My work with clients covered insurance planning, employee benefits, investments and securities, income taxes, estate and gift taxes, retirement and estate planning. I passed the six final exams with flying colors and was one of the first CFPs in the country. However, in order to conduct business, I was required to obtain a few licenses.

Over the next year or so I got my life insurance and securities licenses to complement my real estate license. I could now counsel people on virtually any financial subject and used my new-found expertise to grow my real estate practice. I learned that one of the secrets of success in business is knowing more than your peers and being able to go one step higher in servicing your clients or customers.

Then came the day that changed my life. I was doing a presentation on financial planning for a small group in Laguna Hills. At the end of the meeting, I was approached by a gentleman named Danny Santucci. Danny was an attorney who gave seminars all over the country on the subject of estate planning and asset protection. Danny might also be the funniest person I have ever known. He told me that I had the talent to speak to much larger audiences and offered to introduce me to a man who would ultimately change my destiny, Charles J. Givens.

Chuck Givens was a maverick. He built an empire teaching people how to manage their own resources. He taught his members to stop listening to stockbrokers and financial planners and learn how to

handle their own investments. He wrote a book titled, *Wealth Without Risk*, and it became the number one financial publication of all time. When I watched Chuck inspire his legions, I thought, "That's what I want to do someday."

I want to teach a message of self-empowerment. We all have within us the ability to carve out our own futures provided we are given the proper education and mentorship. That's what this book is all about.

Mr. Givens told me that if I came to work with him, I could touch the lives of hundreds of thousands of individuals, instead of just the hundreds of clients of my financial planning company. I took him at his word and that was the beginning of a lifetime of financial adventure, helping others achieve their goals.

I have spent my entire professional life in the financial services industry. Having worked with institutions, corporations, and individuals has given me a multi-faceted view of many investment asset classes and how they can benefit any investor.

As a *Registered Investment Advisor* registered with the Securities and Exchange Commission, I was privileged to work with individuals and companies providing advice on investing in securities such as stocks, bonds, mutual funds and exchange-traded funds. The standard of care adhered to by a Registered Investment Advisor includes fiduciary responsibility: the requirement to always serve the best interests of the client with no conflicts of interest.

This is important because in this book I intend to provide the same level of concern for my readers. I want you to know that the information and resources here are focused on your best interests. I want you to go out and invest with total confidence in the content of this book.

I love the business of investing and the multiple asset classes investors seek out. That is why I have also held licenses in real estate, securities, insurance and as a mortgage broker. My experience in

running a two billion dollar stock brokerage firm is invaluable when sharing with you investment strategies related to stocks and options with lower risk and higher returns. Option trading ideas are perhaps my favorite thing to share, as my strategies consistently generate 5-20% returns with a statistical probability of success of 80-90%.

With experience as a general and limited partner in real estate holdings, I have developed a thorough knowledge of real estate investing. Using this knowledge, I can compare real estate to other asset classes in order to help you to make informed decisions. As the past president of two financial planning organizations, I am excited to write this book and to share strategies I know will work for you and will help you make the right investment choices.

I have been called a "tell it like it is" speaker and trainer, and I am pleased with that. Hosting a nationally syndicated radio talk show and lecturing to over a million people in the United States, Canada and England, I believe that these audiences were large because they wanted to hear the truth about investing - the "tell-it-like-it-is" truth.

It has been a fun professional life as well, sharing the training and lecture stage with personalities such as Tony Robbins, Jim Rohn, Zig Ziglar, Mayor Rudy Guiliani, Dr. Robert Schuller, Charles J. Givens, and Robert Allen. The attendees at these presentations wanted more than just motivation. They wanted real advice that works, and I enjoy doing my part to provide it.

My book, 30 Day Money Makeover, is available on Amazon.com. However, this book will be more investment oriented, and my goal is to instill in you, total confidence in the investment strategies here and in your ability to put those strategies into practice to secure your financial future.

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Introduction

"An investment in knowledge pays the best interest."

Benjamin Franklin

Short of being a corporate insider, telling the future of a company's stock is something few of us can do on a regular basis. Even if we can do it some of the time, we can easily lose more when we are wrong than we gain when we are right. I am excited about this book because I am writing it for the rest of us, the normal people who would like to invest successfully and understand that we cannot predict the future.

This book is all about making money in the stock market, but not by buying and holding stocks hoping for them to always go up in price. Basically, using only stock shares, there are only two things you can do:

- Buy the stock and hope the price goes up.
- Short-sell the stock and hope the price goes down.

If you are limited to buying a stock long, or selling it short, the only way to make money is IF you can predict the future.

Sure, you can study the fundamentals of a stock, maybe learn technical and candlestick charting, and then make a bet in one direction or another for future price movement. You may even be able to do better than the 50/50 chance of "up or down" because you have done some homework.

This book is all about turning the tables on the up or down odds. I love it when the light goes on for someone when he or she learns how to do a credit spread with a 90% statistical probability of profit. I love it when they see how they can make an up or down bet, but they can increase their chances of making money and cut their chance of losses even if they are not completely right.

Even more fun to watch, is the reaction when someone learns that he or she can make money when a stock or market does not move up or down at all. Yes, if a stock is at $40/share today, and the stock is still at $40/share three weeks from now, you make $300 profit. This is not only possible, it is a popular strategy that is making money for investors every trading day.

Will you learn to always make the right trade? NO. However, there are proven strategies for adjusting trades already in progress when things are not going as expected. Take that 90% probability spread trade. There's still a 10% chance it may go wrong. I will share specific strategies with you to adjust the trade to pull it out of the fire.

I began this Introduction with a Benjamin Franklin quote about knowledge.. Knowledge is the key to successful investing. My goal for this book is to provide not only the knowledge to trade successfully in up, down, or sideways markets, but also how to develop trades with a very high probability of success even if you are not sure about direction.

Read the book, do the exercises, open and trade a virtual learning account, and you'll succeed… guaranteed. You need only apply the knowledge properly. Once you do, you'll find that your family, friends, and even your broker will want to know where you are getting your "inside information".

Chapter 1
Why I Wrote This Book

When I was young I thought money was the most important thing in life; now that I am old I know that it is.

Oscar Wilde

I wrote this book for money… but not for me – for you!

And, I wrote this book to teach, as I have been teaching my whole life. There is a joy in helping others through the transfer of knowledge.

Teaching in my life has taken a number of forms in many venues. In teaching Sunday school for five years for Dr. Robert Schuller, I worked with young people and enjoyed their developing minds and personalities. As a part of the Joint Educational Project while attending the University of Southern California, I was a teacher's aide for inner city schools. I have spoken at numerous high schools and was asked to lecture at the University of Southern California.

In the more physical and team-building arena, I have enjoyed coaching Little League, soccer, and basketball for many years. Much of investing is a solitary activity, but understanding the team dynamic helps us understand how companies operate before we invest in them. In a way, I want to use that coaching mindset throughout this book to help you learn how to win in the financial games and markets.

The concepts I am sharing with you here have been thoroughly vetted for success, and I have included instruction in these strategies in my speaking engagements to more than one million people in the United States, Europe, and Canada. This book brings together market strategies and investing truths that you will not get from your banker, from regular stock brokers, or even from the vast majority of financial advisors.

MONEY IS IMPORTANT

Money is more important in our lives today than at any time in history. Our economy has moved away from farming and ranching to a consumer economy, and now few of us can grow all of the food we eat, nor do we have the time or the space to do it. We don't make our own tools, build our own homes and cars, nor can we distill our own gasoline to run our cars.

We consume, and in order to consume we need money to buy goods and services. Without money a consumer economy cannot function. Sure, there's barter, but barter is limited by the goods and services the consumer possesses and can trade. If your skills or possessions are limited, it is difficult to trade for what you need to feed, clothe and protect your family.

Money, is at the root of everything we do and the workings of our businesses and governments. Our country is trillions of dollars in debt, and consumer debt is rising again after having fallen for a short period of time. Most of that decline, however, was due to millions of home foreclosures and a general economic fear that turned off buying.

There is an ongoing and massive transfer of wealth in our country from the middle class to a small percentage of people at the top of the food chain. That flat screen TV and new SUV are financed with credit cards and loans. The interest we pay is lining the pockets of the few at the top, and we are paying an ever-increasing portion of our incomes as interest on debt.

Politicians and government find more ways to tax us in order to feed the gluttony of government. The tax bite gets bigger every year with city, county, state and federal taxation on every citizen. Every year we are taking home less from paychecks that are not keeping pace with price inflation.

Now we have an entire baby boomer generation entering their retirement years with inadequate savings and a reliance on Social Security payments that average only $1,400 monthly. Ten thousand

boomers retire every day. Even those retirees who have hundreds of thousands of dollars in interest-bearing accounts are not able to live off interest that's averaging less than the rate of inflation.

Because money is important, it is important to me that I help you acquire money at a pace that will enhance your life, no matter what your age. Sure, if you are a boomer and entering retirement with too little money and investments to fund your desired lifestyle, it is going to be a bit more difficult. You must do more in less time than the millennial youth or the middle-aged business person.

No matter what your age, business, career path or education, there will be investment resources here to help you achieve your financial goals. You will learn how to turn things around and start a reverse transfer of wealth *back* into your pockets.

There is a real need for a "how-to" book for the average person who wants to take control of his own investments. There are plenty of books and courses out there, but many of them are focused on guiding you to a product, service or specific asset class that the author wants to promote. I want to provide you with factual, effective and secure investment strategies through this book.

Let's get to the hard truth right away because I want you to understand that controlling your own financial future through investing is not a choice; it is a necessity. Too many of us turn our financial futures over to someone else, and we have a variety of reasons for doing so:

- We doubt our ability to do it ourselves.
- We think that others are "experts" and we should defer to their judgment.
- We don't think we have the time.
- It is just too much trouble when there are financial advisors out there to do it for us.

SAVINGS ACCOUNTS

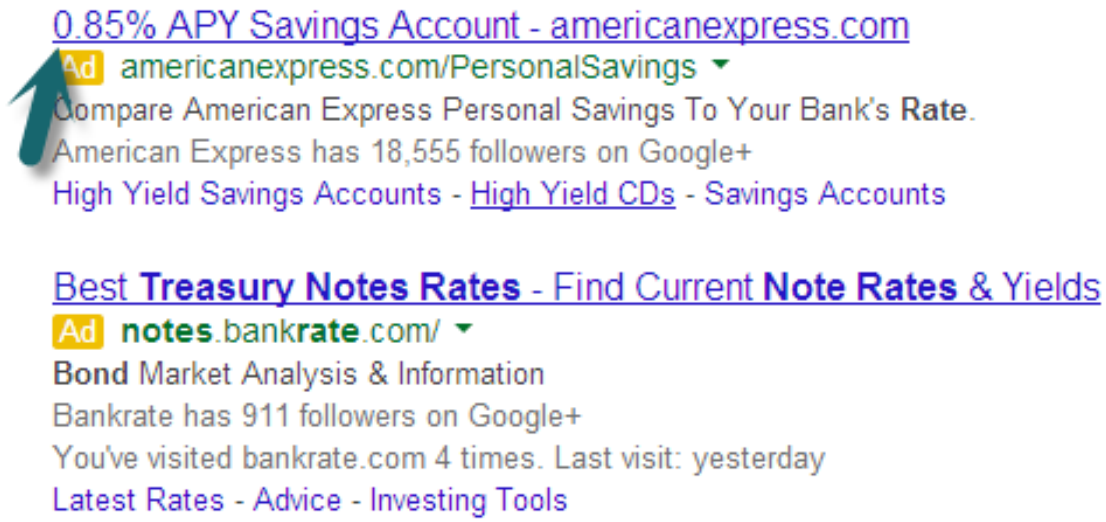
One of the most common ways in which we release control of our assets to others is through simple savings accounts, certificates of deposit, or money market funds for savings. We see that many of these accounts are insured by some government or quasi-government agency, so we feel secure and are satisfied with the interest these accounts will earn over time.

By the time you read this, I have no idea where savings account or CD rates will be set, but let's take a look at why they are the lowest rates of return available to you and what the banks use our money for in their own investing.

We trade off earnings for safety. Savers will accept a lower rate of return if they perceive their investment to be more secure. This is why government bonds carry lower yields. They are considered safer than many other types of savings and corporate bond accounts because they are backed by the U.S. Government.

Savings Rate Safety Differentials

At the end of 2013, savings rates were pretty low and many analysts predicted that they would stay that way for years. In the following Google search on rates, the top result for American Express advertises a rate that my research showed to be in the range of the highest available at that time:



This account allows withdrawals at any time up to a stated maximum number over a monthly period. It is not a long term account or certificate of deposit. A search for the best certificate of deposit rates at that time yielded these results:

CDs Offered	***% Rate***		***% Rate***
1 Year	0.98%	to	1.05%
2 Year	1.05%	to	1.20%
3 Year	1.20%	to	1.30%
5 Year	1.60%	to	2.00%
5 Year Jumbo	1.60%	to	2.05%
*$100,000+			

As you can see, committing your money to the bank for a longer guaranteed period will get you a higher rate of return, though we can hardly call these results exciting. Now let's see the trade-off for perceived security with government bonds:

1 Yr	2 Yr	3 Yr	5 Yr	7 Yr	10 Yr	20 Yr	30 Yr
0.13	0.30	0.59	1.43	2.16	2.81	3.58	3.86
0.13	0.28	0.58	1.40	2.13	2.79	3.56	3.84
0.14	0.30	0.60	1.45	2.19	2.84	3.63	3.90

These are government bond rates for bonds purchased with maturities from 1 to 30 years. You can see the lower rates in exchange for the perceived safety of the investment. You are purchasing a bond at a discount price which reflects the interest if held to maturity.

So, if you are buying a 10 year $10,000 Treasury Bond, you'll pay less than the $10,000 face value. The amount less will be the interest that will be earned if you hold it to maturity. At the 10 year maturity date you'll receive the entire $10,000.

CORPORATE BONDS

Corporate bonds are debt issued by corporations to investors. They can be used to finance operations, growth, or new business initiatives. Unlike Treasury bonds, corporate bonds are purchased at face value and pay out interest periodically. These interest payments are usually quarterly, semi-annual, or annual.

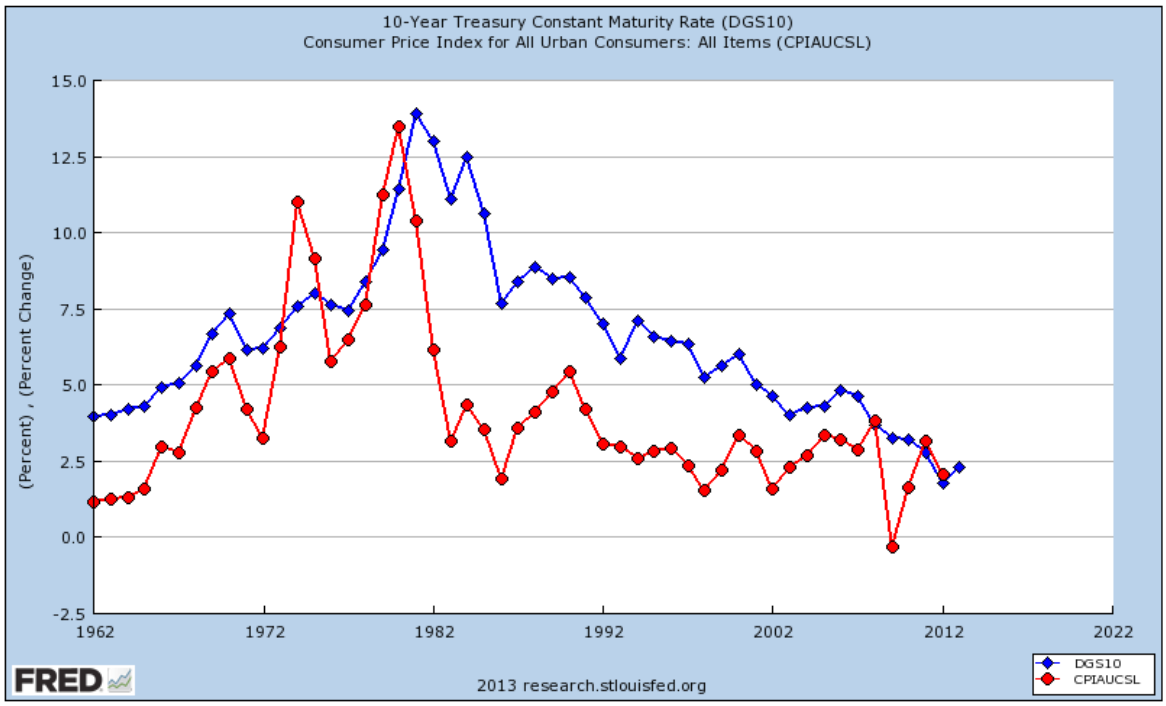
If you purchase a $1,000 corporate bond with a 4% interest rate payable annually, you'll get your $40 interest payment each year. The bond will mature at the prescribed time and you'll get your initial investment returned to you. There are market, credit, and events risk factors in corporate bond investment. A company can run into

financial troubles, have temporary cash flow problems, or there can be adverse news about the industry or market segment.

Savings accounts, corporate bonds, certificates of deposit and government bonds all have differing risk factors in some respects, but they all have one very major risk factor in common: inflation.

Threat #1: Inflation

Saving for the long term in a regular savings account or certificate of deposit is a risky proposition. Here's a historic chart of the inflation rate versus the 10 Year Treasury Certificate Rate:



What we see here is that in normal economic years there is only around a 2% to 4% difference between the inflation rate and the rate of return on savings. However, this chart does not really give us a clear picture, as income taxes are not included. Even if you have no state income tax, a nominal 20% to 25% Federal income tax rate will drop that top line significantly. The top line for most of the time period is the savings interest rate for the 10-year Treasury Note, and the bottom line is the inflation rate.

Let's look at hard numbers. We'll look at $1,000 invested in that 10 year Treasury bond at 2.84% interest rate as in the previous chart. The ongoing inflation rate is a low 2%, lower than historic norms, and you are going to see a 10 year result like this:

Amount invested:	$1,000
Years to save:	10
Annual interest rate:	2.84%
Federal tax rate:	20%
State tax rate:	0%
Inflation rate:	2%
Total savings over 10 years:	**$1,323**
Savings after taxes:	**$1,252**
Savings after inflation and taxes:	**$1,027**

Tack on state income tax or bring the inflation rate up to a more realistic 3% and you'll find that we end up with a number below our original $1,000 invested. It is not fun to watch your nest egg go down in value after ten long years. Sure, interest rates could be higher, helping your return… unless inflation is higher as well.

Remember that inflation is compounding. What you buy for $100 this year will cost you $103 next year with a 3% inflation rate. However, with that same 3% rate, the cost for the same goods or services will be $103 x 1.03 = $106.10 the next year. Inflation is relentless, and just keeping pace is not going to achieve your financial goals.

If you are invested in bonds, either corporate or government, there's another threat to your capital: interest rate risk.

Threat #2: Interest Rate Risk

Interest rate risk can play havoc with your savings accounts. While you may lock in a decent rate by committing your funds for a longer period of time, once that CD matures, you are back in the market at current rates, which could be lower. If your money is in passbook savings accounts, rates change on you at the will of the bank and markets.

However, interest rate risk is not just related to your savings, it is a threat related to your consumer debt as well. While all of us would like to be debt-free, that's usually not feasible when it comes to homes or automobiles. Few of us are debt-free, and we are borrowing at retail lending rates. Our cash outflow in interest payments can easily exceed our inflow from savings. Going backwards is not going to achieve our financial goals.

Bonds and Interest Rates

When you buy a bond, you are locked into the interest rate at the time of the purchase. In other words, if you buy your government or corporate bond paying a 2.90% rate of return, that's the return for the life of the bond. As long as you hold it to maturity and there are no other calamities, you'll get your investment back and will have earned the quoted interest rate.

However, if you have an emergency or for some reason you must sell your bond prior to maturity, you run into interest rate risk. It is a bit of complicated math to determine the yield of a bond at that moment in time you may want to sell. What's important to know is that if interest rates have increased and you still have a significant amount of time before maturity, you may be selling at a loss.

Investors can buy a new bond at the current higher rate, so they will only want to buy your lower yield bond at a significant discount to make it an attractive investment. The discount will depend on the time to maturity of a government bond and the rate. Just know that you do have this second element of risk in bonds

It is Not Just Buy-and-Hold

"A small amount of money can turn into a fortune given a high rate of return and enough years." That quote is attributed to Warren Buffet, but he did not just mean to take a buy-and-hold strategy and sit back and wait for riches.

You are in control of your financial future… or you should be. I am excited about showing you how to take that control back from others. You are poised here and now to change the future, but only if you learn how millions are doing it wrong and how you can do it right.

Money and investing do not have to be dull and boring topics.

Let's move through this material with a common goal of not just keeping you from being bored, but also to do as Buffet said: "*Profit from folly*," not participate in it.`

Chapter 2
Investment Choices

"Wall Street is the only place that people ride to in a Rolls Royce to get advice from those who take the subway."

Warren Buffett

In every aspect of our lives, we love to have choices. We go to Starbucks and have our choice of coffees, teas, and treats. We have a host of choices when we walk the aisles at the grocery store. We choose by balancing cost with benefits or quality, or we sometimes choose solely on what we perceive as the most fun or most entertaining offer.

Many of our everyday choices are fairly low stress decisions and some of them are actually fun. When it comes to investments, asset classes, and risk profiles, it is a whole different story. After all, we are risking our money, savings, and financial future. This is a new ballgame, and it can be very stressful. Wrong decisions have more negative implications than choosing the wrong latte.

Those "subway riding" investment advisors are always preaching mitigating risk through "diversification." By diversifying your holdings into different asset classes across various industries and financial products, we are supposedly hedging our portfolio against unexpected negative events.

I am not speaking against diversification, but there is so much more to investing than just hedging by diversifying. If you are concentrating solely on lowering risk, it is possible that you are cutting your returns unnecessarily. In this book I will cover many different ways in which to invest with lower risk strategies and higher returns. You'll balance your risk concerns intelligently with strategies the "subway riding" brokers are not telling you about. In their defense, they really just don't know about some of these.

MUTUAL FUNDS

Mutual funds have become one of the most popular investment choices over the past 20 years, with close to 100 million people placing trillions of dollars into these funds. A mutual fund is simply a collection of stocks or bonds.

Investors purchase shares in a mutual fund and the fund managers invest the money in stocks or bonds. There are normally some unifying characteristics for the investments. It could be a "Green" fund, with stocks or bonds related to environmentally friendly companies. Many are investing in particular industries, perhaps defense, retail, or energy. Bond funds may be investing in government or corporate bonds.

How You Make Money

Mutual funds return profits to their investors in several ways. Investors receive income or growth in value from the funds in three basic ways:

- Income from dividends on stocks or interest on bonds is paid as distributions to shareholders.
- Capital gains are paid to shareholders as dividends when securities are sold at a profit.
- When fund holdings increase in value but are not sold, the value of each share in the fund increases. This allows shareholders to sell their shares at a profit.

The Advantages of Mutual Funds

Mutual funds offer a number of advantages that investors value, which is why they are so popular:

- They are easy – The investor really does not have to do too much due diligence. They simply decide on one or more funds that meet their investment goals and buy shares.
- Diversification – In addition to being diversified across many different companies or bond classes in just one mutual fund, you are also able to buy into multiple funds to increase diversification.
- Professional management – Fund managers are hired for their knowledge of the markets and the type of companies, stocks, bonds, and asset classes in the fund.
- Lower costs – Because the funds are buying in bulk, transaction costs are lowered.
- Liquidity – It only takes a phone call to sell your shares in the open market.

The Disadvantages of Mutual Funds

Every investment strategy and asset class has some negative characteristics. For mutual funds, they include:

- Costs – While lower transaction costs are an advantage in buying stocks and bonds, as I mentioned, every fund has another cost factor: the costs for those professional managers I mentioned. Management costs can vary a lot and should be a major consideration in choosing a fund.
- Too big – When a fund becomes popular, it can get too much money, creating problems with finding good investments. The holdings can become too diluted, with smaller investments in many companies.
- Taxes – Selling securities in a fund triggers a capital gains tax event. The shareholder has no control over when sales will occur or how large their tax consequences will be.

Each investor has their own goals and timetable for the future. There are a great many mutual funds from which to choose, allowing an investor to match their goals closely.

In My Experience
It is nearly impossible to beat the market using mutual funds due primarily to the expenses of the funds and their size. With the tips and strategies proffered in this book, you can achieve a much higher return with less risk managing your own portfolio.

ANNUITIES

An annuity is a contract between you and an insurance company. You place money into the annuity, and in return you are guaranteed a specified rate of return paid in later installments.

There are "immediate" annuities which begin to pay out from the first deposit. These are generally chosen by investors who have a large amount of money, perhaps an inheritance or settlement payment, and they want to place it somewhere perceived to be safe and start drawing payments immediately. For example, this type of annuity may be chosen by someone entering retirement who wants a more assured rate of return on accounts they hold elsewhere, so they transfer them into an immediate annuity.

The majority of annuities are of the "deferred" type. These are used by people to build value over time, usually over their working lives, so that they can receive a guaranteed income in retirement. Typically, a deferred annuity is started with a large deposit, however, monthly payments can be deferred until some later date.

There are two other major categories for annuities: fixed and variable. *Fixed annuities* offer a definite return no matter what the markets do. You are assured of a specified return; however if markets do well, you don't benefit.

Variable annuities allow you to participate in markets, both up and down, even after you begin to take payments. You lose some guarantees, but if markets do well you'll also increase the value of your account and your payments.

Advantages of Annuities

Annuities offer advantages that appeal to some investors. Advantages include:

- Tax deferral – Many annuities allow the deposit of funds pre-tax. You are depositing money that will not be taxed until you begin to withdraw your payments. This can be very appealing to younger investors who want to put as much money away toward retirement as possible, and pre-tax deposits help them to do that.
- Compounding of tax benefits – When there are capital gains in your account, you are not taxed on them until withdrawals begin. So, your gains can be re-invested again for greater returns.
- Choices for withdrawals – You have choices as to how you want your payments made - over a specified number of years or for your entire life. Choosing to get payments until your death does reduce the payment amounts, but it offers peace-of-mind that you'll have a stated income until you don't need it anymore.

Disadvantages of Annuities

Annuities can be extremely complicated instruments, and these complexities provide both advantages and disadvantages depending on the investor and his or her choices. It is all too complicated for me to provide a comprehensive explanation here, as that could take chapters. However, there are a couple of disadvantages that stand out and are worth mentioning:

- Poor life insurance – While annuities can be a good choice for retirement income, they are not the best life insurance products, as you could die with less available money paid as a death benefit than you anticipated.
- Tax consequences – There are lump sum payouts when you die that can go to your heirs. However, these are not "stepped up" in value, so your beneficiaries pay taxes on the value gained in the account.

As with other investment choices, annuities can be of value depending upon timing and your financial situation. As I said, they are complex, so expert advice is crucial before committing to long-term investments. Most annuities will have significant penalties if you don't stay the course.

In My Experience

Financial advisors love selling annuities because of their big, up front commissions. Annuities are a terrible investment for most people as they contain onerous fees, ridiculous surrender charges, and low returns.

STOCKS

Joke: The market may be bad, but I slept like a baby all night… I woke up every hour and cried.

Risk is relative, and some people can tolerate risk much better than others. Avoiding risk is why many stock market investors choose to turn over their money to "experts" and brokers who they believe will do a good job investing it.

Stocks are shares of ownership in corporations. These companies "go public" by issuing shares of stock for purchase on the exchanges. When you purchase shares of stock in a company, you are purchasing shares of ownership. Some shares have voting rights in corporate decisions while others do not.

In general, we buy shares of stock for one of two major investment goals:

- **Growth –** These shares are ownership in companies that plow their profits back into growth rather than dividends. They generally are purchased with the primary goal of value appreciation. You know that you will not be getting dividends, but you expect your shares to increase in value for great profits.
- **Income –** These shares are purchased with dividends in mind. These companies tend to be older and more established. Their stocks are not as volatile as shares in growth companies, though they generally do grow in value, just at a slower pace. You buy these for periodic dividend payments. As people approach retirement, they generally switch from more volatile growth stocks to more secure income stocks.

Advantages of Stocks

You cannot argue with the popularity of the stock market. With several exchanges and shares available for virtually any type of company, product or service, there are plenty of choices. Advantages include:

- **Liquidity –** Make a phone call to your broker, or just log into your online trading system, and you can buy and sell shares of stock in minutes.
- **Low cost of trading –** Commissions these days are very low, especially with full or limited service online broker-

ages. You can sell shares with commissions under $10 on many systems.

- **Research resources –** Especially on the Internet, it is never been easier to thoroughly research a company's fundamentals and performance.
- **Diversification –** With so many companies in so many different industries, diversifying your portfolio is easy across industries. For example, you can buy into technology companies, consumer products, or the defense industry. Actually, all three would be diversification.

Disadvantages of Stocks

It is not all rosy, as victims of the "October Surprises" will tell you. The stock market can be very volatile, and the actions of governments around the world can have an adverse influence on your account value.

- **Volatility –** If you buy-and-hold individual stocks, you can experience significant valuation fluctuations from month to month, or even day to day. For the risk-averse investor, this can be very stressful.
- **Investment risk –** If you think that big corporations are safe investments, we need look no farther than General Motors. Many stockholders lost their entire investment in the bankruptcy and subsequent government manipulation of the follow-up.
- **Bad news is too late –** By the time bad news about a company gets to you, it is too late. You are then trying to sell in a downdraft. If you have protective orders in to sell automatically when a stock drops to a certain level, you can get "stopped out" just before things stabilize. It is too late then to do anything since your loss is locked in.

It is for these reasons that some investors relinquish control of their stock market investing to brokers who make decisions for them. However, when things crash, their brokers are almost never out in front of it and are left trying to explain later why they did not see it coming.

In My Experience
The secret to making money in the stock market is being in the right stocks at the right time. That's the combination of fundamental and technical analysis taught in this book. It is also important to be hedged to protect against the unexpected.

BONDS

Stocks are equity ownership in a company. Bonds are not; they are debt instruments. Corporations and governments issue bonds to borrow money. When an investor purchases a bond, they become a creditor of the corporation or government. This position is advantageous in that creditor claims normally take precedence over shareholder claims should problems arise.

Bonds are purchased at a stated face value with a maturity date on which that face value must be paid to the investor. The interest rate paid to the investor for the use of their money is also called the *coupon* rate. A $1,000 corporate bond issued at a 7% coupon for 10 years would pay the investor $70 each year in interest. Most bonds pay twice a year, so the investor would receive semi-annual payments of $35 each. There are four main types of bonds in the markets:

Government Bonds

The U.S. Treasury borrows money through the issuance of three different debt categories:

- T-Bills – These debt securities mature in less than one year.
- Notes – Maturity on these is between one and ten years.
- Bonds – These mature in ten or more years.

What most investors value about U.S. government debt is that it is considered to be extremely safe as an investment. This safety obviously carries a trade-off in the form of lower interest rates than corporate or municipal bonds.

Municipal Bonds

Also called "munis," municipal bonds are issued by cities and counties. An advantage for munis is that they are usually tax free at the federal level, and some municipalities also make their debt tax free to local residents.

These bonds offer a lower yield than corporate bonds and taxable bonds because they are considered more secure. However, the city of Detroit is bankruptcy illustrates that municipalities are not risk free investments. In the case of General Motors' bailout, things were even worse because the rights of the bondholders were subjugated to those of the union retirees.

Corporate Bonds

Corporations use debt to finance their businesses in many ways, and bonds are often preferable to issuing more stock. Corporate debt is more risky than municipal or government debt, as General Motors proved. However, the added risk is rewarded with higher coupon rates.

Corporations issue bonds with maturities either under 5 years, from 5 to 12 years, or over 12 years. Another type of bond that corporations issue is the *convertible bond,* allowing it to be converted into stock. Another bond type, *callable bonds,* allow the bond to be redeemed prior to maturity.

Zero Coupon Bonds

These bonds make no periodic interest payments. Instead they are issued at a discounted price to face value. This significant discount price is what is paid for the bond and if held to maturity the face value will be paid to the investor.

Advantages of Bonds

In the descriptions above we mention the relative safety of bonds when compared to stocks. When markets are turbulent, many investors will flee stocks and move their money into bonds until markets stabilize.

Many retirees and people approaching retirement will move their money into bonds, trading off the higher yields of stocks for the relative safety of bonds.

Disadvantages of Bonds

The relative safety of bonds is offset by the lower yields. A super-cautious and risk-averse investor who invests over a long period of time for retirement will usually have far less in their account than a prudent investor in other asset classes. Bonds are subject to inflation risk as well.

Bonds carry two other significant risk factors. Default of the bond issuer is one. I am sure that the bondholders in General Motors had absolutely no doubt that their investment was very secure. Another risk is rising interest rates. A bond is issued at a fixed inter-

est rate over its life. If rates rise, the bond will be worth less on the market because investors will want to buy higher yields.

Bonds can be an effective strategy for diversification, even over the long haul. However, if you are leaning toward balancing the safety with higher yields, corporate bonds can work for you, but the fundamentals of the corporation are crucial.

In My Experience
As interest rates and bond values move in opposite directions, the only time to own bonds is when interest rates are high and coming down. Bonds give investors a false sense of security. These are not safe investments unless government issued and held until maturity.

OPTIONS

The very word "options" gives us a clue as to this market investment tool. Options are "choices," and this trading mechanism allows investors the option to purchase or sell a security based on their outlook on market or specific stock direction. You can take a position for a rise, fall, or stationary price situation over time.

Options are by far my favorite instrument for investors working with $25,000 or less in their investment account. However, this makes it even more important to safeguard your current holdings through careful investing.

The underlying stock is not actually purchased or sold, only the option to do so. Options are complex, and you'll be seeing the following warning on your broker's website: *"Options involve risks and are not suitable for everyone. Option trading can be speculative in nature and carry substantial risk of loss. Only invest with risk capital.*

Even if that statement does not scare them off, many investors , are turned away from option investing whenever they mention options to the typical stock broker. Brokers have been known to throw up their hands and proclaim that "the sky will fall on you!" Few brokers ever learn much about options.

Later in this book, we will go into detail about options as well as some strategies that I will provide for both safety and investment returns. However, for now, let's just say that when you buy an option, you are buying the right, not the obligation, to take certain actions up to the expiration of the option.

Buying options allows you to control stock shares without actually buying the shares themselves. Instead of buying 100 shares of a $50 stock for $5,000, you can possibly buy a $55 (strike price) call option for a few dollars per share. As an example, if you pay $2.50/share for this "call" option, you'll invest $250 plus a small commission. You are now controlling $5,000 in stock shares. If they rise above the $55 strike price at or before the expiration of your option, you'll make the per-share profit without ever owning the stock. If the stock price drops, sits still, or does not rise to $55 or higher, you lose your investment at expiration.

That's a very simple explanation of the simplest of option strategies. There are many more sophisticated option trading strategies, including selling options instead of buying, and we'll be taking a look at those later. This is just the most basic of primers.

Advantages of Options

Options do not require the cash investment needed to actually buy the underlying stock shares. For a fraction of the investment, you can control hundreds or thousands of shares of stock. They allow you to create strategies no matter how you think the market is going to move: up, down or sideways.

Disadvantages of Options

Using options improperly or using very speculative strategies, the investor will frequently lose his entire investment. Even if you are only spending a few hundred dollars to control thousands of dollars' worth of stock, losing the entire investment on multiple trades will require better trading to make up the difference and actually get into profit territory.

In My Experience
Options are the most flexible of all investment instruments, allowing the investor to make money in any market condition (bull, bear, or stagnant) and to protect their stock holdings. Every person with capital in the stock market needs to understand how to use options.

PRECIOUS METALS

Precious metals have always attracted investors, especially in times of political unrest, wars, inflation, and volatile financial markets. Gold, silver and platinum are traded in the markets and are held in many investment portfolios. Gold is the granddaddy of them all, of course, and is highly valued around the world.

The high price of gold makes silver a good investment for many people of more modest means. You can get a lot more silver for $1,000 than that tiny bit of gold when gold is selling for $1,200 per ounce. Silver is spot priced at around $19.50 per ounce today.

Both gold and silver can be purchased in many different forms, from bullion bars to coins. The doomsday "prepper" types not only hoard food for expected calamities, they also hoard gold and silver as a method of barter when paper money is not worth much due to inflation or a massive economic collapse.

Whether your outlook is that pessimistic or not, having some silver or gold around is considered an excellent hedge against inflation.

Advantages of Precious Metals Investment

When inflation rears its ugly head, precious metals normally rise in price because investors flee other assets for the perceived stability of precious metals. Wars and political unrest also scare investors into precious metals. Because gold and silver have always been prized, it is expected that they will be of value if paper money is not.

Disadvantages of Precious Metals Investment

The biggest disadvantage of investing in precious metals is doing too much of it. While metals can be a good choice for a portion of a portfolio to hedge against inflation, they are not easily traded on open markets. There can be a significant spread between the current market spot price and what you can sell your metals for to a trader or broker.

In My Experience
The problem with precious metals is that they don't generate income and they are purchased at retail prices and sold at wholesale. Not a good combination.

COMMODITIES

From that first cup of coffee in the morning, your day is filled with consumerism. We consume gas and oil for transportation, corn for animal feed, fuel and food, and many other commodities. Commodities trading is interesting in that you can control large quantities of a commodity without the hassle of storing or transporting it. Units of measure for commodities contracts include:

- 5,000 bushels of corn
- 40,000 pounds of hog carcasses

- 1,000 barrels of crude oil
- 25,000 pounds of copper

You can see that these are really large quantities with large dollar amounts involved. However, you are not actually buying these commodities, and you definitely do not want to take delivery of them.

Somewhat like options on stocks, you contract to purchase commodities with the right to buy or sell at a certain date in the future (called futures). No matter how much you love coffee, you don't want to wake up one morning and find 37,500 pounds of coffee on your front porch.

When you purchase your coffee futures, you have the right to buy or sell at any time markets are open. The idea is to control a large quantity of a commodity with the expectation that it either rises or falls in value during the life of your contract. If you happen to have a leg that twitches when there is going to be a freeze in South America, you may want to bet on the price of coffee going up soon.

Whether it is corn, soybeans, pork bellies, live cattle, crude oil, heating oil, natural gas or other commodities, you can trade futures and bet on the direction of prices in the open market. However, this is not a game for the uninitiated, and sometimes the initiation can be painful or even bankrupting.

Advantages of Commodities Trading

The main advantage lies in the ability to highly leverage your money and control huge quantities of a commodity with a tiny investment relative to its value.

Disadvantages of Commodities Trading

This is not a game for the timid. If you are betting on coffee prices rising and instead there is a bumper crop, your investment is gone or significantly de-valued. Outcomes are not just dependent upon obvious factors, like, weather – as everything from insects to political problems can greatly influence commodity prices.

In My Experience
Trying to predict the future prices of beef or soy beans should be left up to growers and not the speculators. You will never win this game in the long term.

REAL ESTATE

Real estate is certainly a popular investment strategy for many people. There are several ways in which to profit from real estate, including:

- **Buy-and-hold –** Many a comfortable retirement is financed by rent income from homes, apartments, commercial and retail rental properties. Properties are purchased with an eye toward rising value and a profitable resale in the future. However, the big draw is the monthly positive cash flow from rents that are higher than the combined cost of mortgage payments and expenses.
- **Wholesaling –** Some investors want shorter term profits and specialize in locating value properties that they can immediately resell at a profit to a buy-and-hold or rehabilitation investor.
- **Fix and Flip –** You may have watched one or more of the popular "reality" shows about flipping homes. Some investors will buy a dilapidated foreclosure property and fix it up for resale to a consumer buyer or a rental property investor.

Real estate can be a good hedge against fluctuations in the stock markets or inflation. If goods and services cost more, then it should cost more to build new houses, so prices rise on both new and existing homes. There are also some unique tax advantages in owning income properties.

For more passive investors, REITs can be the best way to go. The Real Estate Investment Trust is like the stock market in some ways. You buy shares in the trust and participate in the income the REIT's properties generate. That's known as an equity REIT, while others exist to buy mortgages, known as the mortgage REIT. The income is generated by the interest on residential and commercial mortgages.

Advantages of Real Estate Investment

I have mentioned that real estate can be a good retirement income generator. Tax advantages are also useful in maximizing income, as you can probably take a depreciation deduction and deduct all expenses and mortgage interest on income properties. REITs must pass a significant portion of their profits through to investors.

Disadvantages of Real Estate Investment

There are a great many "used to be" real estate investors out there because they found out they were not cut out to be landlords. There are others who found themselves holding short term flips when the market crashed, leaving them with properties they could neither sell nor afford to hold. Real estate is not liquid either. It takes a while to sell, and your costs of sale eclipse a stock market commission on the same dollar value. REIT managers do not always make the right decisions, so you are not guaranteed profits.

In My Experience
Real estate investing should be left to those with a lot of time and money on their hands. The rewards can be substantial, but make no mistake, it is a job.

CURRENCIES

After all, this whole book is about money, so we cannot leave out "trading" money. Currency trading involves the control of large sums of foreign currency with heavy leverage, betting on a change in the difference in value between that foreign currency and the U.S. dollar.

So, if you think that there will be developments that will change the exchange rate between the U.S. Dollar and the Japanese Yen, you can invest to take advantage. If the Dollar is worth 120 Yen today, and you purchase 120,000 Yen ($1,000) tomorrow or even later today, the Yen could go up in value versus the dollar. If the dollar can then only buy 110 Yen, you still own the original 120,000 Yen, so you will have the equivalent of $1,090.

Advantages of Currencies Trading

There are two main advantages in trading currencies:

1. The markets are huge, so fluctuations are usually small. Traders can take advantage of a gigantic pool of currency and trade 24 hours/day to take advantage of small swings to make profits through leverage.
2. Leverage can be dramatic in currency trading. Some traders can actually leverage as much as 250 to 1. Of course, with leverage comes risk, so currency trading requires a lot of experience and care.

Disadvantages of Currencies Trading

Because the volatility of currencies is low, it can look like a relatively secure way to invest. However, let's look at an example: If you are using 100:1 leverage and control $100,000 in currency, you are into the investment for $1,000. If the value of the currency only drops by 1%, it is still worth $99,000, but you have lost your entire $1,000 investment.

In My Experience
When you trade currencies, you are trading against the smartest people in the world, and sometimes, the brokerage firm themselves. Do you like your odds of success? I don't.

CASH VALUE LIFE INSURANCE

Cash-value life insurance is a long term life insurance policy that builds cash value over time. The payout at death is the stated value of the policy less any money you may borrow against the cash value at any time. In other words, you may have a $500,000 life insurance policy that has built up a $100,000 cash value since you bought it and have been paying premiums.

You can, according to the rules of the policy, borrow against that cash value at a stated rate of interest. You would then pay it back as you can or at a stated rate. Should you die before it is paid back, your beneficiaries would not get the full $500,000, as there would be some payback of the borrowed funds.

Advantages of Cash-value Life Insurance

Of course, you are buying life insurance to help your family and beneficiaries to carry on in the event of your death. However, should you run into financial difficulties in life, it can be very helpful to have this cash value to borrow to get through a crisis. Also, some investors use the low interest rates for these loans to borrow and fund higher return investments.

Disadvantages of Cash-value Life Insurance

Until paid back, the borrowed funds are deducted from the death benefit paid to your beneficiaries. While some withdrawals are not

taxed, some are, so you are paying taxes and interest on the money borrowed in those cases.

In My Experience
Life insurance should be purchased for its death benefit, not the investment account. Get as much as you need for as cheaply as you can buy it. That means term life insurance.

LIMITED PARTNERSHIPS

Limited partnerships can be family partnerships, or they can be made up of partners from anywhere. They can be used to finance specific projects, and many times such projects are real estate-related. There are two types of partners in a limited partnership:

1. General Partners – The General Partners in a Limited Partnership are like sole proprietors, and they have unlimited liability for the obligations of the partnership. They actively manage it.
2. **Limited Partners –** These partners contribute money in exchange for a share of ownership and profits, but are passive, not participating in management. Dividends are paid to them as their share of operating profits. Their risk is limited to their investment.

Advantages of Limited Partnerships

They are a way for small investors to raise more funds for a project they cannot afford to undertake on their own. There can also be major tax advantages - over time - in a family partnership. Losses for limited partners are limited to the money invested.

Disadvantages of Limited Partnerships

There are very strict laws related to who you can involve in a limited partnership, especially if it is not a family partnership. Consult an attorney to avoid running afoul of these laws. The General Partner(s) will have unlimited liability for obligations of the partnership. Be careful to use proper documentation and partnership agreements, and the ongoing documentation requirements for tax liability can be a bit of a hassle.

Choices, Choices… Choices

You have just been introduced to a number of popular investment choices, strategies and asset classes. Each has advantages and disadvantages, and much of the consideration process really involves determining which choices best fit your short and long-term investment goals and your tolerance for risk.

My goal here was to familiarize you with these choices before guiding you to the secure and profitable investment avenues I believe are overlooked by too many investors. Let's move on now to the 11 biggest mistakes investors make.

Chapter 3
The 11 Biggest Investment Mistakes

"Spend each day trying to be a little wiser than you were when you woke up."
Charlie Munger

Congratulations. You have already embraced Ben Franklin's viewpoint because you are reading this book to increase your knowledge.

One mistake can negate the positive results of doing several things right. When you are starting from a negative position, you have to work twice as hard to get back to zero. Let's take a look at some of the mistakes that I see investors making every day and how to avoid them.

I will give you some examples, but don't assume that they apply only to that asset class. These mistakes cross all asset types, from stocks to bonds, precious metals, options, commodities, currencies, real estate and life insurance. Some of these mistakes involve more than one asset class, such as over-diversification, and not doing your research.

1. BUY-AND-HOLD

Most stock brokerages and many investment advisors will likely tell you: "Buy-and-hold is the best strategy. Your stocks will rise in value over time." It could be true for you, IF it is the right time, IF you are holding the right equities, and IF you don't hold them for too long. However, if you don't have those three criteria working in your favor, you can set yourself back years in your financial growth plan.

The "buy low and sell high" advice we hear so much about is not actually practiced much by the vast majority of investors. They tend to buy low, hold low, hold high, and then too often sell low. They sit back and allow brokers and advisors to keep them in the "hold"

mode until a sudden market correction takes them into loss territory or wipes out most of their gains. Then they tend to sell out of fear.

The buy-and-hold strategy is actually a bit backward if you look at it logically. The investor happens to buy a basket of stocks in a rising market, watches them increase in value, and enjoys the ride. However, with millions doing the same thing and buying many of the same stocks, the most popular equities then become over-valued. The savvy investors, mutual funds, and institutions begin selling to take their profits and our small investor's profits right along with them.

In 2010, Wall Street Journal columnist Brett Arends wrote: *"For years, the investment industry has tried to scare clients into staying fully invested in the stock market at all times, no matter how high stocks go… It's hooey… They're leaving out more than half the story."*

At any given time, stock rating services have been known to rate as many as 95% of all stocks as either "Buy" or "Hold." With the tiny percentage left over rated as "Sell," it is no wonder that investors can be lulled into holding too long. The truth is that many of those rated as "Hold" should be in the "Sell" column. However, analysts are slow to do this because it almost always results in an immediate drop in the price of the shares, hurting those buy-and-hold investors.

Buying any asset and holding it without a plan to take profits, or a plan to exit the investment if problems appear, is just not good investing. It is easy to forget about your investments, but lack of attention may cost you.

2. BUYING BRAND NAMES

What's wrong with branding? This country is all about building brands, marketing them, and building trust in brands. When it comes to consumer goods, the right brand gets the manufacturer the best positioning on store shelves. If branding did not work, you would not see grocery lists with Kraft and Nabisco in front of a number of items.

However, there are some consumers who are taking a look lower down on the shelves for the "store" or "generic" products. They are less expensive because the vast sums of money required for building and maintaining a brand are not required for these generic items. In many cases they are made in the same factories by the same manufacturers as the brand names.

Branding and Investments

Just as they do in the grocery store, people flock to brands in the stock market too. They will pay more for a name brand consumer goods stock than for another in the same industry. Their reasoning is, because they "trust" the name brand. In many cases, investors are steered to the name brands by stock brokers and advisors.

In too many cases, these investors are buying brand name stocks but their timing is not right. Owning these well known companies can be a good move in a rising market. However, these companies are still subject to price drops when the market turns bearish.

Even in a diversification strategy, if only big name brands are held, there can be negative consequences. "Brand" can also apply to a specific type of investment, such as concentrating only on convertible bonds.

There is also the possibility that a broker or investment advisor is simply taking the easy path in recommending a big brand buy-and-hold strategy. It is easier to convince an investor to buy a brand than to buy an unknown. It is also easier to get out of hot water with the investor when a brand stock's price goes the wrong way. *"Who would have thought General Motors was going to be a problem?"*

Brand names are not always a mistake in the stock market, but they are best purchased after some negative event drops the price of a quality company to historically low levels.

In My Experience
Just because you are familiar with a brand does not mean that you should own their stock.

3. LISTENING TO FINANCIAL SALES PEOPLE

Joke: My broker sold me Nortel stock at $130/share, now it's worth $0.47. At this rate, another couple of hundred trades will allow my broker to retire.

Actually, it is not very funny if you are the investor in that position. However, it does illustrate the point that a whole lot of people make money in the financial industries through commissions from buying and selling to others. Many are simply selling the "stock of the day" as passed down from their management.

When you play blackjack, the dealer is not involved in your winnings or losses. They get their salary or hourly wage and tips while you are taking all of the risk. However, they do not make more money the more hands you play.

Your stock broker or advisor is doing one better, in that they actually make more money the more they encourage you to trade.

The IPO Sales Pitch

Initial Public Offerings hold a lot of allure for investors, especially when you look back at major success stories like Google. However, with an IPO, it is anybody's guess how things will go. The brokers, on the other hand, will make a small fortune.

In the Facebook IPO, Morgan Stanley is said to have made more than $100 million, while investors who bought at the $38 initial offering price saw their investments drop by around 18%, in short order.

Knowing who is making money and how they are making it, will help you better evaluate the advice you are being given.

Selling occurs in every asset class and every brokerage out there. Sometimes you just get "sold" on your advisor's expertise, creating a desire to buy whatever they recommend. In the Facebook example, it was obviously a brand everyone recognized, but there was also a lot of selling going on… the next "Google" kind of stuff.

In My Experience
Most financial advisors and brokers are nothing more than telemarketers with a license. The only time you hear from them is when they are trying to pitch you something.

4. INVESTING IN ANYTHING YOU DON'T UNDERSTAND

For the most part, Warren Buffett sat out the entire dot.com bubble. He did so because he did not understand most of the technology and wasn't comfortable investing in those startups. Instead, he kept buying value stocks that were out of favor with prices down from investors moving to the tech stocks. When the dot.com bubble burst and those investors fled back into value, Buffett was richly rewarded.

Sometimes we can make a major investment mistake simply because we like the intended results or impact of a product or service. "Green" investing has turned on many people. There are legions of investors who purchased stock in "green" companies because they like the idea of conservation and saving the environment. Problems occur when the investment is in complicated technology and the investor is not educated in the risks involved. We all want a better environment, but we should not invest in technology that we do not understand.

There can be a strong urge to invest when the opportunity seems great but it is critical that one truly understand the investment. This can apply to anything, even real estate. Many of us own or have owned a home, so real estate is something we believe that we under-

stand. However, jumping into a four-plex with tenants and management requirements could be a big mistake for some.

So how might we find great investments that we do understand? Peter Lynch simply listened to his wife and children after they returned from shopping trips. One of his great investments was in Hanes after his wife brought home some L'eggs she had purchased in a grocery checkout line.

In My Experience
If you don't know the earnings, revenues, free cash flow, and debt structure of a company, you have no business owning their stock.

5. PENNY STOCKS

So just what is a "Penny Stock?" According to the Securities and Exchange Commission, any stock trading under $5.00 per share is a penny stock. Other sources say they are stocks trading under $1.00/share. In general, penny stocks are those trading on the "pink sheets," or the "over-the-counter bulletin board."

Every company starts somewhere, so why would not there be opportunity in buying cheap shares in new companies. One of them may become the next Microsoft or Google. The problem is that rarely will this type of opportunity present itself, and you are far more likely to lose your investment due to the risks inherent in penny stock trading:

- ***Lack of Information*** – Most of these companies are not required to file with the Securities and Exchange Commission, so there is little information available with which the investor can do their due diligence and decision-making.
- ***Lack of Minimum Standards*** – For other exchanges and larger stocks there are minimum standards to remain listed for trading. This is not true for penny stocks.

- ***No History*** **–** With most of these offerings being newly formed companies, there is no performance history on which to base decisions.
- ***Poor Liquidity*** **–** Far fewer traders are buying and selling these stocks. This poor liquidity can make it impossible to sell when you may want to do so. It also allows some to manipulate the prices by buying to drive up the price through buying and then selling quickly, sometimes known as "pump and dump."

When it comes to penny stocks, just don't go there!

In My Experience
I have seen more manipulation of penny stocks than in any other segment of the financial markets. If a stock is trading for less than $5, there is a reason. Just say no.

6. NO EXIT STRATEGY

This is related to "buy-and-hold," in that, you should not enter any investment without having a plan for when and how you will unwind or exit the investment. *Hoping* to sell a stock at 'some point' for a profit, really is not an exit strategy –at least, not one that will work for you consistently.

A formal form of exit planning would be placing a sell order or a stop order in play on a stock you own. If the stock rises in price to a certain point or drops to a danger point, you want the protective order to automatically execute so you end up with either a nice profit, or limited damage on a fall in price.

Another approach might be to plan to sell your holdings in a certain industry's stocks if there is a weakening in the fundamentals, and buy into a different industry. Suppose you have been doing well in utility stocks but see that there is a great deal of bad news for coal-fired power plants. Perhaps you would exit the utilities and move

into another sector that's experiencing better news. This is just one example of an exit strategy.

Exit strategies for options trading are easy in that you are buying or selling options with definite expiration dates. Your trade ends at expiration, win, lose or draw. Your exit strategy is in place from the moment the trade executes. Of course, you can exit earlier, but that would be based on factors that change your plan.

In a rising stock market you can do OK just buying and holding while prices rise. The problem is that, unless you have an exit strategy that will at least protect your profits, you may find that you have wasted months or longer watching the value rise, only to experience a crash that eradicates your hard-won profits.

If the only exit strategy you have in this case is to place a trailing stop order, that's far better than nothing. This is an order to sell on a drop in price, and it follows the stock up as it rises in price. Should bad news hit and the stock starts to fall, your order would kick in to sell and protect much of your gains.

Exit strategy planning is crucial in all types of investing. Even when you are buying rental properties, you should have some plan in place to sell when the timing is right. Perhaps it is when there is a nice price uptrend in place and you believe the market may be about to cool off again. Selling a property and rolling your profits into a higher value rental with a 1031 Exchange with tax deferral could be your plan.

We'll be examining a number of market and trading strategies and techniques, and we'll always have some type of plan or exit strategy to get out of the trade, whether we are reaping profits or protecting them.

In My Experience
You should know under what circumstances you will sell a stock BEFORE you even buy it.

7. LACK OF HEDGING

The easiest way to think of a hedge in investing is as insurance against negative events or losses. Investors hedge their positions to minimize losses or to avoid them completely. The difference can be related solely to the cost of the hedge.

When you buy home insurance, you are hedging yourself against a fire, theft or other damage to your home or possessions. It is much the same with investments. Perhaps you own a large position in a stock, and you want to hedge yourself against a drop in the price of the stock.

Using options is one way to hedge against a loss in a stock position. We'll discuss this in greater detail later, but our goal is to protect ourselves when an earnings announcement is coming. We are optimistic, but just in case there's bad news, we want to hedge against a quick drop in the stock price.

We can do this by buying a Put Option. This option gives us the right to sell the stock at a specific price - our insured level. Let's say we own the stock and it is trading at $60/share, and we have a significant profit in it so far. We want to hedge against a temporary threat of the earnings announcement, so we buy a $55 put. This allows us to sell the stock at $55, no matter how far the price drops should a bad earnings announcement occur.

At or before expiration of our Put, it will gain in value based on how far the stock drops in price. So, you can see that we are going to be gaining back in the Put value the amount we are losing on the stock price. That's a hedge.

Buying gold and silver can be a hedge strategy against economic or political turmoil. Hedging stock market risk with bonds or hedging your holdings in dollars with currencies of other countries are also strategies used by some investors.

The mistake made by many investors is in not having any type of hedge against losses. In some cases, a hedge is too expensive, or we cannot protect ourselves as much as we'd like due to the cost of a

hedge position, but we should always be investigating the possibility of protecting a large investment.

In My Experience
Hedging lets you fight another day, even when you make a bad decision. Win often and lose little.

8. RIDING LOSERS TOO LONG

Actually, most market losers are actually normal investors who are not "playing" the market. They are usually people like us who get into a stock position because they like a company, or it is a company they have made money on in the past. The fastest way to make a big pile of money much smaller is to ride a losing stock down. Sometimes it is because the investor is not paying attention, or is letting someone else handle their buying and selling.

This mistake is related to our previous discussions of hedging and exit strategies. Sometimes you don't have to spend money to hedge a position; instead all you have to do is use your planned exit strategy in case of a negative development. The point is to take action early and stop the losses in their tracks.

You can hold any investment for too long, from gold to real estate. All asset markets are cyclical, so you should plan to liquidate a position if it begins to lose value. You are either locking in profits or avoiding bigger losses.

Falling in love with an investment is very dangerous, as it has caused many investors to hold on too long, thinking that it cannot get much worse. It is really distressing to have held an investment for many years with great gains only to see your gains disappear.

In My Experience
When your horse dies, jump off. Don't let your ego or pride turn a small loss into a large one.

9. NOT DOING YOUR HOMEWORK

"All I'm armed with is research."

Mike Wallace

Homework in investing is known as "due diligence" in business circles. Buying and selling businesses or shares of stock in a business requires that you research the company's fundamental business practices and financials.

If you have ever been involved in the due diligence of a company about to be purchased or taken public, you would have seen weeks or months of research into documents, expenses, income and every other area of the business. Accountants scrutinize the company, usually taking over office space there so they have fast access to every piece of paper on file.

Most likely, you do not employ a staff of accountants. However, you do have a great deal of information available to you in corporate announcements, financial statements, and on Internet market research sites. Buying a stock just because some analyst recommends it is not the way to convert small piles of money into large ones.

Due diligence applies across asset classes and investment strategies. Even if it may seem simple to buy-and-hold gold or silver, you still need to do research to determine in what form you should invest: bars, collector coins, or legal tender coins.

With real estate investing a huge amount of due diligence is necessary in order to make the right decisions. "Location, location, location" is the common mantra of successful investors. It is critical to thoroughly research an areas pros and cons.. You cannot stop there, however, as you still need to know what size home, number of bedrooms and baths, and so forth, will attract the best renters for that specific location. Also, you'll need to examine your competitors and their properties and rental rates.

One of the biggest mistakes many investors make is to simply take someone's word for value rather than doing their homework and getting to the basics of how the company is doing, as well as, exam-

ining the company's prospects for continued profits and stock price growth.

In My Experience
Remember what happened in school when you forgot to do your homework? In the stock market, you don't get a bad grade. You go broke!

10. THINKING BONDS ARE SAFE

We read the headlines periodically: *"Investors flee to the safety of bonds with recent market volatility."* In general, government bonds are considered to be a really safe investment since they are backed by the ability to tax to pay the debt.

However, corporate bonds, particularly in very large and respected corporations, are also considered safe in relation to stocks. In a corporate bankruptcy, bondholders have a place in line in front of stockholders and other stakeholders. However, this does not mean that they will get all of their investment out if there is a problem. In fact, in a corporate bankruptcy, few bondholders exit the situation undamaged, with the majority losing some or all of their investment.

If you think "bigger is better," sometimes it is far worse. The government involvement in the "too big to fail" General Motors bankruptcy, is an example. The government forced a settlement placing bondholder interests behind those of retirees and unions.

Bonds have a place in many investor portfolios, but they are not the slam-dunk "safe haven" many seek. Their lower returns are the trade-off for perceived safety, and it is really depressing to find out that you gave up higher returns, only to be left hanging when your corporate bond investments are lost in a bankruptcy.

In My Experience
Bond values move the opposite direction to interest rates. When interest rates move higher, bond holders lose money.

11. OVER-DIVERSIFICATION

It is easy to make the wrong decisions when just about everything you read and every investment advisor you consult preaches the diversification mantra. Diversification should be a hedging strategy, not a profit strategy.

Spreading yourself too thin into many different asset classes or even in different company stocks across an industry can actually hurt your profits even when there is not any negative information or need for a hedge.

Let's say that you have nice retirement account, maybe an IRA you have been building for years. You have several hundred thousand dollars to invest, and you are very risk-averse.

You buy some stocks, bonds, real estate, gold and silver. Now you are VERY diversified and you feel really safe. You may be protected from some negative market movement, but you have managed to split up your nest egg across too many investments. You don't have enough in any one of them to profit well from positive movement.

Let's say you actually sold some of your holdings in Google at $400/share to buy some of that real estate, gold and silver. You feel a lot safer, but then, when Google hit $800/share, it definitely made you feel more sorry than safe. Now, with Google at more than $1100/share, you have overly protected yourself, at the expense of profits.

Life's a balance, and so is investing. Diversification is a tool that you should employ, but don't let it become your primary investment strategy.

In My Experience
In my opinion, there is no way to keep track of more than ten positions in your portfolio at one time.

Now you know what not to do!

Let’s move on to talk about the mistake of choosing the wrong

help.

Chapter 4
Your Broker is Not Your Friend

"A stock broker urged me to buy a stock that would triple in value every year. I told him: 'At my age I don't even buy green bananas."

Claude Pepper

It is a funny joke that illustrates an investing fact: many brokers are not acting in their clients' best interests. This joke's example is of an older person who does not want to take risks, even for a bigger *possible* return.

Joke: It was so cold today I saw a stock broker with his hands in his own pockets.

In this chapter we are going to discuss three major factors that illustrate clearly that your broker really is not your friend when it comes to providing investment device. Those three factors are:

1. They have multiple conflicts of interest.
2. They are trained to sell, not make money in the market.
3. They are often poorly educated in the varied investment vehicles and asset classes.

Let's deal with items 1 and 2 first, as they both focus on money and commissions which create conflicts of interest for the brokers.

BROKER COMPENSATION AND CONFLICTS OF INTEREST

OK, let's imagine you are a plumber. You have customers who trust you implicitly, and they know NOTHING about plumbing. They are just high income homeowners who want all of the stuff that's sup-

posed to flow out of their house to do just that. They also want all of the water they are supposed to have flowing into the home to do that as well. In other words, they want good plumbing results.

Now, you are about to have to do some repairs to both the supply-side and the waste-side plumbing:

1. They are concerned about the quality of their water. They want some filtration to take care of impurities and bad tastes and smells in their water supply.
2. They have experienced slow flow in their master bathroom sinks and want you to make it better.

There are any number of ways in which you can correct both of these situations. Let's look at the alternative solutions versus what you, the plumber, will make in compensation.

1. **Water filtration –** You can simply install a long-lasting reasonable quality filter with cartridges that you'll change on a quarterly basis. You make a $300 profit on the install, and around $100 per trip to change the filters.

   OR… You can install the GOLD level super filtration system with multiple stages and three filters that will need to be replaced every month. Your profit on the install is $800, and your monthly trips will be around $250 in profit each. That's $3500 more profit in the first year. Lucky for you the plumber, your customers have the money, and take your advice to buy the GOLD level super filtration system.

2. **Slow drains –** You can simply blow out their partially-blocked P-traps, with a total cost of around $150 and tell them to be more careful about keeping the drains clean going forward…
3. OR… You can sell them new GOLD level P-traps with cleanout plugs and a maintenance contract to come in every three months and clean them out– with a cost around

$150 for each. Again, your customers can afford the GOLD choice, and, they trust you, and they just want their drains to… well… drain.

The purpose of this illustration is to get you, the reader, to consider why a particular product or service is being recommended to you. In most instances, the offer will likely be the product or service that is in the seller's best interest, not necessarily yours.

THE BROKER

Now let's suppose that you are a broker in a major firm with clients who rely on your advice for their investing. In walks a well-heeled middle-aged investor who asks for advice on re-allocating a significant amount of money, that they believe is not performing for them. They are not completely risk-averse, but they want to make profits without waking up in fear in the middle of the night.

You have multiple choices for products that will produce low-risk returns that your clients will find acceptable:

- Variable annuities with a 7% commission.
- Bonds with a 3% commission.
- Mutual funds with a 1% commission.

Now if we are talking about $1 million, this is the difference between $70,000 in commissions on the annuities and $10,000 on the mutual funds. If this scenario does not represent a conflict of interests, I don't know what does! And, it is not just the individual broker's desire for a higher commission, as there are other factors at play, such as:

- Management pressure to push certain products to clients.
- Revenue goals and quotas passed down from above.
- Highly variable commissions on different products.

You can see from both our plumbing example and brokerage example that the clients may have no inkling of the conflicts that exist and how big a difference they make to the service provider. In most cases the customers may never know there could have been better results if different products were offered.

Training to be a Broker

First, get that college degree. NO, wait! You don't need one. OK, then do your own investing in all types of assets to gain experience. NO – you don't need to do that either. Well, then enter a formal supervised apprenticeship for several years to hone your skills before you begin advising clients. Nope, don't need to do that either.

From the "How Do I Become a Stock Broker?" page at a website targeting those who want to become stock brokers and pay for training to pass the exams:

"Firms are looking for individuals who can create commissions for the firm. If you are well connected or are "sales oriented" and can generate new leads and accounts, firms like Merrill Lynch, JP Morgan, etc., will be a good fit – since your income will depend upon the commissions you generate."

On this same site the wannabe brokers are told that they will have to take either the Series 6 or Series 7 exam to become fully qualified, but the firms look mostly at sales ability and can train you for the exam.

So, if your Uncle Phil is a veteran on Wall Street, or you have a great track record selling high dollar vacuum cleaners, you'll be in the front of the line for acceptance in a broker training program. That program may teach you how to pass the exam, but it really focuses on teaching you to sell the products of the firm that will be hiring you.

Real-life Broker Experience

Let's take a look at the testimony of McKyle Clyburn in the government trial against Sky Capital. Mr. Clyburn began his career in the investment world while in high school as an intern at the age of 17. When he was describing his first experience as a stockbroker, he said he "lied about pretty much everything, including my age."

We are given even clearer insight when Clyburn, who was asked if he had ever read the warnings and disclosures in documents he had his clients sign, responded by saying, *"No, I didn't need to. I don't like to read."*

Becoming a stock broker requires attending a 5-day class. In some states it takes two years of training to become a hairdresser. There's far less chance of financial ruin from a botched haircut.

OK, I think I have made my point about the education requirements related to becoming a stockbroker. I am not trying to tar the entire group with a broad brush, but you need to understand that a stockbroker is not in business to make money for you.

It is Your Money – You Make the Decisions!

If I have achieved my goal for this chapter, you are in the perfect frame of mind to move forward in this book. You now understand that you need to take control of your investing. You'll be interested in learning everything I am sharing because you are the one who absolutely, positively has your own best interests at heart.

Follow the Money to Prove My Point

The Consumer Financial Protection Bureau (CFPB) released a study of consumer financial services marketing. The study focuses on the size and scope of the financial field and where the major firms spend their marketing and financial education dollars.

The findings show that each year financial services companies spend about $17 billion on marketing. That's around $54 per person per year.

The breakdown is:

> 56% was spent on loan-related products like credit cards, car loans and home equity loans.
>
> 24% was spent on advertising about banking services.
>
> Roughly 19% was used to advertise other services, including ATM networks, credit counseling, check cashing and consumer finance promotions.

Now let's compare what these companies spend on financial education. It is $670 million, or around $2/person. Follow the money to see where these companies place their emphasis.

Chapter 5
Trading is The Perfect Business

"My father told me, never have partners."

Howard Hughes

Howard Hughes did it alone, but he did it the hard way too. You are about to learn about the perfect business. Trading. Whether it is stocks, bonds or options, trading can be the best of all businesses, if you want control and a low cost-to-income ratio.

Let's look at the other end of the spectrum - maybe opening a retail clothing store. You are going to be juggling a whole lot of costly balls, including:

- You'll need a location, preferably in a high foot traffic consumer mall (high rent).
- There will be modifications to the space for a clothing business, as well as shelving, racks and other fixtures necessary for this type of business (high cost fixtures and remodel).
- You'll need to have a good insurance agent, as you'll need liability, hazard, and inventory insurance (high premiums).
- You will need to be ready to fill the store with inventory, whether purchased for cash or on some sort of floor-planning setup with interest (lots of money).
- You will have to hire employees, pay their salaries and benefits, as well as payroll taxes (heavy overhead burden).

You must start planning and ordering marketing in newspapers, magazines, on TV and the radio. You'll need a website too (heavy startup marketing costs).

I think we have seen enough. And, if all of this does not go as planned, you'll find out why a large percentage of new businesses fail in their first two years of existence.

Low Startup Costs

What do you need to get a trading business going? You need a brokerage account or maybe an options account depending on your business plan. Brokerage and trading firms are clamoring for your business and to hold your assets, so you are not going to be paying them a fee for an account.

You may want to use your computer or smartphone for trading, but you already have these items, most likely, and there's no special equipment necessary. You'll be trading online or by phone.

Startup Costs = $0

No Employees



"Your hard work has paid off, Harold. I've decided to give you a $3 an hour raise. But it cost $4 to process it, so we'll be deducting $1 an hour from your pay."

The people who will be executing your trades and who do the accounting and management of your trading account are paid by someone else. You don't have wages, payroll taxes, benefits or any other costs for hired help.

The firm soliciting your account will open it for you for free, and will take care of all of those employee-performed services as a part of their business model and fee structure. However, the fees only come with the actual trading, so there are no weekly or monthly charges.

Employee Costs = $0

No Inventory

It is exhilarating to conduct buying and selling without actually having to hold the items. You have no inventory. One day you may purchase 1000 shares of stock, and another day it may be 10 options contracts. If you are selling short, you are actually selling stock you don't even own. You are borrowing it from your broker with the intent of selling at current prices and buying it back at a later date at a lower price. Instead of buying high and selling low, your aim is to sell high and buy low.

Imagine this is like selling merchandise at retail prices that you currently do not have in stock, but later fulfilling your customer's order after you have purchased the item at wholesale.

Inventory Cost = $0

No Overhead

Forget rent for a store location. Ignore insurance and utility costs. Definitely don't even think about a massive marketing budget for multiple media venues. Don't think about display equipment or cash registers and the like. Anything you need is already in place for your trading business.

Overhead Costs = $0

No Office Space

Get out of bed in the morning and head for the coffee pot and you'll pass multiple places to conduct your business. From the living room couch to the kitchen table, your office is already in place. You don't need to buy any office equipment or rent space to house it. If you are a bit on the techy side, you'll be able to carry your office around with you as a notebook computer, tablet or smartphone.

Office Space Cost = $0

Work Just Minutes Each Day

This is not a book on how to make your broker rich with frequent trading. I am going to teach you solid low-risk strategies that will grow your assets, and you will not be hovering over a buy-sell button like a crazed day trader.

In fact, those minutes you'll spend on many days will simply be checking your existing trades and positions to make sure they are still performing as planned. You'll take a look, see that they are on plan, and then you can go fishing if you want.

Even when you are trading, your major time expenditure will be in research, which is the due diligence to craft a profitable trade. Using the amazing websites and technology research resources available today, you'll be able to "run the numbers" for a potential investment in short order.

Not Time-Intensive

Proven Business

The first stock brokers were regulating agricultural communities for the banks in 12th Century France. You are not learning about "secret handshakes" or strategies in beta testing. If you are not being exposed to risky unproven strategies, why is not everybody a trading expert? Simply, few people have been exposed to the proven strate-

gies I am going to give you in this book. These resources and tools have been around and have proven to be effective, but they are not the ones most brokers are "selling."

The trading business is solid and it is one you can perfect to the point of amazing profits and success. That's because the techniques and fundamentals are tried and true, and you just need to understand when, where and how to use them.

Not Experimental

Never Becomes Obsolete

Companies come and go, stocks go under, and bonds mature. Options expire. However, those are just the cycles of market trading, and there are always buyers and sellers. If you jumped into the fray making Hula Hoops, you would know what becoming obsolete means. It can be all the rage one day and gone the next.

However, if the Mega Hula Hoop Company went broke and was removed from the stock exchange, then you simply trade shares or options of the Mega Pet Rock Company, then… well you get the picture. Once you learn the strategies and techniques in this book, you'll make them pay off for you for years into the future.

Always Effective

It Does not Get Any Better

So, let's take a look at your new business and a typical day.

- You get up in the morning and walk through your office to get some coffee, if you like. No commute, no tie, not even any shoes, if that's what you want.
- You check your stock prices and option positions for about five minutes, unless you need to make a change.
- You log into your favorite company fundamentals research site, maybe your brokerage's website, and check out a pos-

sible option trade on a certain company. You like the potential and it is not risky.

- You log into the trading desk and place your trade. Your day has now been maybe a half hour or so long, and you have managed your business affairs effectively.
- Just before the market closes that afternoon, you check your positions again. All is well. (And, even if you happen to be out and about, you may jump onto the mobile trading site and check your positions!).

Like I said, it does not get any better than this!

In My Experience
Many of the most successful people I meet are self-employed. They work hard, but they derive a sense of control in their lives because they are their own boss.

Chapter 6
The Power of Compounding

"Compound interest is the eighth wonder of the world. He who understands it, earns it ... he who does not ... pays it."

Albert Einstein

Compound interest is simply defined as interest paid on the interest you earn. As a savings account or other account earns interest, periodically the interest is "compounded," and then future interest accrues on the previously paid interest as well as the principal amount.

So if you place $10,000 in a savings account earning 3% interest and compounded annually, this means that the $300 interest earned the first year is compounded in the account and the second year the interest is accruing on $10,300.

This chapter is going to be mostly numbers, but the best way to illustrate the power of compounding is with actual dollars, real interest rates, and growth over time. We'll start simply, with $10,000 deposited into an account with no additional deposits made over the life of the deposit. In the second set of examples, we'll look at starting with $1,000, but adding $50 per month.

Simple Compounding – No Additional Deposits

Let's start with annual compounding, meaning the interest is added in for compounding only once each year. The dollar amounts show what your account would grow to if you did not add any money and just waited and let all of your interest accumulate and compound.

Rate	Compounded Account Balance Each 5 Year Period				
	$10,000 Orig. Deposit with Compounding Once Each Year				
	5 Years	10 Years	15 Years	20 Years	25 Years
3%	$11,593	$13,439	$15,580	$18,061	$20,938
5%	$12,763	$16,289	$20,789	$26,533	$33,864
7%	$14,026	$19,672	$27,590	$38,697	$54,274
12%	$17,623	$31,058	$54,736	$96,463	$170,001
20%	$24,883	$61,917	$154,070	$383,376	$953,962
25%	$30,518	$93,132	$284,217	$867,362	$2,646,978

Now let's look at the same situation, but we are going to add in the interest quarterly for compounding.

Rate	Compounded Account Balance Each 5 Year Period				
	$10,000 Orig. Deposit with Compounding Quarterly				
	5 Years	10 Years	15 Years	20 Years	25 Years
3%	$11,612	$13,483	$16,657	$18,180	$21,111
5%	$12,820	$16,436	$21,072	$27,015	$34,634
7%	$14,148	$20,016	$28,318	$40,064	$56,682
12%	$18,061	$32,620	$58,916	$106,409	$192,186
20%	$26,533	$70,400	$186,792	$495,614	$1,315,013
25%	$33,619	$113,021	$379,959	$1,277,365	$4,294,315

Check out how those numbers grow with either an increase in the interest rate and/or the length of time. Then the quarterly compounding can make a gigantic difference in your returns. Now we'll take a look at starting a savings or investment account with annual or quarterly compounding, but starting with only $1,000. However, you are going to deposit $50 each month into the account.

$1,000 + $50/month compounded annually:

Rate	Compounded Account Balance Each 5 Year Period				
	$1,000 Orig. Deposit + $50/month and Annual Compounding				
	5 Years	10 Years	15 Years	20 Years	25 Years
3%	$4,344	$8,222	$12,717	$17,928	$23,969
5%	$4,592	$9,176	$15,026	$22,493	$32,023
7%	$4,853	$10,257	$17,836	$28,467	$43,377
12%	$5,574	$13,635	$27,841	$52,878	$97,000
20%	$6,953	$21,767	$58,628	$150,350	$378,585
25%	$7,976	$25,265	$94,234	$292,503	$897,573

$1,000 + $50/month compounded quarterly:

Rate	Compounded Account Balance Each 5 Year Period				
	$1,000 Orig. Deposit + $50/month & Quarterly Compounding				
	5 Years	10 Years	15 Years	20 Years	25 Years
3%	$4,385	$8,315	$12,879	$18,179	$24,333
5%	$4,666	$9,367	$15,393	$23,119	$33,024
7%	$4,970	$10,587	$18,533	$29,775	$45,681
12%	$5,837	$14,572	$30,350	$58,845	$110,312
20%	$7,613	$25,160	$71,717	$195,246	$523,005
25%	$9,030	$36,027	$126,786	$431,904	$1,457,667

If you have five or six figures in savings, you can see how quickly the balance grows with compounding. However, the second two charts show that you can build up a sizable nest egg by starting small but adding money regularly.

Compound interest can do wonders with your money. If you are in debt and your credit cards are getting compound interest from you, it is a whole different ballgame. It is far better to retire high-interest debt first and roll those payments into investments.

By the way, you can run your own compounding calculations at www.investor.gov/tools/calculators/compound-interest-calculator. This calculator can help you plan a savings or investment account's return over time.

In My Experience
Due to compounding, the rate of return one receives on their capital is far more important than the amount of capital invested.

Chapter 7
The Mindset of an Investor

"Sometimes your best investments are the ones you don't make."
Donald Trump

Joke: Quick, my light bulb just burned out… SELL MY GENERAL ELECTRIC STOCK NOW!!!

This joke is not as far-fetched as it may sound. In this chapter we'll look at some mental characteristics that help to create a successful investor and which help to keep them that way. They are mostly going to be related to a personal confidence that will grow in you and help you overcome emotion-based investment decisions.

Positive

The investor begins his day with a certainty, a positive attitude that proper investment decisions were made and contingency and exit strategies are in place in case things change suddenly. Later in this chapter, we'll talk about mindset and how this positive attitude comes about, as well as other mental characteristics that feed it.

Successful and careful investors do not wake up in a cold sweat at night in fear of what the markets will do when they open in the morning. Exit and hedging strategies are in place, so even if an unexpected event triggers exaggerated market moves, the positive investor will simply deal with it because they are prepared.

Decisive

An interesting thing happens to some investors when their knowledge level increases and they understand an investment strategy. They can be overcome with "Analysis Paralysis," making them

unable to pull the trigger on an investment because too many possibilities are rolling around in their minds.

If you are positive that you understand the fundamentals of an investment strategy and you have done your due diligence, then there should be no reason to hesitate, and a decision should be easy. You may decide to walk away from this investment or you may choose to jump in. The important thing is that you are able to make the decision with help from the other mindset characteristics in this chapter.

Developing a plan, having a stated endgame, and following your plan will boost your confidence and help you be decisive.

If you encounter an enticing opportunity that falls outside of your predetermined game plan, have the discipline to dismiss it. Continue to search for trades that fall within your well thought out guidelines. Keeping your focus will keep you on track. Once you are an active investor you'll also end up on the radar of stock brokers and pitchmen for every new IPO and penny stock out there. With a strong plan and the discipline to stick to it, you'll be able to be decisive in dismissing these pitches.

Unemotional

For every buyer in the markets, there is a seller, and they both think they have the upper hand. If you could be a fly on an investor's wall on any given day, you could see a whole range of emotions. However, if you only land on the walls of highly successful investors, you are not going to see wild elation or despair. You are going to see business-like decision making because these investors are prepared and educated.

Like the joke states at the beginning of the chapter, emotion makes for poor financial decisions. Fear grows when we are not confident in our abilities, and we make poor decisions. Fear is a very influential emotion. So is greed.

Emotion causes commotion, and you don't want commotion in your daily investment activities. Combining the positive mindset at-

tributes we are discussing here, you should be able to create a structure for your investment activity that contributes to unemotional and decisive investing.

Fully Informed

To become "fully informed", you must learn an extensive amount of knowledge. First, you need to educate yourself – and reading this book will achieve that. However, you then need to take what you have learned and successfully employ the due diligence in order to thoroughly understand the asset and the probabilities involved in your investment.

This process is required in every asset class and investment strategy, but as an example, let's use a simple stock purchase, with the objective of value growth in the near to intermediate time frame. To be fully informed, we would need to:

- Thoroughly understand the company and their products and/or services.
- Have a clear picture of the historic performance of the stock's price in up, down, and static markets.
- We need to understand the bigger picture - the status of the industry sector for this company and the market as a whole.

  It is critical that we know when earnings are to be reported, and have numerous analysts' opinions on what that report should say. However, these opinions are merely validation for our own due diligence into the fundamentals of the company: assets, liabilities, income, expenses and management.

Being fully informed also means keeping up with national business events and trends, as well as government activities that could influence this company's future.

Have a Global View

We don't live in a glass bubble. We live in a world where countries are coming closer together in many different ways and which are interacting economically due to better technology and communications. An industry sector can be impacted positively or negatively at any time by actions taken anywhere around the globe. When you read or hear about America exporting jobs and importing products, you need to understand the impact these actions may have on your investments.

Events around the world, positive or negative, are influencing stock prices daily. Just take a look at a chart of the overall stock market with major global news announcements superimposed on it. You will see that major events happening around the world can turn markets on a dime. New tensions in the Middle East can create higher prices in defense stocks and lower prices for other large segments of the market.

Success Builds on These Mindset Characteristics

If you are well-informed, with a global view of economic factors, you'll be able to make better decisions without allowing emotion to derail your investment strategies. For instance, knowing the factors that influence the profitability of the technology company stock you have purchased – particularly when foreign companies are competitors– helps you to avoid stress and emotional buy-sell decisions.

In My Experience
Once you can evaluate the risk and reward of any trade, it allows you to take that trade with complete confidence.

Chapter 8
Opening Your Trading Account

"Know what you own and why you own it."

Peter Lynch

Peter Lynch's quote is appropriate here since we are going to discuss brokerages and services. If you turn over decision-making to someone else and you stop paying attention, it can lead to mediocre results or worse.

Opening Your Business

As we discussed before, the great news is that you are not going to need office space, employees, inventory or overhead. Your business *is* your brokerage account, and the provider of those brokerage services will be providing all of the overhead-intensive business components.

Your business will be totally operated and will be financially reported within your account, either via mail, online or by phone. Today's online brokerages offer complete research and trading tools and order executions. They report to you via paper statement and online access. Some offer ancillary banking services, such as check writing.

Let's take a look at three major categories of brokerage, full service, online brokers, and options specialists.

FULL SERVICE BROKERAGES

Over at Investopedia.com, there is a pretty good definition of "full service broker": *A broker that provides a large variety of services to its clients, including research and advice, retirement planning, tax tips, and much more. Of course, this all comes at a price, as*

commissions at full-service brokerages are much higher than those at discount brokers.

You rarely see a "full service" lane at gas stations anymore. When you do the price for that full service is higher than the self-service lanes. The reason for the increased price being that the gas station employee providing personal service to you, must be paid, in the form of wages and benefits.

Full service brokerages are the choice of many investors, as can be noted from the size of these firms. Some investors may find that a full service brokerage is right for them due to the ancillary products and services. A cost comparison needs to be done to ensure that the extras are both useful and cost effective. Regardless, I would caution you against turning over the decision making to someone else. Taking control of your own investments is the purpose of this book. . .

In 2012, various surveys of brokerages report the following about some of the largest:

Merrill Lynch

- 17,300 brokers
- 722 branches
- Sadly, a post market crash survey by the research firm Forrester reports that only 40 percent of the firm's customers agreed with the statement that "my financial adviser does what's best for me, not just its own bottom line."

From their website: *Following the combination with Merrill Lynch, Bank of America has become:*

- *The largest brokerage in the world, with more than 15,000 Financial Advisors and approximately $2.2 trillion in client assets*
- *A leading provider of global corporate and investment banking services, including commercial lending, global high-yield debt, global equity and global M&A*

- *A global leader in wealth management, private banking and retail brokerage*

Raymond James

- 5100 brokers
- 2350 branches
- A survey by J.D. Powers & Associates found that customers of Raymond James gave their interactions with their advisors very high marks.

From their website: *Founded in 1962 and a public company since 1983, Raymond James is a diversified financial services holding company with subsidiaries engaged primarily in investment and financial planning, in addition to investment banking and asset management. Our stock is traded on the New York Stock Exchange.*

Edward Jones

- 12,300 brokers
- 11,450 branches
- Edward Jones was one of the best at stock picking in 2011, outperforming the S&P 500 Stock Index.

From their website: *If you think Edward Jones is like every other large investment firm, think again. We are a leader in the financial services industry, but we take a personal approach to business, an approach that starts with a face-to-face meeting between a financial advisor and you.*

MORGAN STANLEY SMITH BARNEY

- 17,650 brokers

- 765 branches
- Morgan Stanley purchased Smith Barney after the financial crisis. Comments seem to be that this very large company is struggling to improve on low marks given by their customers on their relationships and costs.

From their website: *Since its founding in 1935, Morgan Stanley and its people have helped redefine the meaning of financial services. The firm has continually broken new ground in advising our clients on strategic transactions, in pioneering the global expansion of finance and capital markets, and in providing new opportunities for individual and institutional investors. Click below to see a timeline of Morgan Stanley's growth, which parallels the history of modern finance.*

UBS

- 11,200 brokers
- 300 branches
- This brokerage gets good marks for their website and customer satisfaction.

From their website:

- *Headquartered in Zurich and Basel, UBS is a global firm providing financial services to private, corporate and institutional clients.*
- *UBS is present in all major financial centers and has offices in over 50 countries.*
- *UBS employs approximately 62,000 people around the world.*
- *UBS's historical roots stretch back more than a century.*

Wells Fargo Advisors

- 15,200 brokers
- 1,500 branches
- A J.D. Power report ranked Wells Fargo low in customer satisfaction due to poor stock recommendations and high fees.

From their website: *Wells Fargo Advisors is one of the nation's premier financial services firms, serving and advising clients nationwide through more than 15,000 Financial Advisors. As the heir to some of America's most respected regional firms, which came together through mergers over many years, Wells Fargo Advisors has retained a strong and abiding commitment to exceptional service based on trust and knowledge and a determination to put client needs above all else.*

Each of these major full service brokerages offers a laundry-list of services and account features, some including checking and debit cards. In my chapter about your broker not being your friend, I made the point that they are compensated not on how your investments perform. Instead, most of these brokers are sales people, and they are pushing products as instructed by their management.

Another thing to remember concerns surveys and ratings. Every year is a new one. A firm that gets great client reviews for stock picks in 2011 may be at the bottom of the pile for satisfaction in 2012. The problem is that you will not know that until 2013, when it is too late. Also, a common complaint is about high fees, but you hear it less when the stocks they pick work well for their clients.

When opening a full service account, you are lured with multiple services and claims of performance. A frank discussion with examples and the costs for each service or trade is absolutely necessary. If you want to be primarily hands-off with your investments, a full service brokerage can work for you. However, balance what they are promising to provide with the costs of services.

I don't want to imply that you cannot make your own decisions about which stocks to buy if you use one of these full service brokerages. However, they will constantly pitch their recommended products.

Also, if you are going to do the research and control the trades, why would you want to pay higher fees for services you are not using? You are paying for those hundreds or thousands of branch offices and the overhead to maintain them. If you don't need to stand in front of a broker and get their advice, consider the next category of brokerage: online brokerage.

Online Brokers

Some of these online brokerages also offer research reports and even stock recommendations. One major reason for the lower cost is because you are not paying for highly compensated full service brokers. Another cost saving factor is that you are making most or all of your trading decisions rather than the brokerage making them for you.

In today's high-tech and mobile world, you may find that an online brokerage is a great resource. Many will have Smartphone apps that allow you to do almost everything that you can do on a desktop computer. Most will have online research resources and tools to help you with fundamental research and performance charting.

Kiplinger rated their picks for the top ten online brokerages in 2012. Let's take a look at how they ranked them, why, and also, some clips or shots from the websites of each.

*# 1 E*TRADE*

Kiplinger put E*Trade in the number one position due to top ratings in investment choices, user experience and customer service. This online brokerage was rated lower for its costs, however. One positive comment was the offering of 92 exchange traded funds without commissions.

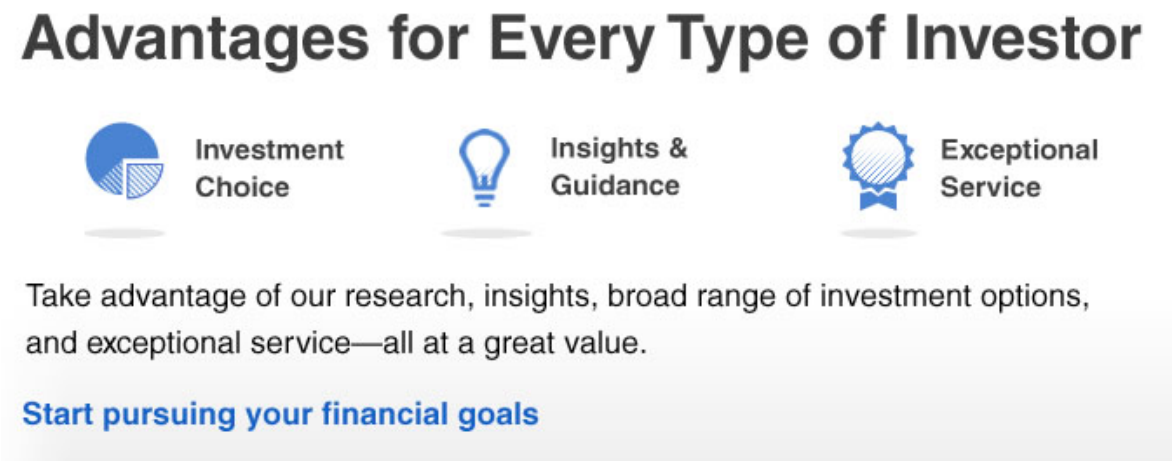
From their website: *E*TRADE is an innovative financial services company offering a full suite of easy-to-use online brokerage, investing and related banking solutions, delivered at a competitive price. We empower individuals to take control of their financial futures by providing the products, tools and services they need to meet their near- and long-term investing goals.*

*We provide these services to customers online and through our network of customer service representatives, investment professionals, and investment advisors – over the phone and-in person at our 30 E*TRADE branches.*

#2 Fidelity

Fidelity took high honors for additional banking services, research and tools, and user experience. However, this brokerage got low rankings for costs and customer service.

From their website:



#3 Scottrade

Scottrade's highest marks were for user experience and banking services. They offer no-fee checking and free ATM withdrawals. As far as cost, Scottrade rates better than E*Trade and Fidelity.

From their website: *At Scottrade, it starts with our clients and their needs. We share their passion for trading and investing, and*

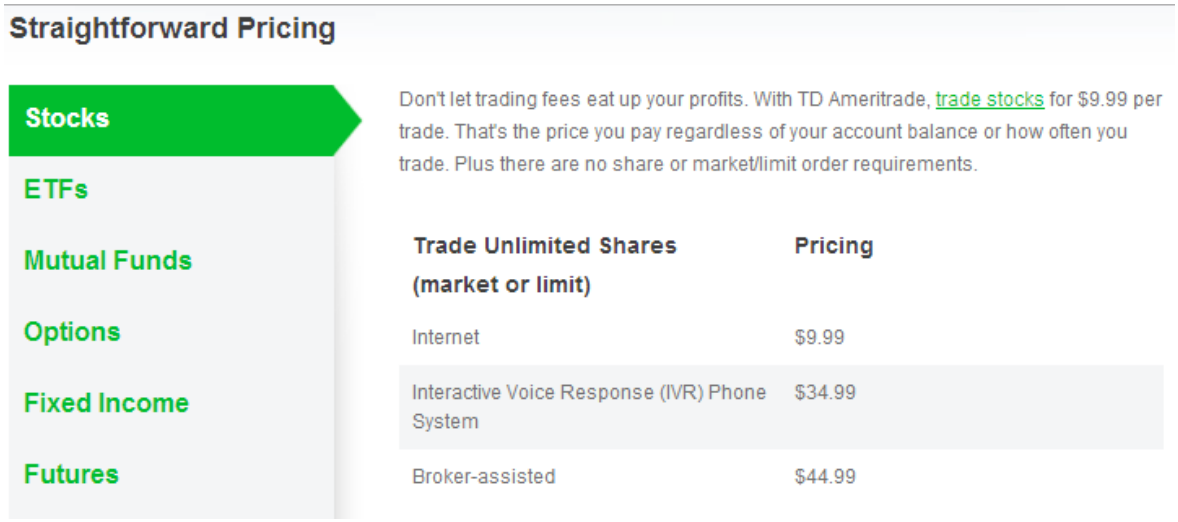
listen carefully to what matters most to them. It is that client-centric approach and our creative solutions that set us apart and help our clients not only do more, but achieve more.

To continuously improve our clients' online trading and investing experiences, we rely heavily on their input. Knowing what they need and integrating it into our trading tools and services, helps us deliver innovative solutions that better serve their unique investing and trading styles.

#4 TDAmeritrade.com

TDAmeritrade received consistently good scores for user experience, research and tools, customer service and banking. This brokerage provides online stock research from 12 firms.

From their website:



#5 TradeStation

Rating high for user experience and investment choices, TradeStation lost ranking for poor scores in customer service and research and tools categories.

From their website: *TradeStation Group, Inc., through its principal operating subsidiaries, TradeStation Securities, Inc. and IBFX, Inc. offers the TradeStation analysis and trading platform to the active*

trader and certain institutional trader markets. The TradeStation *platform offers electronic order execution and enables clients to design, test, optimize, monitor and automate their own custom equities, options, futures and forex trading strategies. TradeStation acquired IBFX Holdings, LLC in November 2011, expanding TradeStation's forex business in the U.S. and globally. TradeStation is a wholly owned subsidiary of Monex Group, Inc., one of the largest online financial services providers in Japan.*

#6 Firstrade

Firstrade rated high for investment choices, but only middle-of-the-road for user experience, customer service and cost. Banking and research and tools got low ratings. Though this firm offers more than 6000 mutual funds, only 507 enjoy no transaction fees.

From their website: *Proudly serving our customers since 1985. Firstrade is a leading online investment firm offering a full line of investment products and tools designed to help investors take control of their financial future. Since its founding in 1985, Firstrade has been committed in providing high value and quality services to our customers.*

Combining proprietary trading technology, a highly intuitive user interface, outstanding customer service and mobility applications, Firstrade offers a comprehensive solution for all of your investing needs. Whether you are a new investor or active trader, at Firstrade, we are committed to excellence, and putting the investor first. Firstrade is a member of FINRA/SIPC.

#7 Charles Schwab

Getting good marks for investment choices, user experience and banking services, Charles Schwab suffered with lower ratings for cost, research and tools, and customer service. Schwab came close to a perfect score in the banking category.

From their website:

High Yield Investor Checking Account – Enjoy no ATM fees worldwide, no minimums, and bank anytime, anywhere with Schwab Mobile. The Schwab Bank High Yield Investor Checking® account is linked to a Schwab One® brokerage account so you can easily manage both accounts with a single login.

High Yield Investor Savings Account – Looking for a good alternative for your cash? The FDIC-insured Schwab Bank High Yield Investor Savings® account offers a variable APY with no account minimums or monthly service fees.

#8 Merrill Edge

Merrill Edge got excellent ratings for user experience, banking and research, and tools. The ratings were very poor for costs, investment choices, and customer service. One surveyed customer stated that they were told to "Google it" when seeking broker advice.

From their website:



#9 Just2Trade

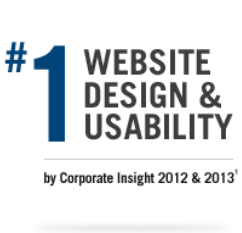
Just2Trade rated best in the investment choices category, mediocre in user experience, and low in all other categories. Their website is sharp with nice features, however. The firm charges $35 each year to maintain your IRA.

From their website: *Value for the Experienced Investor. At $2.50 per trade and $0.50 per option contract*, along with low margin rates, we offer one of the best pricing models on stock and options trading; no hidden fees, no gimmicks, and no surprises. Designed for you, the investor, Just2trade is dedicated to surpassing expectations and ensuring that you are empowered to command the total trading experience. At no extra cost, you will enjoy quality executions, low pricing, comprehensive trading and research tools, and attentive customer service.*

#10 ShareBuilder

Rating best in user experience and banking services, investment choices were poor and other categories were rated medium to low.

From their website:







Powerful, easy-to-use site

Easy to navigate, easy to understand. No clutter here. Simple is better when you want to invest and get on with life.

Research up to the minute

Ever miss a story that might have changed how you invested? Daily video news from the Wall Street Journal boils down the market buzz.

Top Notch Customer Service

Call, chat, or email – whichever you prefer, you'll experience award-winning Customer Service from a real, live person.

Many Choices

There are plenty of online brokerages from which to choose. Ultimately you'll select based on the criteria most important to you and your trading strategies. For some people, the banking services are very valuable because they can keep more of their money invested and they can use the account for other financial transactions.

The ability to see your positions online or on your smartphone at any time may be very appealing to you. The ability to actually adjust a position or to buy and sell online may prove to be a very valuable convenience. It allows you to get things done efficiently without time-consuming phone calls to a broker.

Options Specialists

Options trading is more complicated and more interesting in many respects than stocks and bonds. Many stock brokers have zero understanding of options, and they will be quick to tell you that options are very risky and you should not be trading them. However, in this book I am going to show you strategies that are low risk and profitable. You'll want to work with a brokerage that specializes in options or, at least, has an options division with experienced brokers.

Many of the full service and online brokerages you have just read about in this chapter will offer options trading. Whether one or more of them are suitable to your needs will depend upon several factors, such as:

Order Execution

Because most options traders work online, the trading costs come second in consideration to the reliability of the trading platform and the speed of executions. If a trade is delayed or does not get through because of overloaded systems, you'll wish you had used a more expensive and more capable brokerage.

In the Internet age, information moves with the speed of light around the world. When you become aware of market-moving information, sometimes the speed at which you can get into the system and place a trade or unwind a position can make a big difference. (Of course, using a slow Web connection may also cause you to experience slow execution that could cause you to miss out!)

Execution Quality

All brokers are required to guarantee customers that their buy orders will be executed at the best available ask price. They must also guarantee that sell orders will execute at the best available bid price. Look for brokers that attempt to exceed this requirement.

User Experience

When you are placing complicated options trades online, you don't need the added problem of complicated interfaces and order forms. Complication leads to errors, and errors cost money.

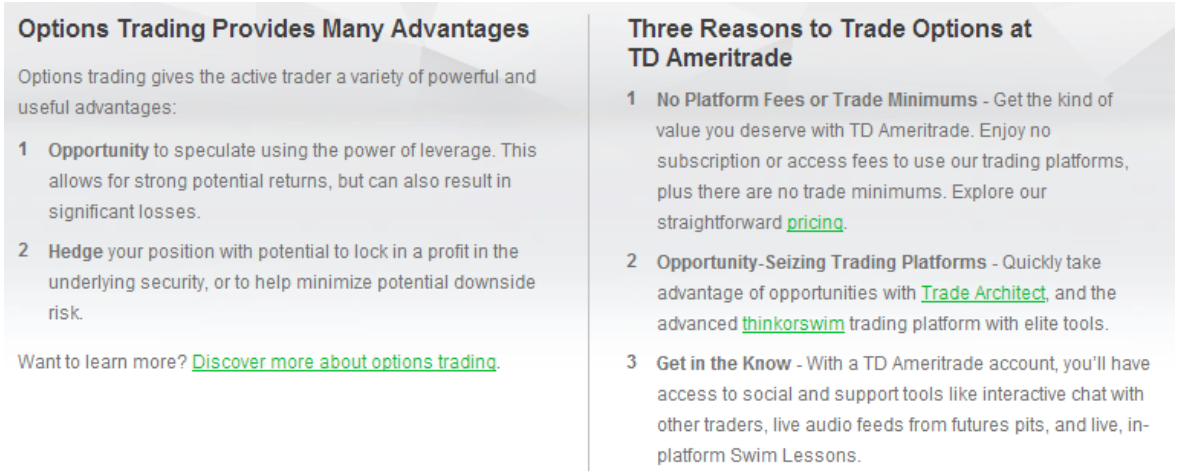
Options Brokers Compared

While I really could not find a reliable and unbiased source for ratings of options brokerages, I will give you some comparisons and website clips. Some of these will be firms you have already seen in the full service and online sections. They are in no particular order.

TDAmeritrade

This brokerage was covered in the online brokerages, and it offers an options division. Specialized options research tools are also provided, which help immensely in structuring complex spread trades.

From their website:



LightSpeed.com

Offering fast trading and low-cost options and futures fees, LightSpeed deserves consideration.

From their website:

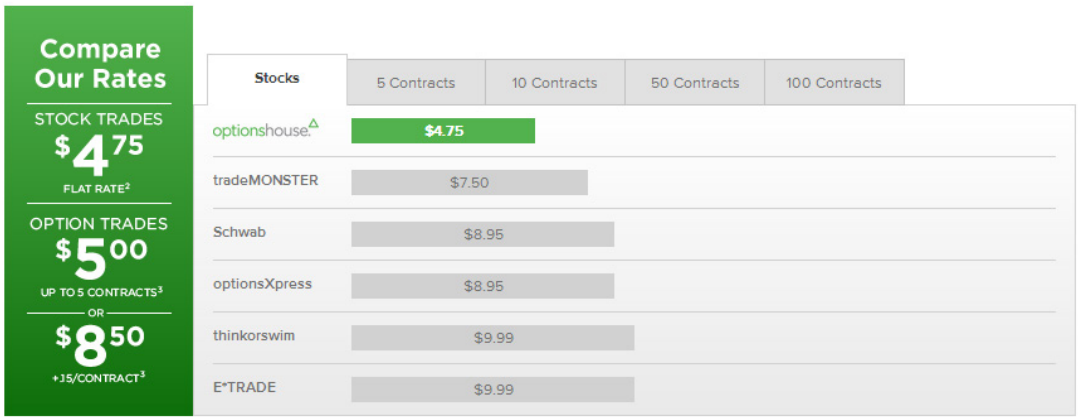


OptionsHouse

This is an options specialty brokerage that boasts superior tools and low cost trades.

From their website:

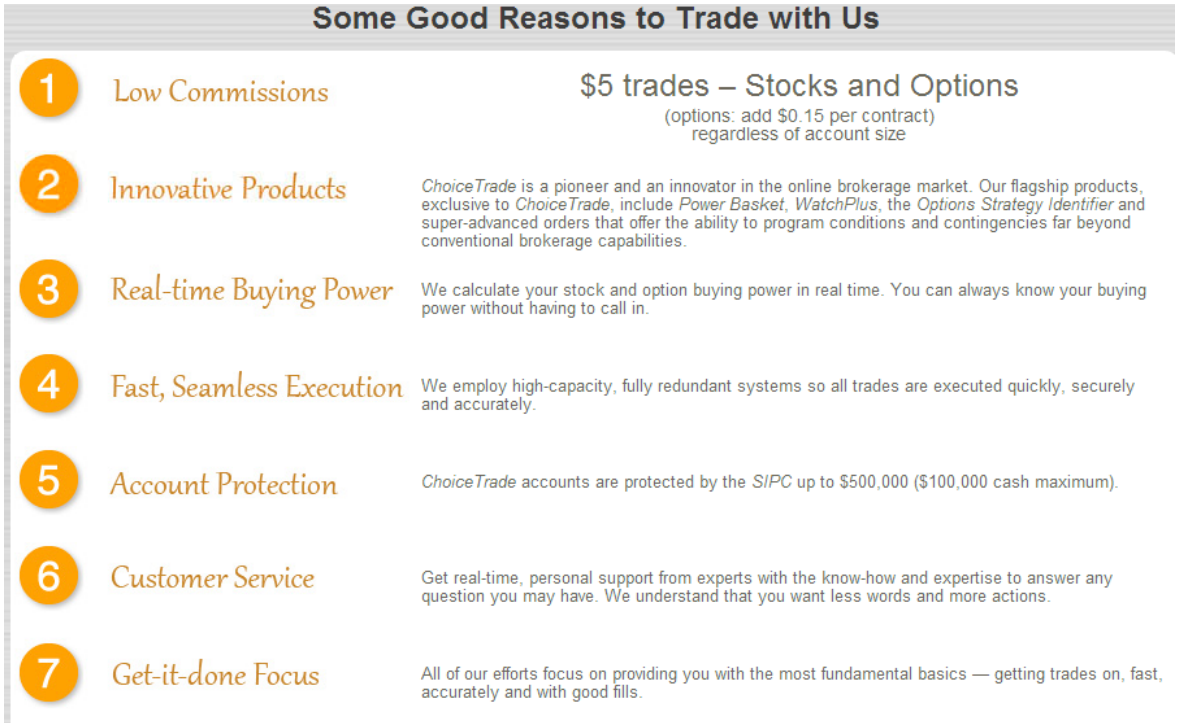
When you compare OptionsHouse commissions within the industry, there really is no comparison. Just look at the savings you get with an OptionsHouse account with each and every trade. And, as you will see, with OptionsHouse the more you trade, the bigger your savings will be. For more information, please visit our rates page.



ChoiceTrade.com

This is another low cost brokerage, and it offers stock trading as well as options.

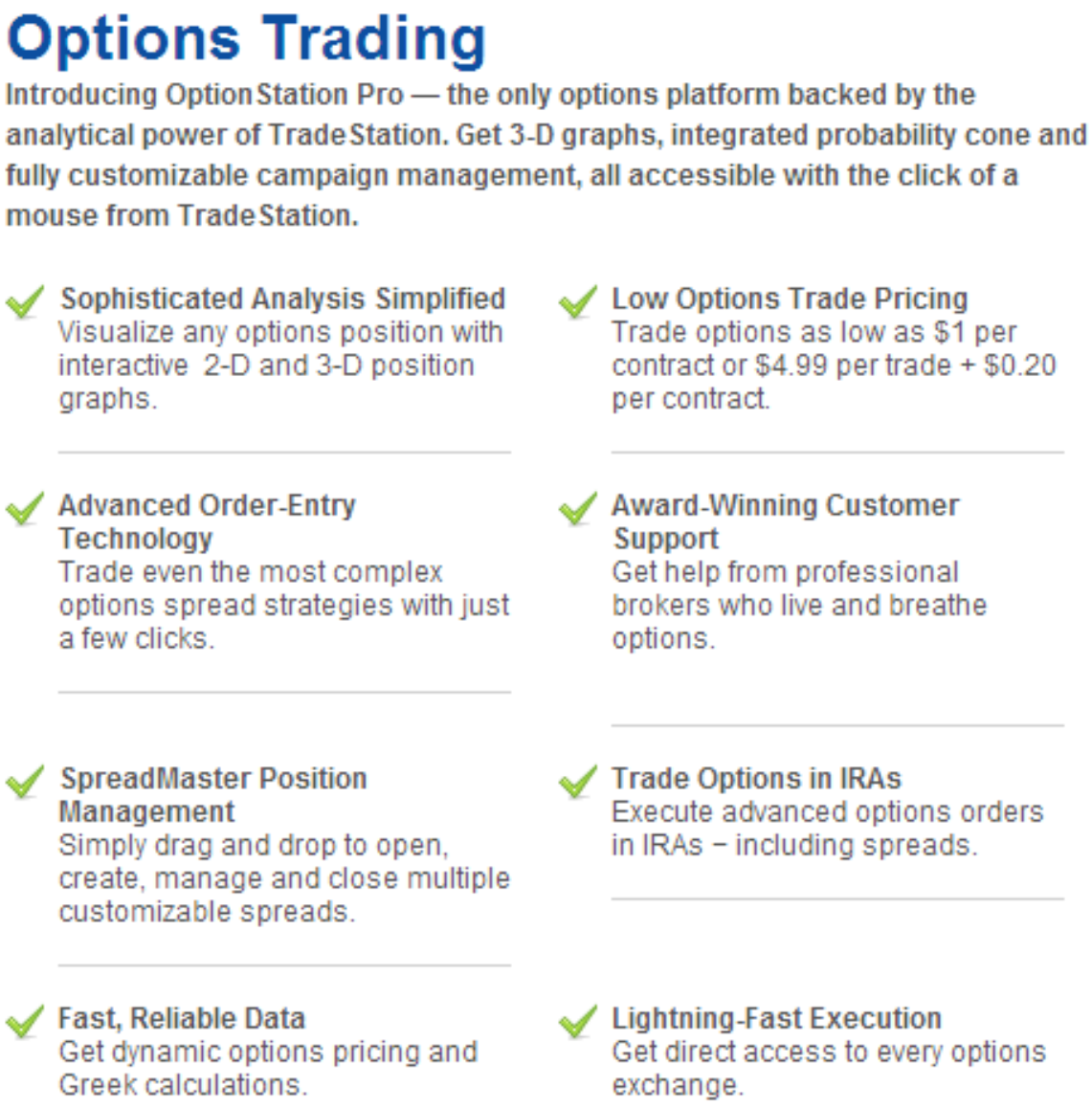
From their website:



TradeStation

While TradeStation was in the middle of the pack for online stock brokerages, it gets better reviews for its options platform.

From their website:



Interactive Brokers

Offering brokerage services for options, stocks, commodities and currencies, this brokerage gets high marks from Barron's.

From their website:



optionsXpress.com – A Steven Sitkowski Pick

optionsXpress.com is all about options trading, though you can trade stocks and futures as well.

From their website: *Experience Powerful, Easy-to-Use Tools – Find ideas and place your trades with intuitive, easy-to-use trading tools including:*

All-In-One Trade Ticket – Called by Barron's a "model for the industry" our All-In-One Trade Ticket lets you easily build strategies and place all your trades from a single screen.

Strategy Scan – Identify options strategies based on your personal risk tolerance and sentiment of the underlying symbol.

Trade & Probability Calculator – Quickly identify the opportunity and risk of an options trade with the Trade & Probability Calculator.

Virtual Trade – Test your strategies and ideas risk-free with $25,000 in a Virtual Trade account.

tradeMONSTER – A Steven Sitkowski Pick



While you can trade stocks and futures at tradeMonster.com, this site and brokerage really shine for options trading. As you'll see when I get into detail about options strategies later, they can seem quite complex if you don't take the initiative to truly understand how they work and what influences options prices. From the site, there is quite a bit of instructional material at your disposal:

BEGINNING OPTIONS (Select Link Below)	INTERMEDIATE OPTIONS (Select Link Below)	ADVANCED OPTIONS (Select Link Below)
OIC Option Basics – Part 1	Diagonal Spreads	Backspreads
Covered Call Writing by Lawrence McMillan	Options Greeks	Butterflies and Condors
OIC Options Basics – Part II	Options Pricing	Calendar Spreads
OIC Options Basics – Part III	Straddles and Strangles	Iron Condors
Equity vs Futures Options	Verticals	High Probability Option Trading
Options Basics	Long Straddles	Hybrid Hedging by the Risk Doctor
Buying Calls	Long Strangles	Selling Iron Condors
Buying Puts	Vertical Spreads – McMillan	The Black-Scholes Formula
Covered Calls	Index Options: An Introduction – OIC	Long Calendar Spreads
Selling Puts	Index Options by OIC – Part III	Exercising Calls Early
	Index Options by OIC – Part II	VIX Options – by Lawrence McMillan
	Index Options by OIC – Part IV	WHERE DOES THE SKEW COME FROM?
	Using Weekly Options	How Pro's Trade the OEX
	Option Hedging	Portfolio Protection
	Scaling and Sizing Your Trades	
	Sheridan on the Greeks – Delta	
	Sheridan on the Greeks – Gamma	

tradeMONSTER executions are fast, accurate, and they are priced for frequent trading.

TAKE YOUR TIME AND DO YOUR RESEARCH

The brokerages I have introduced here are not all of the choices available, so do your own thorough research. Many of the online brokerages have demo trading platforms allowing you to experience the user interface. Don't be afraid to ask questions.

Take all the time you need to make the right decision, as it is time-consuming and expensive to change brokerages. While many have no fees to open an account, some have closing fees.

Chapter 9
Making Money in the Stock Market

"October: This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August and February."

Mark Twain

Mark Twain has it right – if you are engaging in speculation, that is. One definition of speculation says that it is, *"The act of trading in an asset, or conducting a financial transaction, that has a significant risk of losing most or all of the initial outlay, in expectation of a substantial gain."*

This chapter is not about speculation; it is about investing conservatively with the goal of profits combined with protection of your capital. Later, I am going to be sharing some carefully crafted options trading strategies that I think are preferable to stock market buy-and-hold and straight investment for dividends. However, you may find that some of each will be appropriate. So let's talk about the non-speculative ways in which money is made in the stock market.

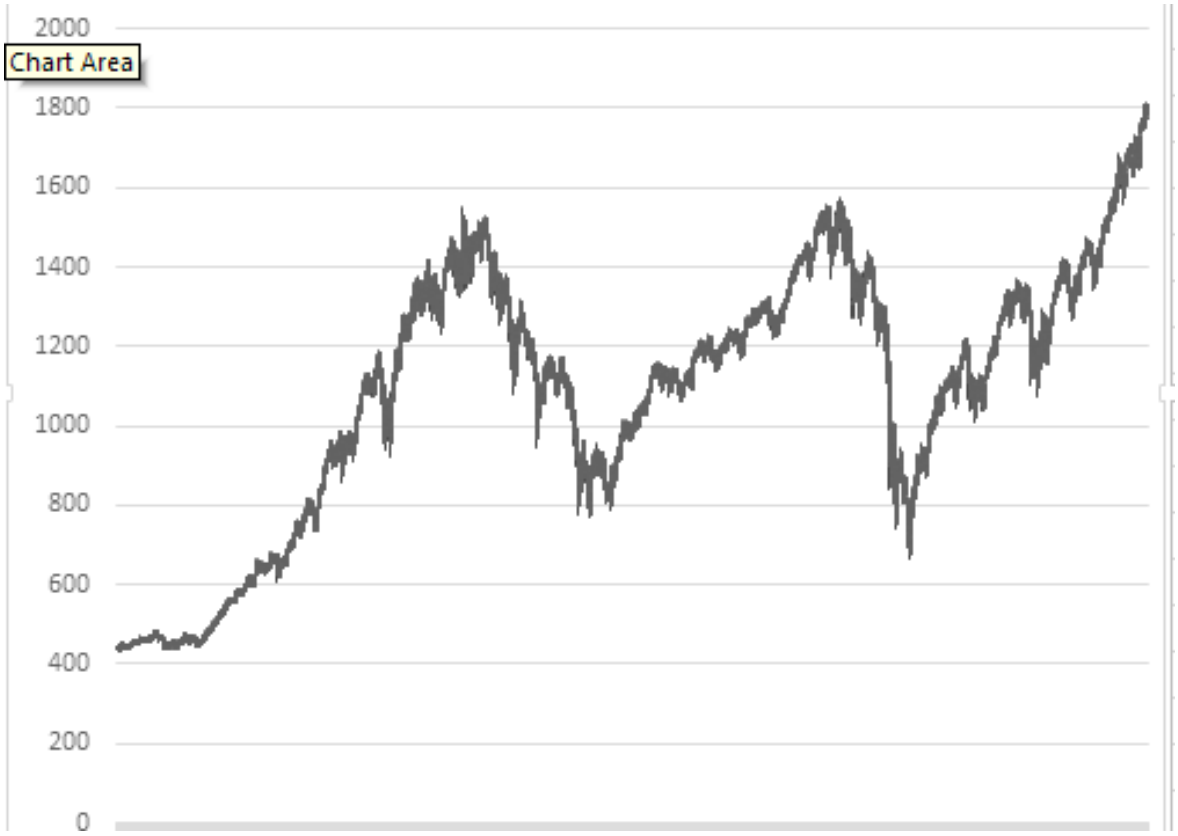
Buy Low – Sell High

If you want to test this out, just speak with a stock broker at any of the major brokerages, and ask them if buy-and-hold is a good strategy. You'll most likely hear that stock prices as a whole rise over time, so buying and holding is a great strategy.

Of course, there is the other extreme - day trading. You are still trying to buy low and sell high, but you condense the time down to days or even minutes. The basic goal either way or anywhere in the middle of these extremes is to buy a stock at one price and sell it at a price high enough to cover trading fees and make a profit.

Whether you are taking the conservative long-term buy-and-hold approach or the more speculative selling in the shorter term, it is not

the slam dunk that many brokers make it out to be. Let's take a look at a 20 year history of the S&P 500 Index:



This chart covers the period from 1993 to December of 2013. It is not easy to show this to a client and say that buying and holding over the long term is going to be profitable. Sure, if 20 years is the time window, then it certainly worked here. However, if for any of a number of very common reasons, you want or need to sell in the shorter term, there can be a very different result.

Obviously, this is a composite index of 500 companies, and there will be some stocks performing much better, but there will also be stocks that are not performing as well as the index as a whole. I just wanted to set the tone for the remainder of this explanation of buying low and selling high in the stock markets. It can work for you with careful company selections and supervision of your account to make sure you sell when many others are actually buying, when the stock is

still rising in price. The idea is to sell and take your profits before an inevitable decline. Note in the chart that there were a couple of drops of around 50% in market value.

Growth Stocks & Buy Low-Sell High

Companies that work best for the Buy Low and Sell High strategy are growing, both in business and earnings. They are the most likely to experience increases in stock price. They rarely pay any dividends, instead plowing all of their earnings back into growth of the company or into research.

The general consensus is that over time it will not matter too much when you buy these stocks, as they are predicted to continue growing and increasing earnings and/or stock price. Of course, this is not the way it works in many cases, which is why everyone cannot make money buying low and waiting to sell these stocks high.

Value Stocks & Buy Low-Sell High

There is not a hard and fast definition for a "value" stock, but most investors would say that the term applies to good companies with shares selling at market lows, undervalued when compared to other companies in the same sector.

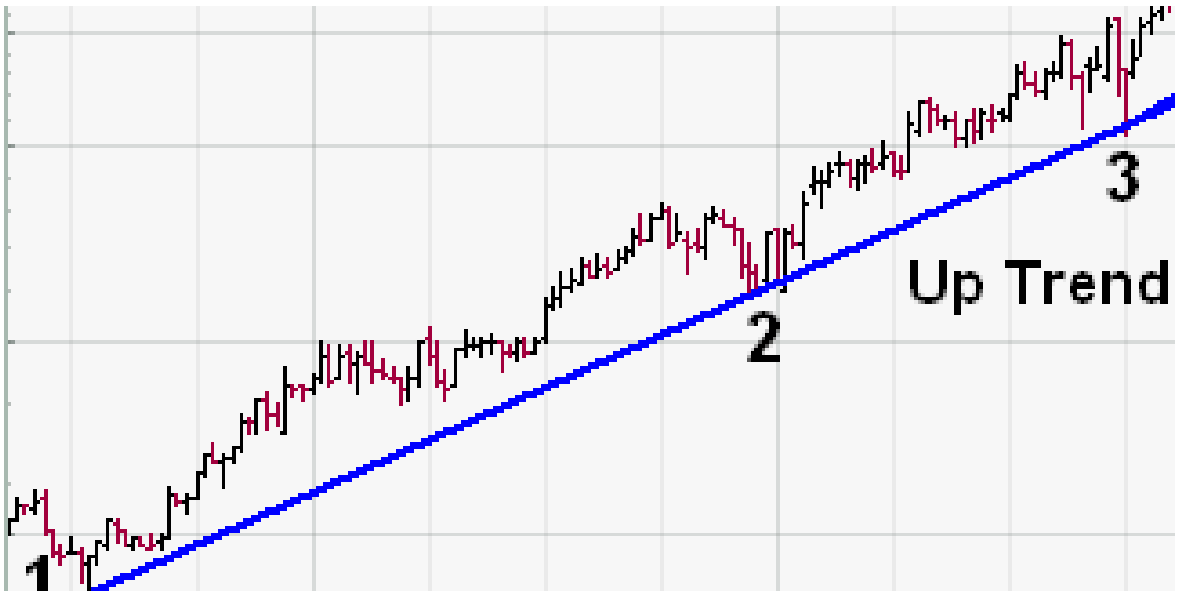
The theory here is that the investor buys when the stock hits a measured low, perhaps a 52 week low, meaning the low point in a year's trading. Maybe it is at a previous low price from which it recovered and began to rise again. The idea here is to buy when the stock is undervalued and you will profit from its return to a more normal valuation.

Due Diligence and Patience

In this longer term approach, you would study the market as a whole, or as a segment of the market or industry, and then identify

individual companies in that group with share prices you consider to be undervalued. Perhaps recent earnings performance did not live up to expectations and investors pulled out of a stock. If you believe that the value is there and you expect improvement, then buying would be your approach.

You then exercise the "patience" part of the equation. You wait and watch, and hopefully your assumption proves true and the stock rises in price. Of course, along the way it will take dips, and it may run up and then run down. However, your assumption is that the overall trend will continue upward in price.



The image shows an uptrend in place. It is indicated by a series of higher highs and higher lows. The trend line shows that this stock is in a solid uptrend. If you are in a Buy Low and Sell High mode, this looks like a stock you would have been fine with owning. You are trying to identify stocks that will illustrate this trend.

If you are right, at some point you'll need to sell and take out your profits. However, if you wait too long, there could be a significant drop and you would forfeit much or all of your gains. And, even if you decide to keep holding at that point, it can be a long time before you get back some or any of that lost profit.

The problem is that the "selling high" part is counterintuitive because, when the stock is rising, you become enamored with the stock as your profits pile up. It is not easy to pull the "sell" trigger when you are fretting over whether you could end up looking back in despair should the stock continues to rise. However, what if the stock takes a dive and you are still holding? Let's take a look at a very popular tech stock, Apple, and a chart from June through December of 2013. Apple closed at $549.03 on the 2nd of January, and you have watched it drop until this chart begins on June 3rd.

Now, you like tech stocks. You have an iPad and an iPhone, and you love Apple. It is June 3, 2013 and you see that Apple is down by about $100/share since the first of the year. If you decided to buy at that $450 +/- price, you can see (on this chart) that just 18 or so days later (bottom scale is trading days) you would be down by around $60/share.

In this situation, your resolve will really be tested as you may be tempted to bail on the stock and cut your losses. However, if you stay the course, you'll begin to see improvement. But it is still around 23 trading days before you break even. You are feeling pretty good after some good news comes along and the stock hits 510. The stock then pulls back about $30/share, but you hold because you are still in profitable territory. When it is back up to $510/share, you are feeling pretty good.

Then, in September the stock takes a dive right back down to where you entered the trade at the beginning of June. Now your resolve is being tested big time. Getting out at this point would get you back almost all of your investment, so it is really tempting to just write off around three months of holding the stock and do something else instead.

You are in the mode to hold-the-line so you hang in there, and the stock starts rising again. By the end of the year, you are looking at a great return on your investment with the stock back up higher than it was at the beginning of the year. Will you sell and take your profits?

The point of this example is that buying low and selling high is not an easy strategy.. That skill set requires expertise in the area of technical analysis, which will be covered in a later chapter. I just want to give you some context from which you can make your own decisions.

Trading Price Bands or Channels

A shorter term approach to Buy Low and Sell High is to trade stocks that tend to trade in price bands or channels. In other words, some stock charts will indicate that a stock tends to rise in price whenever it hits a specific low price, and then drop when it hits a specific top price. It can happen over and over.

There are valid reasons why this can become a trend for some companies. Sometimes it is just investor sentiment or evaluation that causes investors to pull their money out of the company when the stock hits what they consider an overvalued position. Then they buy back shares when they consider the stock undervalued.

PLCM is not a high-priced stock, nor one I would necessarily recommend trading. However, it does illustrate the price band trading strategy. Notice that in four or five instances over this roughly seven month period, the stock turns up from a bottom price around $9.00 to $9.25. It turns down from around $10.50 to $11.00 several times, and definitely plummets when it hits $12.00 twice.

The trader in this case could theoretically buy at around $9.00 and sell at $10.50 to take profits of around 10% in days to weeks. And doing this over and over is a possibility. I wanted to show you this trading strategy because you will hear about it, and it may seem enticing. I do not recommend it, however, as these patterns can develop, but then disappear, just as quickly as they started.

The Buy Low and Sell High method of making money in the stock market is one of two very popular approaches.

Dividend Investing

Companies that pay dividends do so in order to distribute profits to shareholders. Though most companies pay dividends each quarter, some pay a single dividend annually, some twice a year, and a few even pay monthly dividends.

Dividends are normally paid in cash, though at times shareholder dividends come in the form of more stock, called a stock split. A cash dividend is declared as a specified amount of cash per share owned. So a company may announce a dividend of $0.25/share, and if you own 100 shares, you'll get $25.00 that quarter or dividend period.

Generally, companies that pay dividends are not going to have the share price growth of companies that plow all of their earnings back into the company and research. So investors who are seeking dividends are usually willing to sacrifice some value appreciation in return for regular income payments. Dividends are taxed as investment income in the year they are received.

Retirees, or those approaching retirement, may reallocate some of their portfolio from growth to dividend stocks. They may want or need the monthly or quarterly income from dividends to pay for their living expenses. Generally, dividend paying companies offer more established and secure investments, as well. So, investing in them is perceived as more secure and the income is the bonus.

The **Dividend Yield** of a stock is the annual dividend amount divided by the stock price per share. So if a stock selling for $50 per share is paying a $1.00/share quarterly dividend, that's $4.00 annually.

$$\frac{\$1.00 \times 4 = \$4.00}{\$50.00} = 8\%$$

There are a couple of definitions pertaining to payment of dividends on which shareholders get the current dividend.

In-dividend date: The last day, which is one trading day before the ex-dividend date, on which existing shareholders will receive the

dividend, and any buyers of the shares on this date will get the dividend, too.

Ex-dividend date: This is the day on which all shares bought and sold no longer come attached with the right to receive the most recently declared dividend. This is generally two days before the dividend record date.

Buying Stocks for Growth and Dividends

This chapter gives you an overview of the reasons people invest in the stock market. They hope to buy stock shares at prices lower than they will eventually sell them for, in order to profit from their increase in share price. They also may buy shares that pay dividends, if they are interested in getting a steady income from their holdings.

The two goals are not mutually exclusive. However, in general, dividend paying stocks do not provide the price growth of stocks that reinvest their earnings back into the company. The investor can seek a reasonable balance between the two goals and enjoy income with some growth.

Chapter 10
What Moves the Price of a Stock?

"The difference between playing the stock market and the horses is that one of the horses must win."

Joey Adams

We are talking about individual stocks and market sectors in this chapter, and we'll talk about market cycles in the next. We want to understand the factors that influence the price of stocks and why.

Fundamental Factors

If we were talking about an "efficient" market only, fundamentals would be the primary and most influential effect on the price of a stock. In many cases they are, but we'll see in the next section how technical factors also influence prices significantly.

Fundamentals basically are comprised of two factors:

- An earnings base.
- A valuation multiple

When you own a common stock, you have a claim on a share of that company's earnings or EPS, Earnings per Share. It is your fundamental return on investment. This can be in the form of dividends, or it can be in the form of valuation increases when profits are re-invested in the company.

The "valuation multiple" is the P/E Ratio, the Price-to-Earnings Ratio of the stock. The P/E Ratio is normally calculated by dividing the price of a share of stock by the preceding 12 months' earnings per share (EPS). If a stock selling for $50/share had earnings the previous 12 months of $2.47/share, it would look like this:

$$\frac{\$50.00}{\$2.47} = 20.24 \text{ P/E}$$

You can also calculate the P/E using the current earnings or projected future earnings. In fact, using projected future earnings could lead some investors to buy a stock if they see the potential of lower P/E numbers over the next year. With higher earnings predicted, the price today could be enticing looking forward.

If the analysts project earnings of $3.68/share next year, our example stock above would have a P/E of 13.59 going forward. It may be a BUY indicator, as the share price would normally move up to bring the P/E more into line with that stock's sector.

Different market sectors can have very different P/E Ratios. Many factors create this situation, including the type of business, profit margins, return on capital invested, and others.

Industry Name	*Number of Firms*	*Price/Current EPS*	*Price/Trailing EPS*	*Price/Forward EPS*
Advertising	31	50.53	49.37	37.48
Aerospace/Defense	66	22.96	24.32	22.13
Air Transport	35	43.45	16.16	14.15
Apparel	46	23.22	21.97	28.83
Auto Parts	54	19.76	23.26	16.99
Automotive	11	16.61	12.65	27.88
Bank	375	26.80	18.14	17.99
Bank (Midwest)	86	21.47	18.57	17.08
Beverage	36	24.36	28.96	20.84
Biotechnology	232	99.87	63.71	32.78
Building Materials	42	41.81	755.50	34.51
Cable TV	18	24.76	25.95	23.55
Chemical (Basic)	18	15.79	14.55	13.00
Chemical (Diversified)	32	222.66	22.16	18.06
Chemical (Specialty)	73	25.83	30.18	22.40
Coal	19	16.89	36.36	37.76
Computer Software	181	110.76	65.03	120.22
Computers/Peripherals	68	18.06	51.52	21.55
Diversified Co.	123	39.37	28.68	20.04
Drug	199	48.08	49.11	29.28

The partial spreadsheet above shows just a few of the many sectors, and you can see the P/E Ratios based on three columns computed with Current, Trailing (previous 12 months), and Forward (next

12 months) Earnings per Share. You can see that they are all over the board, so these numbers are better utilized to compare stocks to their peers within a sector. Let's go to the Technical Factors, as they influence prices significantly too.

Technical Factors

If we think of Fundamental Factors as more "internal" to the operation of the companies, then Technical Factors could be considered "external" factors influencing stock prices.

Trends

It helps to understand this technical factor if you change the last letter to a "y" and make it Trendy. Like fashion, some stocks can begin to move higher for any number of reasons and it can become a situation of, "buying brings more buying." It is trendy to be buying this stock, as it is perceived to be in an "upward trend." Unfortunately, this cuts both ways, and trends can be in a downward direction and even turn on a dime.

Market Sentiment

Many times really good stocks suffer from poor market sentiment. Either economic factors or other world news can weigh on the market as a whole, thereby causing otherwise strong individual stocks to suffer along with it. Of course, on the other hand, great news and rising markets tend to float a lot of boats.

Sector Strength or Weakness

Much like market sentiment, industry sectors ebb and flow with news and economic trends. If new car sales are down, companies that make parts, tires, and accessories can suffer as well. News of pend-

ing new restrictions on coal-fired electricity plants can cause individual energy stocks to drop. Of course, as with any of these factors, they work in both directions.

Inflation

Inflation impacts all types of business and every industry due to costs of labor, materials, and services. Depending on the industry and the level of inflation, some stocks will gain while others lose. Deflation, on the other hand, is generally bad for stocks as a whole, as it is tough for businesses to raise prices and increase earnings during deflationary periods.

Liquidity

Large-cap stocks like Walmart have high liquidity, lots of shares, and a great deal of investor attention to their announcements and related news. Small-cap stocks are not on the radar screen for nearly as many investors and their shares are not as actively traded.

Competitive Investments

Stocks are just one asset class. There are bonds, currencies, options, commodities, real estate, and others. At different times and for a variety of personal and economic reasons, investors will move money from stocks into other investments or vice versa. News can generate a "flight to safety," causing investors to move money from stocks to bonds whenever they have economic concerns.

Don't forget just plain old supply and demand.

Markets operate with an underlying "supply vs. demand" tug-of-war constantly influencing prices. When people start buying a stock for any reason, there is a fixed supply of shares. More buying creates

upward pressure on prices. When people stop buying, it works the other direction, with share prices dropping due to more sellers than buyers.

Institutional Trading's Role in Stock Prices

Pretend you are a well-off investor in the stock market, and you like to make big trades - let's say around 1000 shares a pop. You call up your broker and buy 1000 shares of Walmart. How many market-watchers and analysts do you think will notice your trade and take some action because you made this purchase? Answer: ZERO. Don't get your feelings hurt, because while it is a lot of money for you, it is a grain of sand in today's trading of Walmart stock.

Now let's assume that you have a club or group, and it has one hundred thousand or even a couple of million members. All of you like to trade the same way and all agree on Walmart as a great buy based on today's news. Suddenly, a few million or more shares are purchased in short order. This generates significant interest among traders and analysts, possibly even some articles and recommendations that something good is happening for Walmart shares. Now millions of other investors are jumping on this bandwagon.

Every day there are major institutional traders in the marketplace, buying and selling. When they buy, it sends ripples through that stock's price to the upside, and when they sell, it causes the price of a stock to drop. These institutional investors include:

- Mutual funds
- Hedge funds
- Banks
- Insurance companies
- Brokerage firms

In a 43 page report titled *The Impact of Institutional Trading on Stock Prices,* Josef Lakonishok, Andrei Shleifer, and Robert Vishny had some interesting observations.

Herding – The Wall Street Journal quoted a pension fund manager as saying: "Institutions are herding animals. Like lemmings, we tend to move in the same direction at the same time." Various reasons can be inferred for this herding by institutions, with one being that they are more prone to herding than individual investors.

Institution fund managers give credence to the background research that their peer institutions must have employed in making a buying decision, so they tend to herd along with them and buy as well. Now we have several major buyers in the market for the same stock at the same time. Herding was found to be more prevalent in industry sectors than individual stocks.

Even if there are hundreds of companies in a sector, a significant herd of funds, pensions and insurance companies buying in the sector can create upward pricing pressures in that sector. Of course, as with all of our discussions, this works in the other direction as well, if the herd starts selling a sector.

Fundamentals and Short-term Focus

The study reports that strategies based on fundamentals can take a long time to come to fruition. *"Since money managers can be dismissed after only a few quarters of bad performance, contrarian strategies put managers at significant risk. As a consequence, money managers might follow short-term strategies based not on fundamentals but on technical analysis and other types of feedback trading."*

The point here is that these are major market traders, and you can see some stock price trends that may not be based on good fundamental research. If other institutional traders join the herd, prices move, but you may not want to be trailing that herd, as you could be lost either in the mud or the dust.

Working Paper: What Moves Stock Prices

This paper comes from the National Bureau of Economic Research and the work of David M. Cutler, James M. Poterba, and Lawrence H. Summers.

I wanted to mention this study, since you may be thinking you are on the verge of a great new trading strategy watching the news based on what you have learned so far. You are not. There are far too many variables influencing stock prices, and they really cannot be ranked or quantified easily.

One of the statements bearing on the effect of economic and other news on stock prices in the Conclusions section of the study is: *"Our results suggest the difficulty of explaining as much as half of the variance in stock prices on the basis of publicly available news bearing on fundamental values."* And, *"First, macroeconomic news as we have defined it explains only about one-fifth of the movements in stock prices."*

So economic news may not be as big of a price influencer as we may think. OK, what about other news - major stuff like wars, election results, deaths of prominent people, etc? Tables in this report show us the percentage changes in the S&P Index when specific items hit the news historically.

Almost all of these major news events resulted in up or down moves of the Index of less than 5% (including the Japanese bombing of Pearl Harbor), with the vast majority resulting in either a decline or rise of less than 2% in the Index value.

However, among those with a greater than 5% influence, we find:

- Oct. 19, 1987, Worry over dollar decline and trade deficit; fear of U.S. not supporting the dollar. Index ***drops*** by 20.47%.
- Cascading over the next week, there were two other announcements:

» Oct. 21, 1987, Interest rates continue to fall; deficit talks in Washington; bargain hunting. Index ***rises*** 9.10%.

» Oct. 26, 1987, Fear of budget deficits; margin calls, reaction to falling foreign stocks. Index ***falls*** 8.28%.

There's a lot more interesting information in this study, but what I have given you here shows that what you might find as a really influential event, like the bombing of Pearl Harbor, would have far less impact on the markets than some economic news. Playing the market based on news is too little, too late, and unpredictable.

The Cyclical Nature of the Market

While everything we have discussed up to now has consisted of influencers of stock prices, we are taking a look now at cycles, which are markets moving in a cyclical way. There are different types of cycles used in market analysis.

Cyclical cycles usually last four years or so, with Bull and Bear market phases lasting from one to three years. Secular cycles are longer, around 30 years, with Bull and Bear markets lasting 10 to 20 years. There is also a presidential election cycle, with overall market valuation influenced by political developments.

So there can be cycles inside cycles, with some trending upward while others are moving in the other direction depending on cycle length. With compound cycles in play, it can get very complicated for market analysts. We don't really need to get into complex Fourier analysis, or even longer cycles called Kondratiev cycles. What we want to understand is the basic three states:

- Under-valued
- Fairly valued
- Depressed or Under-valued

Depending on the time frame you are analyzing, you could have different periods in different states. However, the long-term investor (relative to your choice of cycle) is interested in taking specific actions based on the cyclical state of the market.

Under-valued: Generally, the long-term investor would want to be buying in this cyclical state. Of course, we also have sector cycles, so the investor may be buying technology but ignoring or even selling utilities based on their cycle status.

Fairly valued: This is a holding phase, or you could be trading with shorter time windows to take advantage of normal cyclical and counter-cyclical stock price moves influenced by news, earnings announcements, or other technical factors.

Over-valued: On the other end of the cyclical spectrum from under-valued, the market as a whole would be selling at inflated prices and investors would be advised to sell before the cycle turns and values start to fall.

Investors use various charting tools and moving averages to try and identify cycles and price patterns. Sometimes multiple moving averages will be used to identify and quantify different trends and cycles within cycles. In one chart, the investor could be charting multiple trends or trend relationships:

- Long-term trend.
- Intermediate-term trends and how they relate to the longer term.
- Shorter term price movements.

In his explanation of his ***17.6 Year Stock Market Cycle,*** Kerry Balenthiran breaks a full 17.6 year cycle down into alternating 4.4 year and 2.2 year Bullish and Bearish cycles. One of his publications presents this 17.6 year cycle as it connects the Panics of 1929, 1987, 2000, and 2007.

Confused About Predicting Prices Yet?

It is all good. As you learn more, develop your own preferences for fundamental and technical analysis, and learn trading strategies, you'll find that it begins to come together for profits. The good news is that you don't have to trade with a trend, as you'll learn about long and short positions and making money in all three states of a cycle: under-valued, fairly valued, and over-valued. You'll also learn to trade in a market moving sideways.

In My Experience
Sometimes stocks move in a logical fashion, and other times their direction seems random. At the end of the day, investors are buying earnings, revenues, and dividends. Keep an eye on those fundamentals at all times.

Chapter 11
Finding Under/Over Valued Stocks

"The contrary investor is every human when he resigns momentarily from the herd and thinks for himself."

Archibald MacLeis

I will just start by saying again that you will learn how to profit from buying an undervalued stock and selling overvalued shares. It will also be possible to do so without actually owning the shares, as you will learn options strategies to profit from both extremes of value.

However, we cannot profitably buy or sell shares, Put options, or Call options with any certainty of success unless we can locate stocks that are in either an undervalued or an overvalued condition. It is the participation in the return to fair value or even moving into the opposite valuation territory that creates profit. I will also share some strategies with you for profiting from a stock in a run up or a crash in price.

CAUSES FOR STOCK RUN UPS & PRICE CRASHES

First, what is a "run up"? *It is a sharp and rapid rise in price of a stock*. There do not have to be any fundamental factors involved in a run up. There does not even have to be a news announcement that grabs the attention of investors, though there can be.

For this discussion, I will use the unscientific term "crash" for a rapid change in price in a negative direction. As with a "run up", the same principles apply, as there may not be any readily identifiable reason for a crash in price.

Let's run through some reasons for stock prices making big moves in either direction.

New Earnings Announcement

Run up: Immediately after an unexpectedly good earnings announcement that exceeds analyst estimates, a stock can run up when investors pile on. By the time the average investor hears that earnings were higher than analysts had predicted, it is usually too late for immediate gains, but they still tend to jump in and buy. The stock usually does not run up very far, and it is usually a short duration situation. Institutional buyers normally don't participate in this, and the stock can settle back down quickly to a more fair valuation.

Crash: Logically, if the majority of respected analysts have been predicting earnings of $1.50/share for a stock and they come in at $0.67, it is a big deal. If all of those analysts were off by that much, investors can become scared about a company and it may cause them to flee the stock and crush the share price.

Earnings Announcement Note: All publicly traded companies report their earnings on a quarterly basis. These announcements are expected, and any delay can cause share price fluctuations.

Companies that announce earnings that beat expectations are likely to beat earnings again in the future. When analysts project conservative revenue and earnings numbers, then, when the company actually reports these figures, earnings expectations will be exceeded. In fact, companies beat their earnings estimates approximately 66% of the time. Some companies want to make a regular occurrence, as underestimating and hitting or exceeding estimates is much better than falling short.

Analyst Ratings Upgrade or Downgrade



Analyst Stock Upgrades

Briefing.com
Live Market Analysis

Upgrades / Downgrades / Coverage Initiated

Name	Symbol	Market	Brokerage Firm	From	To
Adecco S.A.	AHEXY	Other OTC	HSBC Securities	Neutral	Overweight
AOL	AOL	NYSE	CRT Capital	Fair Value	Buy
CSX	CSX	NYSE	Argus	Hold	Buy
Esterline Techs	ESL	NYSE	UBS	Neutral	Buy
NetSuite	N	NYSE	FBR Capital	Mkt Perform	Outperform

Run up: The partial screenshot shows how you might see some analyst's stock upgrades. This too can result in a short duration run up in a stock's share price. However, if there is a major upgrade, say from Sell to Buy (not as common as Hold-to-Buy), there is usually some other news out there that preceded the analyst's upgrade.

Crash: Once a ratings agency, organization or individual, gains a reputation as being very accurate in their predictions of stock performance, their downgrading of a stock can create a rash of selling, taking the price down into undervalued territory.

Analyst Ratings Note: "No news is good news" is not a saying that holds true when it comes to analysts' ratings of companies. They are happy to report ratings increases. However, they are far less likely to be quick with downgrades.

Ratings organizations and analysts are very hesitant to downgrade a company, preferring to stick with "Hold" or other non-negative positions. This is how you can get caught in a situation such as what happened when Enron unwound. The stock was not downgraded until the stock had fallen all the way from $90 to $5/share.

Positive or Negative Stock or Sector News

Run up: If you get a newsflash on your computer or in the morning paper that Samsung just lost a patent lawsuit to Apple, would you consider buying Apple stock in anticipation of it running up in price? Another example in play in early 2013 and 2014 was positive housing market news. With investors still putting upward pressure on home prices, some home builder stocks saw significant gains. In May they peaked and took a dive, which indicates they had run up to an overvalued status.

Crash: We may see our example of Samsung and Apple take down the share price of Samsung if the loss of the lawsuit was going to impact a new product line. People are like lemmings sometimes when there's bad news. They will follow the herd over the cliff, and at the bottom is a much undervalued stock.

Merger or Acquisition News or Rumors

Run up: Mergers and acquisitions have created some of the most dramatic moves in stock prices historically. Even before the event occurs, (or even if the news is actually just rumor, such as: that one company has been "rumored" to have an interest in the intellectual property of another in the tech industry, the company to be purchased can see a run up in stock price in anticipation of a big offer by the acquiring company.

Crash: Just check out what can happen when a rumor about an acquisition is proved to be fake or wrong. The stock that previously was doing quite well in anticipation of a takeover will plummet in price on the news that the takeover is not going to happen.

Insider Trading

Run up: Back in the 80s, the SEC did a study and announced that insider trading does not have as profound of an influence on stock

run ups as many people believed. However, because the management and other major shareholders can have information well before the rest of us, they can then take action to buy their own stock in *front of* good news. Those with significant positions of 10% or more who keep buying, could be on the radar of analysts or investors who follow their lead and run up the stock's price.

Crash: As with many things, bad news or bad reviews are much more influential than good news or reviews. And the effects of negative activities can be multiplied and crush a stock's price. When insiders start selling, especially in large numbers, the word can get out and a stock's share price can be crushed.

Just Plain Hype

Run up: In January of 2014 there was an article at Seeking Alpha about Yelp's stock price. The title is "*Yelp's Ridiculous Run-Up Continues*." The article says that Yelp was considered overvalued at $50/share, but in a few months it rose to around $78/share. A quote: *"Yelp continues to be one of those stocks getting pumped up by hype alone."*

FINDING OVERVALUED AND UNDERVALUED STOCKS

We see how stocks can become overvalued or undervalued, so now let's take a look at how we can locate these stocks so we can profit from it. First, if we are simply using a buy-low and sell-high strategy, we would not want to be buying overvalued stocks. However, catching an undervalued stock can be a good buy-and-hold strategy for the short or long term.

Using P/E Ratio

We saw earlier, how the P/E ratio is calculated and used in stock share valuation. As a reminder, P/E is the price per share divided by earnings per share, either over the previous 12 months, or current earnings, or future projected earnings. We also learned that P/E ratio ranges can be sector-specific, with more volatile sectors like technology frequently trading at much higher P/Es than other sectors.

One way to begin to zero in on possible opportunities using the P/E Ratio is to compare a stock's P/E to other stocks in the same sector. Of course, this should not be your only selection criteria, as you can then apply other fundamental and technical analysis processes to help you in narrowing down your possible choices. Here's a chart from Yahoo.com showing the average P/E Ratios for some of the major sectors.

Sector	1 Day Price Change %	Market Cap	P/E ▲
Financial	91.68	1237093.6B	13.90
Conglomerates	0.49	1557.2B	20.20
Services	129.84	146108.7B	21.61
Basic Materials	0.31	236415.7B	23.93
Consumer Goods	19.39	2405746.2B	23.97
Technology	1.41	1276965.1B	24.99
Utilities	1.02	29630.1B	29.72
Industrial Goods	190.52	70845.8B	31.42
Healthcare	0.14	83419.0B	44.28

Now, in an effort to point out how you could locate overvalued stocks in a sector, below are some example stocks from an article about overvaluation in November of 2013. Note that the chart above shows an average P/E for Technology stocks of 24.99.

- **AOL (AOL): Valued at $3.3B – 38.8P/E**
- **Netflix (NFLX): Valued at $19.7B – 278P/E**

- **Linked In (LNKD): Valued at $25.6B – 965P/E**
- **Amazon (AMZN): Valued at $160B – 1,266P/E**

The author of the article that mentions these stocks was strongly advising readers to sell them and gave specific reasons why each stock could not justify the valuation. Does that mean that we could initiate trading strategies betting on them to drop significantly in value very soon? Not necessarily.

People may continue to buy when reason would dictate otherwise, particularly with technology stocks that they like, and products they use (e.g. Netflix). However, by doing a comparable study, we would be able to see how some stocks in a sector can have P/E ratios far out of the norm for that sector.

Using P/E Ratios works in the other direction as well. It is an example of a stock that was previously undervalued but became overvalued. AOL was mentioned in a low P/E article in August of 2012. At a share price of $33.40, earnings at that time gave it a P/E of only 3.15. As you can see, later it was trading at ten times that P/E.



Again, if you were buying low to sell high, you could have purchased AOL at that $33.40 share price in August of 2012 and held it until November of 2013 and sold it at around $47/share.

The point of this exercise is not to give you a trading strategy based on buying at low P/Es compared to the sector and then selling when they get too high. It may work at times, and at others it definitely will not. However, now you know how to spot potential candidates for other strategies, possibly options trades, that you use when a stock is undervalued or overvalued in your opinion and about to move in the other direction.

Insider Trading

One definition used for an "insider" is an investor owning at least 10% of a company's stock. Others would consider any highly placed manager, CEO, COO, Vice President or Director as insiders, no matter how much stock they own. Either way, when insiders are buying, it can mean that their inside knowledge is not yet available to the rest of us, so the stock could be undervalued based on release of coming news or earnings.

From the other direction, when insiders are selling, it can mean the opposite, that bad news or low earnings are coming and the stock is overvalued with that as yet unpublished news considered. However, insiders also regularly buy and sell stock for a variety of financial and personal reasons wholly unrelated to "secrets" they may know about the company or share price. There are online resources to monitor insider trading activity, one of which is Finviz.com.

Latest Insider Trading | Top Insider Trading Recent Week | Top 10% Owner Trading Recent Week **Filter** All Transactions

Ticker	Owner	Relationship	Date	Transaction	Cost	#Shares	Value ($)	#Shares Total	SEC Form 4
HAL	Pope Lawrence J	EVP Administration & CHRO	Jan 15	Sale	50.44	3,000	151,320	167,712	Jan 17 10:28 AM
VPRT	Hansen Hauke	Chief Manufacturing Officer	Jan 15	Option Exercise	0.00	510	0	14,611	Jan 17 10:14 AM
HMSY	LUCIA WILLIAM C	CEO	Jan 15	Option Exercise	3.15	20,000	63,000	325,426	Jan 17 10:06 AM
HMSY	LUCIA WILLIAM C	CEO	Jan 15	Sale	25.02	20,000	500,400	305,426	Jan 17 10:06 AM
SAM	ROPER MARTIN F	President and C.E.O.	Jan 16	Option Exercise	149.51	10,000	1,495,100	11,030	Jan 17 09:55 AM
SAM	ROPER MARTIN F	President and C.E.O.	Jan 16	Sale	219.51	10,000	2,195,092	1,030	Jan 17 09:55 AM
MTH	Sferruzza Hilla	Chief Accounting Officer	Jan 15	Sale	45.15	357	16,119	2,674	Jan 17 09:49 AM
AMWD	BRANDT WILLIAM F	Director	Jan 15	Sale	37.83	2,000	75,661	2,701,981	Jan 17 09:45 AM
AMWD	BRANDT WILLIAM F	Director	Jan 16	Sale	37.58	1,000	37,579	2,700,981	Jan 17 09:45 AM
TTGT	Cotoia Michael	Chief Operating Officer	Jan 16	Sale	6.91	2,800	19,348	240,534	Jan 17 09:45 AM
ADI	SEIF MARGARET K	VP, General Counsel, Secretary	Jan 15	Option Exercise	32.13	4,000	128,500	14,368	Jan 17 09:39 AM
ADI	SEIF MARGARET K	VP, General Counsel, Secretary	Jan 15	Sale	49.75	4,000	199,000	10,368	Jan 17 09:39 AM
VMC	Sansone Daniel F	Sr. VP & CFO	Jan 16	Option Exercise	46.76	2,500	116,900	19,774	Jan 17 09:38 AM
VMC	Sansone Daniel F	Sr. VP & CFO	Jan 16	Sale	60.00	2,500	150,000	17,274	Jan 17 09:38 AM
VLGEA	Estate of Perry Sumas	10% Owner	Jan 16	Sale	30.10	3,686	110,954	1,464,116	Jan 17 09:30 AM
ABCO	FELSENTHAL DAVID L	President	Jan 16	Sale	60.24	6,437	387,787	17,275	Jan 17 09:28 AM
TTGT	Hawk Don	Executive Director	Jan 16	Sale	6.95	800	5,560	209,523	Jan 17 08:38 AM
IBKR	Galik Milan	SVP Software Development	Jan 14	Sale	22.75	1,000	22,753	836,517	Jan 16 08:33 PM
IBKR	Galik Milan	SVP Software Development	Jan 15	Sale	23.04	1,000	23,040	835,517	Jan 16 08:33 PM
VG	Tempora Michael A.	SVP, Product Mgmt.	Jan 15	Option Exercise	1.37	12,219	16,740	26,890	Jan 16 07:41 PM
VG	Tempora Michael A.	SVP, Product Mgmt.	Jan 15	Sale	3.67	14,711	53,978	14,671	Jan 16 07:41 PM
ACM	NEWMAN RICHARD G	Director	Jan 14	Sale	30.02	10,000	300,235	160,160	Jan 16 07:36 PM

Trades are shown for buy and sell, as well as exercising of options. Locating multiple transactions of several insiders for a company could hint at an opportunity in the making.

Let's take a look at a couple of examples, one of buying and another of selling by insiders.

Insider Buying

The chart is displayed for buying only, and a company, LTS, is seen with multiple insiders buying shares.

LTS	Malamed Adam Scott	Chief Operating Officer	Jan 13	Buy	2.96	5,000	14,800	313,478 Jan 14
LTS	ZEITCHICK MARK	Executive Vice President	Jan 13	Buy	2.95	5,000	14,739	2,161,336 Jan 14
LTS	LAMPEN RICHARD	President and CEO	Jan 13	Buy	2.96	5,000	14,803	826,917 Jan 14
LTS	ROSENSTOCK RICHARD J	Director	Jan 13	Buy	2.96	5,000	14,801	129,000 Jan 14

The column fourth from the right is the number of shares purchased, and the next-to-last column before the date is their current holdings in number of shares.

This is a low-priced stock, with these 5,000 share purchases being executed at $2.96/share. Notable though is that these four different people, the top management and a director, are all buying. It could be for no "insider secret" reason, but you are just trying to spot opportunities. Here's the chart with an arrow where they bought.



You would then do some careful fundamental analysis to see if the performance of the company might justify following their lead with a Bullish strategy. We can see that the President and the Vice President both have significant holdings, so there could be some reason for adding more shares now.

Insider Selling

Now we are going to re-display the chart with just Sale transactions and see if there is anything of interest.

AEIS	Herron Danny C	Executive VP & CFO	Jan 16	Sale	27.00	16,124	435,348	25,849 Jan 16 (
AEIS	Herron Danny C	Executive VP & CFO	Jan 15	Sale	26.17	19,686	515,116	25,849 Jan 16 (
AEIS	GRADY EDWARD C	Director	Jan 16	Sale	27.62	8,000	220,957	12,500 Jan 16 (

Again, the fourth column from the right is the number of AEIS shares they sold, and the next-to-last column is their current holdings. So, we see one Executive VP and CFO and one Director selling a significant portion of their holdings on the same day. Here's the chart, with an arrow to the days of the trades.



Perhaps they are trading the swings in the stock, anticipating that there is resistance to going higher at this price and selling to take profits. If you have been following this stock, you may look back at mid-December and see whether there are buy transactions to prove the strategy.

It is Not Just Patterns and Charts

You have learned a lot in this chapter about stock valuations and identifying POTENTIALLY undervalued or overvalued stocks. I use those all caps to illustrate a point. You cannot just use what we have covered here - P/E Ratios and insider trading. You can begin to zero in on trading candidates this way, but must then go through the fundamentals of the stock, products, company information, earnings growth and more.

Fundamental analysis will back up your preliminary research, and you can narrow your options to the best candidates. Weak fundamentals and higher than sector P/Es could provide a trade opportunity for an overvalued stock. Strong fundamentals and lower than sector P/Es can give you an undervalued stock trading idea.

In My Experience

It is rarely a bad thing to execute a bullish strategy on an undervalued stock or a bearish trade on an overvalued stock. In time, all stocks return to their true value once the rhetoric about them dies down.

Chapter 12
The Concept of Long and Short

"In investing, you can be really right but temporarily quite wrong."
Jim Chanos

An article at BusinessInsider.com calls Jim Chanos the most successful short-seller in the world. He has made a lot of money for himself, clients and funds with a simple strategy:

"We try not to short on valuation, though at some price even reasonably good businesses will be good shorts due to limitations of growth. We try to focus on businesses where something is going wrong.

Better yet, we look for companies that are trying – often legally but aggressively – to hide the fact that things are going wrong through their accounting, acquisition policy or other means. Those are our bread-and-butter ideas."

So basically he looks for problems and shorts the stocks of those companies in anticipation of a drop in stock price whenever the problems become generally known. Let's see how shorting works.

When Borrowing Can Make You Richer

The basic structure of a trade when you are shorting (short-selling) a stock is that you borrow shares you don't own and sell them. Let's say that I have a strong belief that news of possible accounting abnormalities at ABC Corporation has some merit. It hasn't become big financial news yet, but I believe that it will. If so, the shares of ABC will plummet. Now, if I own ABC stock, I would be selling to protect myself.

However, I don't own ABC. You are my next door neighbor and you own 100 shares of ABC, and you love the company. I ask if I can borrow your shares, and do so. Then I sell them at the current value of $22/share, putting $2200 in my bank account.

The news about ABC's problems goes mainstream and the shares do just what I expected, dropping to $15/share. Once the dust settles, I buy 100 shares at $15, and I still have $700 profit left in my account. I return the shares and so you have your 100 shares back. Unfortunately, you are whole share-wise but with a dent in your net worth.

The process is actually a lot easier in application, as you don't have to know anyone who owns the shares you want to borrow and sell. Your brokerage will usually be holding a great many of those shares on behalf of other investors. When you place an order to short 100 shares of ABC, you are selling someone else's shares. Your obligation is to buy them in the future to close out your position.

The objective of the short sale trade is to sell them at the current price and to buy them back at a lower price, which is the direct opposite of buying long. Theoretically, a short position has a limited profit potential, but it also carries the risk of unlimited loss. If we are talking about our $22/share ABC Company shares, our maximum gain would be $22/share if the stock drops all the way to zero.

However, unlikely, should the news reported be wonderful, the stock then would has unlimited potential to the upside, and you'd be losing all the way up until you are able to buy it back.

Short Sellers Are Not Darth Vader

Short sellers would seem to be the evil alter-ego to the long-term buy-and-hold investors. Short sellers are betting against buy and hold investors, which is not a popular thing to do. However, the facts tell us that short sellers are actually very beneficial to a healthy market.

If everybody wants to buy, irrational exuberance can rule and stock prices can skyrocket to ridiculous levels. Short sellers supply shares when there might not otherwise be sellers, providing an alternate and balanced market from a company point of view.

Consider the long and the short investors as a kind of a debate club. Those buying long are bullish on the company or the market as a whole. They see good times and higher stock prices ahead. Short

sellers are bearish, perhaps just betting against the crowd, but often they have valid reasons for being skeptical about a company's stock prices in the near term.

Rules for Short-Selling

While you can pretty much buy any stock you can afford at any time, shorting stock must follow certain rules and limitations.

- **SEC Rules:** After severe market gyrations in 2008 and 2009, the SEC issued new short sale rules in 2010. If any stock drops 10% or more from the previous day's closing price, short selling is restricted. Like "piling-on" is penalized in football, restricting short sales when a stock is being beaten up helps to moderate downward price pressure.
- **Margin Requirements:** Standard margin account requirements apply, but there are also brokerage-specific requirements for the amount of value the account must hold to back up short sales transactions. With a potentially unlimited loss situation, account holders must maintain a minimum balance to reduce risk.
- **Margin Calls:** If account values drop below specific points, you could receive a "margin call" requiring you to deposit more funds to maintain an acceptable account position. You could be required to close out the position if you cannot meet the margin call.

There are other rules specific to brokerages and perhaps your experience level. However, it is just common sense to understand the limited reward and unlimited risk profile of a short position.

Short Sales as an Analytical Tool

The amount of short-selling activity can help investors to analyze stocks and make decisions. There are two specific indicators:

- **Short Interest:** This is the total number of shares held short in a stock, and it is often expressed as a percentage of all of the shares outstanding. This is a regularly-reported indicator, and it can mean two very different things based on just how high the percentage gets.

  Up to a point, the higher the short interest, the more bearish the outlook for the stock. However, if this percentage gets very high, it can be bullish. That's because at some point all of those shares held short will have to be purchased to close the positions, and that much buying can bring higher share prices.
- **Days-To-Cover:** This is the number of days it would take at the average daily trading level to liquidate short positions. In other words, if there are 24 million short shares outstanding, and this stock trades at around 4 million shares per day, it would take 6 days of normal trading to close out all of those short positions.

(1) Illumina Inc (NASDAQ:ILMN) – 17.92 Days to Cover

As of:	Total Shares Short:	Avg. Daily Volume	Days to Cover
12/31/2013	23,009,893	1,283,687	***17.92***

The screenshot shows how days-to-cover is reported. Paying attention to the short interest in a stock is a great way to safeguard a long position.

Don't limit your thinking

Buying a stock can certainly be a profitable strategy, but taking a short position can be much better in the right situations. Expand your knowledge of using a bearish strategy when a stock is overvalued.

Chapter 13
The Buffett Approach

"Rule No. 1: Never lose money; Rule No 2: Don't forget rule No. 1."
Warren Buffett

Don't believe for a moment that Warren Buffett has never lost money on his investments. However, he has won so much more than he has lost, and has a reputation as one of the greatest investors in the world. When he speaks, people listen and take action.

Along that line, some of what you read here may seem contradictory, as Buffett is quoted everywhere and has been asked thousands of questions. Sometimes the context of the interview and question can elicit a response that seems contradictory to something he said in another context. However, generally investors seeking value will try to follow in Buffett's footsteps.

Buffet invests for value over the long term, and we are going to look at some of his valuation strategies and the rules he applies to evaluate a company and whether to buy their shares or not.

Intrinsic Value Investing

Intrinsic value is the actual internal value of a company based on the fundamental performance of the business. Value investors seek to purchase shares of companies with shares trading below their intrinsic value per share; in other words, they are undervalued.

Value investors understand that markets and individual stocks can be volatile based on trading overreaction. People will buy and sell based on emotion, good or bad news, or just because some "guru" analyst upgrades or downgrades a company. By carefully studying the fundamentals of the company and financial measurements, value investors seek to find companies trading below their intrinsic value.

The fundamentals and financial measures used can include price-to-earnings ratios, high dividend yields, and price-to-book ratios.

There are others, and we are going to take a look at those in this chapter.

Considering Mr. Buffett's quote at the top of this chapter, let's think about how two investors may arrive at different intrinsic values for the same company, using the same measurements. Different investors will place different weights on some fundamental characteristics or financial measures. It is subjective in some cases, so investors will frequently arrive at different conclusions for the value of a company. So the more undervalued the company appears to be, the better. This provides for more room for error and less likelihood of losses.

BUFFETT'S BIG PICTURE ANALYSIS

Before we look at different fundamental analysis tools and financial measurements, let's review some quotes by Buffett that illustrate his big picture analytical approach to valuation.

Is the Business Simple to Understand?

"The business schools reward difficult complex behavior more than simple behavior, but simple behavior is more effective."

If a business is doing something too complex to understand, it can add risk. It is far easier for an investor to value a company that makes a simple product but does it very well.

How Does Management Communicate with Shareholders

"The CEO who misleads others in public may eventually mislead himself in private."

How honest is financial reporting by management to shareholders? Accurate data based on sound accounting principles should be the rule, and it should be consistently applied in all communications

with shareholders. If management is glossing over problems or hyping mediocre numbers, it is not a company Buffett will want to buy.

What's the History of Operational Performance?

"Only buy something that you'd be perfectly happy to hold if the market shut down for 10 years."

Has the company been around for a while, and has it been consistently producing earnings from the same products or services? If so, chances are that holding stock in this company for a long while will be profitable, as that's their historic performance.

Focus on Return on Equity

"Focus on return on equity, not earnings per share."

If a company is producing a high earnings rate on the equity capital in the business, and can do so without high leverage or accounting tricks, then it is a sign of good management.

How High is the Profit Margin

"It is far better to buy a wonderful company at a fair price than a fair company at a wonderful price."

Buffett has made it clear in many statements that he values companies with low expenses and high margins. Berkshire Hathaway is a great illustration of this concept, as the management expenses of the company are very low compared to other investment companies.

What is the Value of the Business?

"Price is what you pay. Value is what you get."

Again, this is related to "intrinsic value". However, this introduces Buffett's reliance on DCF, Discounted Cash Flow analysis. He

values a business in part based on the net cash flows expected over the life of the business. We'll look at the DCF model later.

Can You Buy at a Good Discount to Value

"If a business does well, the stock eventually follows."

Buffett does a thorough analysis of the company and determines intrinsic value. He then targets the company and waits to buy until it is significantly undervalued. The quote illustrates his view that just because he can buy it at a low price now, his valuation is accurate and the stock will move up.

DISCOUNTED CASH FLOW ANALYSIS

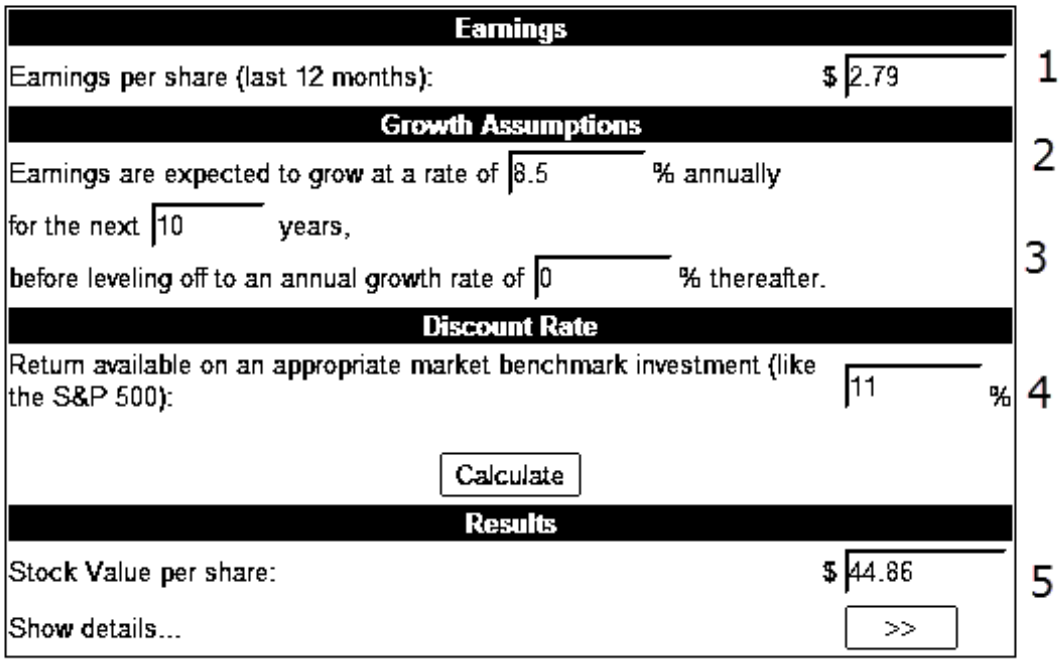
Warren Buffet uses Discounted Cash Flow extensively as a tool for valuing companies. . Basically, Discounted Cash Flow (DCF) takes the future estimated cash flow from a stock and then discounts the value into today's dollars. This yields the intrinsic value of the stock today, and if the stock can be purchased below this level, it may represent an attractive investment.

There are pages of detailed formulas needed to do this analysis, and it also requires some subjective input, such as what your expected return would be if you invested your money in other assets, and what analysts are predicting for the future earnings growth of the company. The good news is that we don't have to get into the complex formulas, as we have the Web to do the heavy lifting for us. There are a number of online DCF calculators available, some free and some with membership.

Here's a screenshot of a DCF calculator from MoneyChimp.com. I have entered data for GIS, General Mills. Let's look at it "by the numbers."

Discounted Cash Flows Calculator

This calculator finds the fair value of a stock investment the theoretically correct way, as the present value of future earnings. You can find company earnings via the box below.



1. The $2.79 is the previous 12 months' earnings per share.
2. Here we can use prior history or analysts' expectations to estimate the growth in earnings annually into the future. GIS has been rather consistent, so the 8.5% is a good number to use.
3. We decide to look at earnings growth for the next 10 years, and the zero in the other box indicates we are not going out any farther than that with any estimates of value or earnings. In other words, in 10 years, we are out of the stock.
4. We are going to compare this as an investment with the historic overall return as if we invested in a diversified bucket of stocks. Many use 11% as the average return we would have experienced.

5. All of those complicated formulas are done for you, and here we see that this calculator shows the current intrinsic value of GIS, General Mills stock per share. Today it is trading at $48.28, so we are not seeing a screaming value here. However, this has been a long-term good company paying dividends, so we may not rule it out simply based on this calculation alone. Also, things can change tomorrow and the stock could drop in price.

Another thing to remember is that you can test out the same numbers with multiple calculators and get somewhat different results. Some ask for long-term debt and outstanding number of shares, which can change the results based on the Debt to Equity ratio.

It is a Basket of Variables

We have taken a pretty extensive look at many of the factors that play into whether Warren Buffet would like a stock. It is not hard science, since on any given day we may put more emphasis on one calculation's results than another. Then there's also how we feel about the company and whether we personally like and use their products.

Everything we have covered here is based on a long-term buy-and-hold strategy, buying into companies expected to perform well for years into the future. We know this is important to Warren Buffet, as seen here in two of his more famous quotes:

"I never attempt to make money on the stock market. I buy on the assumption that they could close the market the next day and not reopen it for five years." AND,

"Only buy something that you'd be perfectly happy to hold if the market shut down for 10 years."

This chapter dealt with definite considerations Mr. Buffett employs in valuing a company. However, he also uses many of the other Fundamental Analysis tools and measures that we will discuss in the next chapter, so let's take a look at those.

In My Experience

Buffet says: "I would rather own a great company at a fair price than a poor company at a great price." I agree. Great businesses almost always increase in value over time.

Chapter 14
Fundamental Analysis

"Even the intelligent investor is likely to need considerable willpower to keep from following the crowd."

Benjamin Graham

The financial measurements used in accounting and to evaluate the performance of companies, if applied honestly and accurately, will give you a complete picture of how a company is doing. They also allow you to develop a pretty good idea of the company's future. Let's look at some definitions and calculations used in fundamental analysis.

ROIC – Return on Invested Capital

This is a calculation used to assess the efficiency in how a company allocates the capital it controls to profitable investments. It is a measurement of how well a company is using its money to generate profits.

$$\text{ROIC} = \frac{\text{Net Income} - \text{Dividends}}{\text{Total Capital}}$$

Total capital includes common and preferred shares, as well as long term debt. ROIC is always expressed as a percentage. It is major drawback is that it does not inform us as to where the income is being generated. It could be coming from operations or from a one-time event.

ROA – Return on Assets

This is an indicator of how much a company is doing with the assets employed in the business. In other words, how much in dollar value is invested in the business divided into the net profit.

$$\frac{\text{Net Income}}{\text{Total Assets}}$$

So if a company has $10 million in assets and creates $1.2 million in profits, it would look like this:

$$\frac{\$1{,}200{,}000}{\$10{,}000{,}000}$$

0.12 or 12% ROA

While this number will vary considerably across industries, it is a good ratio with which to compare companies within a sector or industry.

Price-To-Sales

The Price to Sales Ratio values a company based on dividing the price of a share of stock by the previous year's sales revenue per share. So if a company has one million shares of stock outstanding, overall sales were $12,000,000 last year, and a share of stock is selling for $16.50, here's how it would look:

$$\frac{\text{Share Price}}{\text{Sales/Outstanding Shares}}$$

$$\frac{\$16.50}{\$12.00 \text{ per share revenue}}$$

1.38 Price to Sales

The lower this number, the better. It allows you to compare a company with itself and its performance over time, as well as to compare it with other companies in the same sector.

Price-To-Book Ratio

Every company has two valuations on any given day, the book value as shown on the financial statements versus the valuation indicated by the stock price the market valuation. The book value is roughly the value you would receive if you liquidated the assets of the company. So you would subtract the book value of liabilities such as loans from the book value of assets, inventory, facilities, cash, etc.

This ratio works best for companies with mostly tangible assets, as intangible assets such as intellectual property are not considered. Here's how the calculation looks:

$$\frac{\text{Price Per Share}}{\text{Book Value of Equity}}$$

So if a company has a book value of $120,000,000, and 10 million shares outstanding selling for $36/share, the calculation would look like this:

$$\frac{\$36/\text{share}}{\$12 \text{ (book value / 10 million shares)}}$$

This would be a Price-to-Book ratio of 3.0. P/B ratios of 3.0 or lower attract the attention of value investors, but it may not be all good news. The stock could be undervalued, or, there could also be problems in the company which are depressing the stock price. Using this ratio in tandem with Return on Equity can indicate a truly undervalued stock.

ROE – Return on Equity

The Return on Equity is the amount of net income a company generates with the money invested by shareholders. ROE is calculated this way:

$$\frac{\text{Net Income}}{\text{Shareholder's Equity}}$$

Using this calculation we can compare companies in the same type of business to see which generate more profit from the money invested by shareholders. An example comparison might be Google and Yahoo, both in the Internet sector. At the end of September 2013, ROE for Yahoo was 9.14%, while ROE for Google was 16.48%

Of course, this is just one of many comparisons you would do if you were trying to decide between the two companies for investment. The fact that a share of Yahoo at that time was trading at around $39/share, while you'd have had to fork out $1155.90 for a share of Google, would definitely weigh into your decision process, if you had limited cash to invest.

Sometimes it is of value to compare the change in shareholder's equity over time. You could find return on equity trending higher for one company while diminishing for another company. As Another term for return on equity, RONW, Return On Net Worth, is one of many forms of fundamental analysis for many investors.

Cash Per Share Ratio

This is as simple as the name implies. It is the amount of cash or cash equivalents on hand divided by the number of shares. Therefore, if the company has $10 million dollars in cash on hand and 10 million shares, this would be a Cash Per Share Ratio of 1.0. Of course, the higher this number, the better. On occasion there can even be a Cash Per Share Ratio approaching the price of a share of stock, which is a

strong buy indicator for many investors. Too much cash versus the price of the stock can result in takeover actions as well.

Dividend Yield

Investors desiring income from dividends will make dividend yield a target for their attention. Of course dividend yield is not the only factor for analysis, as there can be many reasons why one company has a higher dividend yield than another yet not be as suitable an investment. The calculation is simple; you divide the annual dividend amount paid by the company, by the price per share.

$$\frac{\text{Annual Dividends Per Share}}{\text{Price Per Share}}$$

A stock paying $0.80 per year in dividends ($0.20/quarter), and selling for $25/share, would have a dividend ratio of .032, or 3.2%.

Payout Ratio

Companies that pay dividends do so out of their earnings. The Payout Ratio is the percentage of earnings paid out as dividends. Some companies may be plowing money back into the company for research or development, reducing available funds with which to pay a dividend. So the formula is:

$$\frac{\text{Dividends Per Share}}{\text{Earnings Per Share}}$$

This number is expressed as a percentage. So a company paying out $2.00 per year in dividends with earnings of $4.00 per share would have a Payout Ratio of .50 or 50%. There can be good reasons for retaining earnings, but, dividend seekers will pay attention to the Payout Ratio. It changes from year to year.

P/E – Price to Earnings Ratio

This is a widely followed ratio for companies. It is the price of a share of stock divided by the earnings per share over the preceding four quarters. So if a stock is selling for $38/share, and earnings for the previous four quarters totaled $2.85, the P/E would be:

$$\frac{\text{Share Price}}{\text{Earnings Previous Year}}$$

$$\frac{\$38}{\$2.85}$$

13.33 Price to Earnings Ratio

Different sectors and industries have very different average P/Es, but it is a widely-used comparison for stocks within the same group. Value investors search for stocks trading at P/E ratios lower than their peers. All other factors being roughly equal, a lower P/E might mean a good buy.

Forward P/E

This is the same calculation as above, but it is using the future 12 months of projected earnings for the calculation. The Forward P/E of course is only an estimate, and a company or analysts may be off in their future estimate of earnings.

However, using both the normal P/E and the Forward P/E, investors can spot opportunities if there is a large difference in the two. Suppose the Forward P/E is much lower because of increasing earnings. In our previous example, if the stock is selling at $38/share and the projected earnings next year is $4.85, the Forward P/E would be 7.84; this is quite a bit lower and maybe an indicator of future share price increases as earnings prove to be accurately predicted.

PEG – Price/Earnings to Growth Ratio

Even better to aid you in valuation of a company and investment decisions, using the PEG ratio adds context to the straight Price to Earnings number. You see, you are going to compare the P/E to the anticipated growth in earnings per share in the future. Here's the formula:

$$\frac{\text{P/E Ratio}}{\text{Annual EPS Growth}}$$

As the number on the bottom gets larger, meaning good growth in earnings, the PEG will get smaller. So a smaller PEG could indicate value better than just the current P/E.

Google Key Statistics

Currency in USD

Current Valuation

Market Cap	389.22B
Enterprise Value	337.50B
PE Ratio (TTM)	31.08
PE 10 Pro	Go Pro
PEG Ratio (TTM)	1.671
Earnings Yield (TTM)	3.22%
PS Ratio (TTM)	6.730
Price to Book Value	4.690
EV to Revenues (TTM) Pro	Go Pro
EV to EBITDA (TTM) Pro	Go Pro
EV to EBIT (TTM) Pro	Go Pro
Operating PE Ratio (TTM) Pro	Go Pro
Operating Earnings Yield (TTM) Pro	Go Pro

This is a valuation chart for Google, and it shows us a current P/E of 31.08. Now that may or may not look good when compared with the P/E of other Internet companies, but take a look at the PEG just below it. With a PEG of only 1.671, this is telling us – by working the formula backwards – that the expected annual growth in EPS for Google is 18.6%. [31.08 / 1.67]

So we see that the expectation is for Google's earnings per share (EPS) to grow by 18.6% next year. Since Google already looks pretty good against competitors based on P/E alone, this could tip your decision to a Buy (if you can afford the hefty per share price.)

EPS – Earnings Per Share

Earnings Per Share is a direct indicator of a company's profitability by outstanding share. There are a couple of ways to calculate EPS, one being very easy and the other just a bit more complicated in order to remove dividends from net income.

Option 1:

This one is pretty straightforward. You divide the annual earnings amount by the number of outstanding shares.

$$\frac{\text{Earnings}}{\text{\# Outstanding Shares}}$$

So a company with $12 million dollars in earnings and 5 million shares outstanding would look like this:

$$\frac{\$12{,}000{,}000}{5{,}000{,}000}$$

EPS = $2.40/share

Option 2:

In this option we want to calculate with dividends removed. So if this same company in our example paid $1.00 in dividends, it would look like this:

$$\frac{\$12{,}000{,}000 - \$5{,}000{,}000\ (\$1/\text{share dividend})}{5 \text{ million shares}}$$

$$\frac{\$7{,}000{,}000}{5{,}000{,}000}$$

EPS - $1.40/share

EPS is a very popular and widely-quoted comparison valuation ratio.

Insider Ownership

This is an indicator that can help you to gauge the commitment of the ownership of a company. It is the number of shares held by "insiders" in a company, divided by the total number of shares outstanding. Insiders are defined as those who own more than 10% of shares or who are officers or board members of the company.

Obviously, when large numbers of shares are owned by insiders, you would expect them to be very dedicated to the success of the company. The formula is simple:

$$\frac{\text{Shares Held by Insiders}}{\text{Total Outstanding Shares}}$$

A high percentage of insider ownership would normally indicate that the insiders are pretty confident in the company's future and are committed to success.

Debt-to-Equity Ratio

Debt-to-Equity Ratio is calculated by dividing the company's Total Liabilities by the Stockholders' Equity.

$$\frac{\text{Total Liabilities}}{\text{Shareholder Equity}}$$

This calculation yields a view of the leverage being used by the company to finance assets and operations. It there's lots of debt, the Debt/Equity Ratio will be high, indicating a major influence of debt on company operations and profits. The interest payments on this debt can cause fluctuations in stock prices as other financial performance factors change.

This ratio can be calculated in different ways. One analyst may include all short-term and long-term debt, while another may only include long-term obligations. Some analysts exclude accrued liabilities and leases or other forms of off-balance sheet financing.

The Debt/Equity Ratio varies by industry, as some industries such as auto manufacturing are capital intensive and require more debt to buy equipment and operate. For this reason, it is a calculation best used to compare companies within the same industry.

Profit Margin

If you divide the net income of a company by the revenues (sales), you get profit margin.

$$\frac{\text{Net Income}}{\text{Revenue}}$$

Because expenses impact net income, comparing two companies' profit margins can help to determine which is operating more efficiently. A higher profit margin usually indicates that a company has better control of its costs compared to another.

This calculation helps us get past looking solely at earnings increases. While a company can increase sales and earnings from quarter to quarter, if profit margin is not also going up or, even worse, it is going down, then there could be increasing cost issues.

Net Income

This is profit from operations. Subtracting the costs of doing business, depreciation, taxes, interest and other expenses, you get Net Income. Net Income is reflected on the company's income statement. If all costs and revenues are accurately reported, this number is a reliable indicator of how well the company is being managed and how profitable it is. Here's how you may see net income reported in an income statement analysis. This is for Apple.



Income Statement

Revenue (TTM)	170.91B
Revenue (Per Share Quarterly) Pro	Go Pro
Revenue (Quarterly YoY Growth)	4.19%
EPS Diluted (TTM)	39.63
EPS Diluted (Quarterly YoY Growth)	-4.73%
Net Income (TTM)	37.04B
EBITDA (TTM) Pro	Go Pro
Income from Continuing Operations (Quarterly) Pro	Go Pro
Other Comprehensive Income (Quarterly) Pro	Go Pro

Chart courtesy of YCharts.com

Should less-than-accurate or even manipulated income or expense items enter the calculation, it would not be reliable. This is important to know, as you will read now and then about "accounting irregularities" that call a company's bottom line into question.

Net Sales

Sales are the top end of the income calculation, but they don't necessarily include every dollar taken in at the store or consumer level. Net Sales are adjusted by subtracting returns, allowances, damaged or missing inventory, and any discounts given.

Gross sales are before those deductions, and if there is a large or growing difference between gross and net sales, it could be an indicator of delivery or quality problems.

Market Capitalization

You have seen articles that state a company is "worth" a certain amount of money, perhaps in a discussion of its growth or how it may

be the target of an acquisition strategy. This "worth" is really the Market Capitalization for a publicly-traded company. It is the total number of outstanding stock shares times the current market price per share.

So if a company currently has 10 million shares outstanding, and today's cost per share is $28, then it currently has a market capitalization of $280 million. Different investment analysts use variations of groupings of companies by market cap, but three categories and values commonly used are:

- Large Cap: $10 billion and higher
- Mid Cap: $2 billion to $10 billion
- Small Cap: Less than $2 billion

There are different challenges and business best practices across this value spectrum, so you'll possibly use Market Capitalization in your analysis to make a decision between companies of different sizes in the same industry or sector.

It is Really Fundamental

These are measurements of the fundamental operations and finances of a company. If they are accurate and not falsified or inflated, they will give you a very thorough view of the health of a company.

In the next chapter, we'll take a look at Technical Analysis which is a very different animal.

In My Experience
If you own stocks in companies that have good earnings growth, good revenue growth, solid free cash flow growth, and a sustainable dividend, you WILL make money. The formula cannot be disputed.

Chapter 15
Researching a Company

Now that we have learned about fundamentals, let's get some basics in how we research companies for investment potential. Plenty of information is out there in both print and online. In this chapter we'll cover various information resources including:

- News
- Charts
- Corporate websites and reports
- Annual reports
- Balance sheets
- Income statements

The more you know about a company, the more secure you can feel in your investment choices.

News

Stocks are the vehicle by which we trade ownership in public companies. "Public" is the keyword, and there will be a constant stream of news items out there about a company, especially if they are dominant or active in their marketplace.

You can read the Wall Street Journal, available either in print or online. There are numerous websites that follow the news releases on companies, and online resources get them to you almost immediately after release. CNBC, Yahoo Finance, and MarketWatch are a few of my favorites.

Charts

Charts provide a visual graphic representation of a stock's price or fundamental performance. Here is an example of a price chart:



All charts are similar in that they plot the stock's price on the vertical axis and the time on the horizontal. Most allow you to choose a time period, usually daily, weekly, monthly, or a year or more. Just glancing at a chart you'll get a quick overview of how the price has been moving over the chart time period.

Fundamental traders use charts for historical information, but don't focus on price patterns. Technical traders, on the other hand, do focus on analyzing price movements and classifying them into movement patterns. Technical traders use these shorter term patterns to make buying and selling decisions.

One useful quick analysis tool used with charts is to compare an individual stock's chart price movement with other companies in the same business group and with an overall index of a group. If a stock is moving differently than others in the same business, there could be reason to investigate further.

The addition of items such as moving averages and other indicators to a basic chart can add a great deal of interpretive data to help the technical trader make decisions. Everyone uses charts in one way or another, and there are numerous free online chart services.

COMPANY PROFILES, REPORTS AND WEBSITES

Company Profiles

There are numerous print and online company valuation, rating and profile services. Examples include Standard & Poor's, Value Line, and Moody's. These companies pull together much of the information we are discussing in this chapter into a comprehensive profile and overview of the company, including predictions of future performance.

Corporate Websites and Reports

Excellent resources for company information are their own websites. They are generally quite comprehensive, with information about the company's products, services, marketing strategies, market position, and copies of recent reports and SEC filings. There will also be a press section with recent and historic news releases.

As far as reports required from public companies, The SEC requires a quarterly 10Q report, which is made available to all interested parties. Annually, a 10K report is required, and it is much more detailed, and also made available to anyone. The company may also make various reports available on their website.

Letter to Shareholders

The company Chief Executive Officer publishes an annual letter to shareholders with the highlights of the previous year, and includes charts and basic financial information. The business of the company is described, and any financial highlights deemed of interest will be included.

Financial Statements

All reports will include the following financial statements:

- Income statement
- Balance sheet
- Statement of shareholders' equity
- Cash flow statement

Included in these reports is a discussion of the financial figures presented in the report and a comparison of each year with the two prior years. Explanations of ups and downs of cost and revenue items will also be included.

The accounting principles used in preparation of the reports are cited in Footnotes. Inventories, debt, lease calculations, depreciation, and income tax calculations are always shown.

An auditors' statement is included as well. All public companies must be audited at least once each year by a licensed public accounting firm. A letter from the firm signifies that the audit has been satisfactorily completed.

All contact and management information is also included in the reports. Lists and contact information for the Board of Directors and corporate officers are included, often with photos.

The Balance Sheet

The balance sheet presents the accumulated assets and liabilities of the company. The total assets always equal the total liabilities plus shareholders' equity. There are no exceptions to this rule. Here are the primary terms used in a balance sheet.

- **Current Assets** – Assets which are readily liquid or come due in less than one year.
- **Cash** – The amount of money a company has in the bank or similar accounts.

- **Marketable Securities** – Securities such as short–term government debt which a company can liquidate into cash on short notice.
- **Accounts Receivable** – This represents money to be collected for the sale of product or service by a company. For example, if you buy a soft drink from the corner grocery and promise to pay him tomorrow, he then has an account receivable. He sold the good, believing you will pay for it, but the money is still owed to him.
- **Inventories** – Products manufactured by the company but not yet sold. Check the footnotes of the company's report to see how this is calculated. This number is netted to reflect the sales and the purchases of the prior year.
- **Other** – This can include just about anything, from tax refunds owed, to loans to employees that need to be paid back. Often, the footnotes or the management's discussion provide more detail.
- **Other Assets** – Again, this can include about anything and is sometimes described further in the footnotes or the management's discussion.
- **Plant, Property and Equipment** – The total value of all assets owned by a company that are not readily disposable. This number is netted to show the effects of a year's purchases and depreciation. Details of the calculation are always provided in the footnotes.
- **Goodwill** – When a company buys another company much of the purchase price gets categorized as goodwill. It is amortized over many years following rules presented by the Accounting Standards Board and further described in the footnotes.
- **Total Assets** – The sum of all the assets. Remember this always equals the total liabilities plus shareholders' equity.
- **Current Liabilities** – The debts of the company, which must be paid within one year.

- **Notes Payable** – Generally represents short–term debt such as lines of credit or commercial paper.
- **Accounts Payable** – The amount owed to suppliers of products used by the company.
- **Income Taxes** – As described in the footnotes of an annual report, the amount of money the company will have to pay in taxes during the current year for the prior year's profits. Taxes paid to the government, and taxes declared in an annual report often differ. The difference over time is accounted for in the many tax entries on the balance sheet.
- **Current Portion of Long–Term Debt** – Represents the original long–term bonds and other loans of a company that come due during the next year.
- **Other Current Liabilities** – Again, this can include about anything and is sometimes further described in the footnotes or the management's discussion.
- **Long–Term Debt** – All debt that is due in more than one year, such as corporate bonds or loans.
- **Deferred Income Taxes** – Income taxes which the company will owe the government in more than a year's time that result from differing tax and financial accounting methods.
- **Minority Interest** – This represents the holding of less than 50% of the voting stock of another company. It generally appears in the shareholders' equity section of a balance sheet. This may vary depending on the details of a deal. In addition, any profits or losses from this should show up on the income statement.
- **Other Non–Current Liabilities** – This can also include anything and is sometimes further described in the footnotes or the management's discussion.
- **Stockholders' Equity (Shareholders' Equity**) – Represents the amount of money invested in the company by shareholders.

- **Common Shares at Par Value** – All shares of stock have a par value, which is a somewhat arbitrary value assigned to the stock when issued. It is generally either one cent, but can vary by company. This amount multiplied by the shares outstanding on the balance sheet provides the number shown.
- **Additional Paid–In Capital** – Represents the additional value paid to the company per share of stock issued when the stock was originally issued.
- **Retained Earnings** – The net income of a company less any dividends paid. This money would also be owed to shareholders if the company spontaneously liquidated, so it counts as part of stockholders' equity.
- **Total Liabilities and Stockholders' Equity** – This is the sum of all the numbers on the liabilities side of the balance sheet. Remember, it always equals total assets.

Income Statement

The income statement reports how much money a company made or lost in the prior year (or quarter). It also provides some detail of where the money was earned and was spent. Some terms used in the income statement include:

- **Revenues** – The amount a company made selling its products and/or services. If a company has many divisions or geographic groups, the subtotals are shown. Sometimes this breakdown is shown elsewhere in the report.
- **Costs of Goods Sold** – Shows how much the company spent to manufacture or directly provide the product or service. For example, if a company sells steel, this number represents the cost of the raw materials, labor and other expenses directly related to making steel.

- **Gross Profit** – The difference between costs of goods sold and revenues. It shows you how much the company would have made if it did not have any other expenses or taxes.
- **Selling, General and Administrative Expenses (S, G & A)** – The expenses of a company for necessary operations not directly related to the manufacture or delivery of a product including the cost of offices, a sales team, information technology and management salaries and benefits. Often, depreciation and amortization is lumped into this number. In these cases, you need to look at the cash flow statement to find the true number.
- **Depreciation and Amortization** – When a company invests in plant property or equipment designed to last more than one year, it is allowed to declare this expense over many years. The number of years and methods of declaring it vary by item and by company.
- **Operating Income or Earnings Before Interest and Taxes (EBIT)** – The gross profit less the S, G & A, depreciation and amortization. It shows how much a company made from operations before financing activities, other unusual activities and taxes.
- **Interest Expense or Income** – Shows how much interest a company paid on its outstanding debt during a year. Sometimes a company has little debt but has made some loans to other companies, in which case it would have interest income.
- **Other Expenses or Income** – Often a company has expenses or income not related to its main lines of business. This can be from the sale of stock held in another company, from the sale of a plant, or from other sources. These numbers are sometimes explained in the management discussion and analysis.

- **Income Before Taxes** – The sum of all the numbers above. It shows how much profit a company would have made without taxes.
- **Provision for Income Taxes** – Shows how much the company owed the government in taxes. Remember from the balance sheet that companies calculate taxes using both income tax accounting and financial accounting. These numbers generally differ in which case the actual amount of taxes paid can be computed using the footnotes.
- **Net Income** – The income a company earned after all sources of revenues and expenses are taken into account.
- **Earnings Per Share** – Equals the net income divided by the average shares outstanding. It shows how much the company made per share of stock.
- **Fully Diluted Earnings Per Share** – Equals the net income divided by the fully diluted shares outstanding.
- **Average Shares Outstanding** – shows how many shares of stock are issued and held by an investor.
- **Fully Diluted Shares Outstanding** – Often a company issues options to employees, management, bondholders or other parties. This number shows how many shares would be outstanding if all these options were exercised.
- **Statement of Shareholders' Equity** – This statement provides the detail behind the balance sheet shareholders' equity by showing the additions of net income and equity raised as well as any subtractions. The end sum is transferred directly to the balance sheet.

All of the resources in this chapter will be useful to the investor in researching a company, its business, and its performance. A fully informed investor is a successful investor.

In My Experience

There is no substitute for doing research on a company. The task will seem tedious at first, but once you get comfortable with it, it is actually fun… and profitable. It is good enough for Mr. Buffett.

Chapter 16
Technical Analysis

Goal: To explain technical analysis in a way that helps you use it to support fundamental analysis for stock selection.

What is Technical Analysis?

Technical analysis is the process of predicting a stock's future price movements by studying past activity. It is partially a study of price data, but it is also analysis of price chart patterns. How does technical analysis differ from fundamental analysis?

You just completed the chapter on fundamental analysis, so you have seen that it is a very detailed set of measurements of the performance of a company: sales, expenses, profits and more. It also includes some less tangible analysis, such as the popularity of the brand, or the competitiveness of the company.

Technical analysis assumes that all of this information is known, so it is already factored into a stock's price. While a few "in-the-know" people may get early notice of changes that influence value, the vast majority of investors are buying or selling after any news has already been factored into the price.

Technical analysis also attempts to learn from human nature and past reactions to a stock's good or bad news or changes in operations of the company. By looking at the past price movements and the volume of trades associated with them, sometimes a technical trader can make an accurate prediction of future price action.

Technical analysis is a topic that could easily fill a complete book, and is in fact the subject of many books on the market. For our purposes here, I will give you an overview, as well as some specific technical analysis tools that may help you in some of the option trades I will explain later.

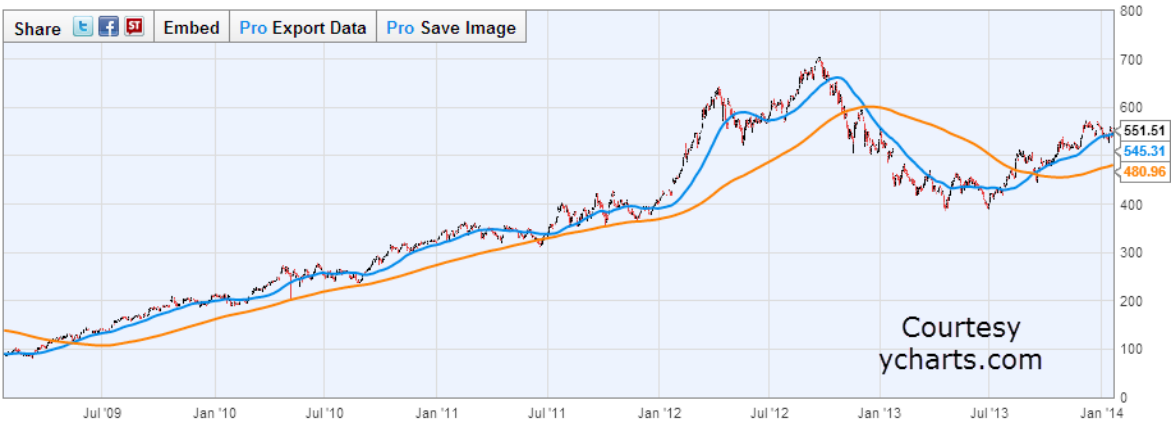
Technical analysis is one of many tools we use in market study and individual stock and options trading. I do not recommend a purely technical approach to any investing. It is simply another tool that can help you make decisions or reinforce a decision you have already made.

Trends

Technical traders focus on the analysis of trends. The famous sayings that, "history repeats itself", and, "the trend is your friend", are both popular because they both tend to be true. However, by their very nature, trends end, therefore you cannot count on their continuance one hundred percent of the time. The good news is: You don't have to be right one hundred percent of the time to be a successful investor. You only need to be right *most* of the time.

With stocks, there are three major trends: up, down, and sideways.

Up Trend



The screen shot of a chart for Apple shows a long term UP trend from 2008 into mid-2012. Sure, there were many short-term ups and downs during that period, but the long-term trend was pretty defined.

Note also that when it ended, it did so with a significant drop over six months or so. An uptrend is defined as a series of higher highs and higher lows.

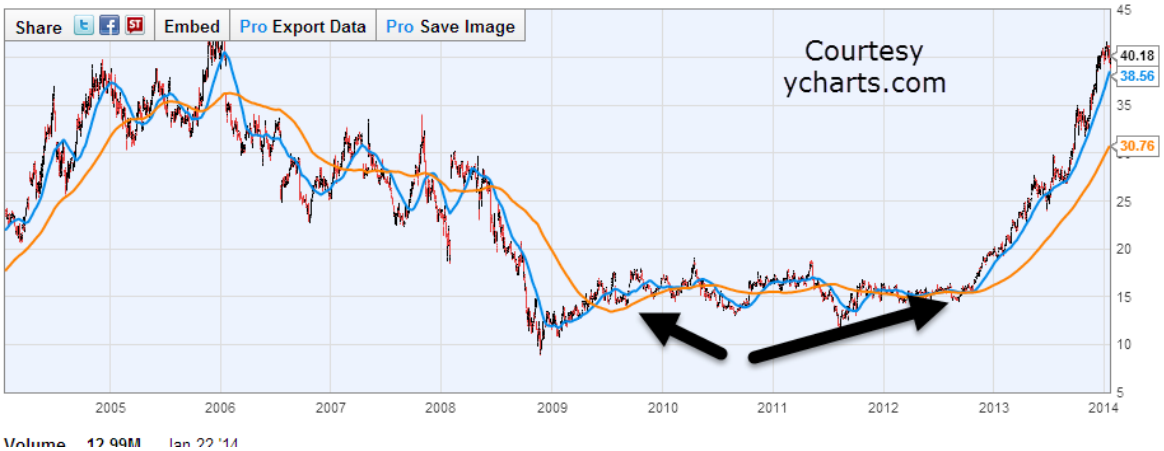
The fact is that technical traders are not always assuming a trend is long-term. They work with trends over shorter periods and look for indicators of changes in short-term trends that may indicate the direction of price movement is about to change. We could be seeing the beginning of a reversal in the shorter term down trend in this chart around July of 2013.

Down Trend



This is a Yahoo 10 year price chart. We can see a clear down trend for three years or so from 2006 into 2009. There are some significant reversals, but for the most part this fits the definition of a downtrend of a series of lower highs and lower lows.

Sideways Trend



This is the same Yahoo chart showing how the down trend ended and the stock exhibited a three year movement sideways. Actually, we could have used the long-term Yahoo chart to illustrate all three trends, as it left the sideways trend and is currently in an uptrend.

Again, trends vary in duration. It might be an expensive mistake to assume that two three-year trends for Yahoo indicate that this current uptrend will last for three years. Notice that it is also a steep uptrend at this time, not necessarily sustainable, or it could be in for some short-term reversals along the way.

Support and Resistance

As it is human beings buying and selling stocks, sometimes a general buying bias will be displayed. More buyers enter the market for whatever reason, perhaps unexpected higher than forecast earnings, and the price of the stock rises. At some point, the allure of the stock is not as great due to the currently higher price, and then the stock's price will settle into a sideways trend or it will even reverse and start downward. That represents ***resistance*** to further price increases when buyers begin to resist paying more.



The upper horizontal line in this Yahoo chart for 2012 shows a sideways trend with resistance at a price just over $16/share. Note that this resistance trend line shows the stock bouncing off this level several times. Apparently enough investors thought that the stock wasn't worth more than that price during that period.

Now let's take a look at the other end: ***support*** for a certain stock price level. Using the same chart above, we see that during that same period, sellers slowed their selling and buyers picked up their buying along the lower horizontal line, at somewhere over $14/share. The price bounced off this support level numerous times that year before it reversed and an uptrend started.

Many technical traders will closely follow these trends and actually trade based on support and resistance. They would buy the stock or take some other bullish position (options) when a stock is hitting support. They would let their position ride as long as the stock bounces off support and starts to rise. When the price approaches resistance, they will sell or go bearish in position.

When is Support the Same as Resistance?

Support becomes resistance for technical traders when a stock breaks through a support level and continues downward. Technical traders then use that previous support price as a future level of resistance.

There is some logic here and it is born out of historical trends. When sellers overtake a stock at what used to be a support level and take the price downward, buyers and sellers alike will view that previous support price as a point where the stock may sell off again.

Of course, it can work in the other direction as well. When a stock's price takes off upward and breaks through previous resistance, that price can become a floor, moving forward. In other words, it becomes a new support level.



While it is not a perfectly straight line, this six month chart for General Mills shows the stock rapidly dropping through support at around $51/share. Notice that it then continues topping out at about that level, so it became resistance. Technical traders use support and resistance in combination with other tools for buy/sell decisions.

MOVING AVERAGES

A moving average is an indicator used in technical analysis to smooth out random price fluctuations. By taking an average of prices over a specified time period (as in a 30-day moving average), the shorter term price fluctuations are filtered out and a smoother price line is created.

SMA – Simple Moving Average

This is pretty much defined above, as we use prices at specified time intervals to create a simple moving average of the stock's price over a longer period.

EMA – Exponential Moving Average

The difference in this moving average is that it gives greater weight to more recent prices. Sometimes an EMA can help to identify a trend or trend change sooner due to the emphasis on more recent prices.



The screen shot shows a Google three year chart with two moving average lines superimposed. They are both simple moving averages, one 50 days and the other 200 days. So for the 50-day MA, a price is taken every 50 days back through time and the line is drawn using that. The same goes for the other, but prices are only taken every 200 days.

Notice that the 50 day line is not nearly as smooth as the 200 day line, because it covers a period of shorter duration. Following both lines, a long-term investor may, at times, be tempted to sell in an uptrend based on a shorter moving average. The line moves up and

down frequently, but the stock is still in an uptrend if you use the 200 day moving average for guidance.

Crossovers



I have added a couple of Xs to the chart to illustrate moving average crossovers. These occur when the shorter timeline average crosses above or below the longer timeline average. Crossing over to the upside can mean a trend change to an uptrend, while crossing downward can mean just the opposite. This is a good chart to illustrate, as it shows you cannot necessarily make quick decisions right after a crossover.

Notice the first X does indicate an uptrend of several months when the 50 day SMA crosses over the 200 day. However, notice that it crosses below just before the second X. It did not indicate the beginning of a downtrend, as it crossed back over soon thereafter.

This is a good lesson because the 200 day MA line shows an uptrend throughout the period after the first X. It still was indicating that when there was a temporary crossover to the downside, so caution should be exercised in assuming a trend change.

RSI - Relative Strength Indicator

The RSI is a momentum indicator used by technical traders to try to identify stocks with prices in overbought or oversold territory. It compares the magnitude of recent gains to recent losses in the stock price. The formula looks like this:

$$RSI = 100 - \frac{100}{(1+RS)}$$

There's another variable in there: RS. RS is the Relative Strength number. The formula for that is:

$$RS = \frac{\text{Avg of x days of up closes}}{\text{Avg of x days of down closes}}$$

Generally a stock is considered to be overbought if the RSI is above 70 and oversold if it is below 30. However, some investors like to use 80 and 20 to be more certain of the results.

The good news is that many charting programs will show you RSI right along with the price chart.



In the chart above, we see the RSI for this stock below the price chart. The shaded areas show where the RSI was over the 70 mark. Notice that the stock did end up retracing in price after the first instance. The second instance is current, so an investor may assume the stock is again overbought.

You should not rely just on this indicator, but it can work with other technical analysis indicators to give you more confidence in your buy or sell decisions.

MACD – Moving Average Convergence Divergence

The MACD indicator calculates the difference between a stock's slower 26-day EMA (Exponential Moving Average) and the faster 12-day EMA. The histogram and the two lines provide both trend tracking and momentum trading indicators.



The histogram shows divergence between the two moving averages. When the MACD line crosses over or under the signal line, and especially with significant divergence, it can indicate a change in price direction. Many traders use this indicator as it is very graphic and can help in catching price reversals earlier.

Stochastics

The Stochastic Oscillator was developed by George C. Lane in the 1950s. It is a momentum indicator that does not follow prices or volume. It follows the momentum of price change. Generally the momentum of a stock changes direction before the price. Followers of the Stochastics Oscillator attempt to identify overbought and oversold stocks.



Under the price chart above, we see a Full Stochastic chart and a Slow Stochastic. They are very close to the same, as the slow uses a three period Smooth Moving Average, and the Full Stochastic uses another three period average for more smoothing.



The above chart shows the Fast Stochastic using no moving average smoothing. It is much choppier because it is based on daily data. The standard period for Stochastic Oscillators is 14 periods (days, weeks, and so forth.)

A stock is generally considered overbought when the oscillator crosses over the 80 line and oversold when it crosses below the 20 line.

Bollinger Bands

Bollinger Bands are made up of a middle band, that's a simple moving average (SMA), and two outer bands. The middle SMA band is usually set to 20 lookback periods. The outer bands, though adjustable, are normally set at two standard deviations above and below the middle band, and these also use an SMA.



In the image we see the three bands and how, in general, they almost completely enclose the stock price indicators. Bollinger Bands are frequently used to identify two chart patterns popular with technical investors - the W Bottom and the M Top.

W Bottom

One chart pattern that technical investors use when attempting to identify a bottoming out of a stock and a potential uptrend is a "W Bottom". This takes the shape of the letter "W", and the last leg pointing up is supposed to be the beginning of an uptrend.



In this chart above we see a W Bottom. Note three things about the Bollinger Bands: The first point of the W bounces off the two standard deviation band. The middle and high point of the W and the last bottom point before the uptrend are both inside the bands. However, in the middle the lowest price of the stock penetrated the band to the downside.

M Top Pattern



This is a bit like the flipside of the W Bottom Pattern. Notice the high at the top of the second point of the M that pierces the band. Bollinger bands are used in many different analysis strategies.

CHART PATTERNS

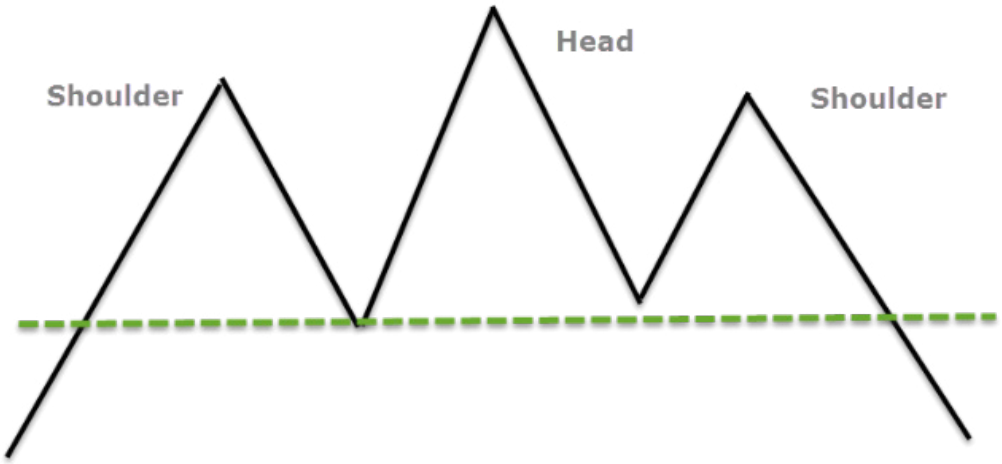
There are two general types of stock chart patterns: reversal and continuation. The reversal patterns are supposed to indicate a probable reversal of the current price trend, while continuation patterns would signal that the trend will continue.

No chart pattern will be 100% accurate. In fact, they are just one set of analysis tools you'll need to use in combination with others, along with fundamental analysis, before making a trading decision.

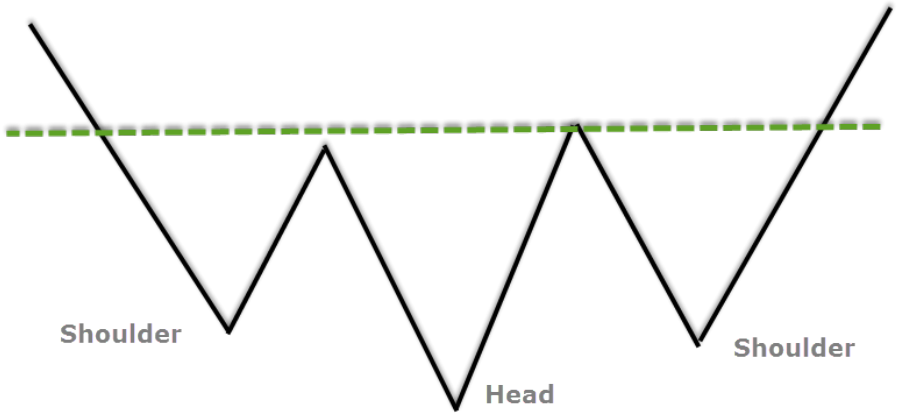
The fact is, history does have a habit of repeating itself. Over time, these chart patterns have proven to be fairly accurate at predicting either reversals or continuation of price trends simply because they have done so, many times.

Head and Shoulders

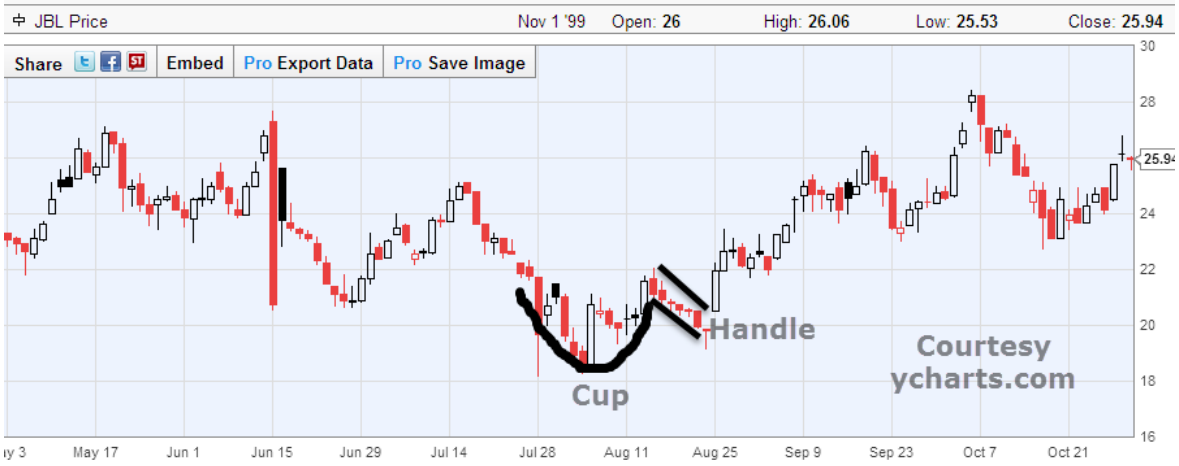
At the top: You might also call this an M Top, since it is very similar. When a stock has been trading above a previous level of resistance (the dotted line), and the head and two shoulders appear, you are looking for the stock to trade below the current support.



At the bottom: On the flipside, the same pattern is pretty reliable when a stock is about to make a run up in price. The stock continues to trade below resistance with the head and shoulders, then pierces resistance to the upside.



Cup and Handle



This is a bullish continuation pattern. The upward trend pauses but continues up after the pattern is confirmed. Once prices pierce the resistance upward (top line of the handle) the uptrend can continue. This pattern can take weeks or months to develop.

Double Tops and Bottoms



The chart above shows a double top formation, which is a trend reversal indicator. An uptrend tests highs/resistance twice and then when prices penetrate the low point of the V, a downtrend is indicated.



Here we see a double bottom pattern, an indicator that the preceding downtrend has bounced off the low support twice and a trend reversal to the upside is indicated.

Triangles

These triangle patterns usually develop over a two week to two month period of time. There are three types: symmetrical, ascending, and descending. They can last for many months as well.

Symmetrical



In a symmetrical triangle pattern, two trendlines converge toward each other, and it is a neutral pattern. A breakout can be either

up or down out of this pattern. However, once the breakout occurs, it is supposed to indicate a new up or down trend.

Ascending Triangle

In this pattern, the upper trendline is flat and the lower line slopes upward. It is considered a bullish pattern, and technical traders look for a breakout to the upside.



Though these two lines don't meet in this screenshot, you see most of the ascending triangle and the subsequent uptrend beginning at the breakout.

Descending Triangle



Here the bottom trendline is flat and the upper line is sloping downward. This is a bearish pattern that is confirmed when prices break out of the triangle to the downside.

Pennant and Flag

These are short-term patterns, generally forming in one to three weeks. The patterns form after a sharp movement in prices, either up or down, and once fully formed, they are both continuation patterns.

Pennant



The chart above shows a sharp move up for a stock in a definite downtrend. The pennant forms, looking much like our previous symmetrical triangle, and when confirmed, the prices breakout to the downside to continue the downtrend.

Flag



The flag pattern also forms after a sharp price move, but the lines do not converge as they do in the pennant pattern. They form a channel, and when the prices break out of that channel the continuation of the previous trend is confirmed.

Wedges

Wedges have two converging lines, but they are differentiated from triangles in that both lines are slanted and in the same direction. There are rising and falling wedges.



Rising wedges are continuation trends of the bearish variety. They appear in a downtrend and once formed, the prices breakout down again.



In the second chart we see a falling wedge, a bullish continuation trend. The stock had been in an uptrend but took a break. As the lines converge at some point the stock is expected to break out and confirm the previous trend.

TECHNICAL ANALYSIS IS FUN

It is hard to argue with a technical trader who loves to spend his or her time searching charts for these and other patterns. When a pattern is located, it can be exciting trying to back up the pattern's prediction of future price movements with other research.

However, it can be a better approach to understand these patterns and do fundamental research. If you are zeroing in on a stock with the right fundamentals and you also happen to see one of these chart patterns that indicates a move in the direction you want, it may be the impetus you need to execute that trade.

In My Experience
They say that a rising stock market floats all boats. In a bullish market, 80% of all stocks are rising. In a bearish market, the opposite is true. Only purchase stocks with good fundamentals and bullish technicals, in a bullish market. It is the closest thing the stock market offers to a sure bet.

Chapter 17
Trading Styles

"Everyone has the brainpower to follow the stock market. If you made it through fifth-grade math, you can do it."

Peter Lynch

Peter Lynch's quote is appropriate for this chapter. There are various styles of trading the stock market, and their risk/reward profiles are different. You can also adopt more than one trading style, with one hedging another. The point of the quote is that you can do this. Just determine your goals, your risk tolerance, and get started.

Value Investing

You are already well aware of this investing style since it is explained in detail in the Warren Buffett chapter. Value investors attempt to locate companies with stock trading below the intrinsic value of the company.

Carefully analyzing the basic business, products and services of a company and comparing the company to others in the sector is one component of value investing. Using DCF, Discounted Cash Flow analysis, you would then use projected earnings into the future to determine their value in today's dollars.

Then it is simply about identifying companies you can buy with their stocks trading below the intrinsic value of the company. Refresh your knowledge if necessary by re-reading the Warren Buffett chapter.

Growth Investing

Growth investing is buying into companies that are expected to grow their earnings at rates greater than their competitors or other companies in the sector.

Growth investors are trying to maximize capital gains in many cases, as the high earnings growth should result in increasing share prices and a nice profit when the stock is sold.

Warren Buffett says that "growth and value investing are joined at the hip." If you can buy a company at below its intrinsic value, you are also investing for growth, especially if you have used DCF and know that earnings are going to grow at rates better than other companies in the sector.

One definition of what makes a stock a "growth" stock is that it is expected to double in value within five years. This would, of course, require that the company be managed well, control its costs, increase sales, and grow earnings at a rapid rate.

So far it seems clear that a stock can easily be in both the Value and the Growth categories. It could be great for growth as you find doing a DCF analysis but also selling below intrinsic value. This is not common, so most growth investors are willing to pay above the intrinsic value.

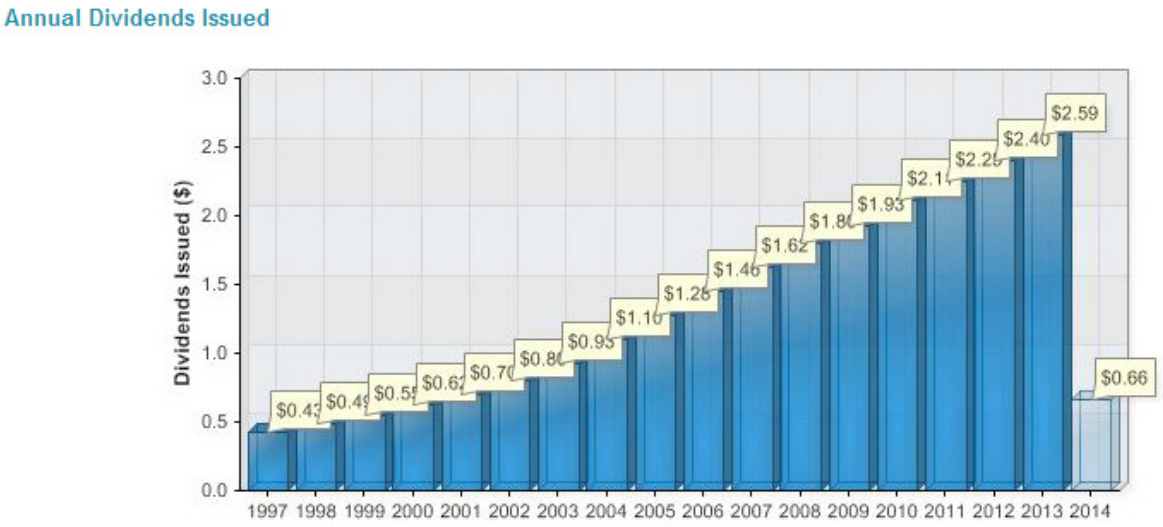
Growth stocks do not pay dividends, but, instead reinvest all of their earnings back into research, development, new products, and other things that will increase earnings.

Income Investing

This is one of the more popular investing styles, particularly with retirees or those nearing retirement. This investor group typically invests for value and growth. But may now need to generate steady income, and will need to do so without much risk.

While bonds are one popular method, stocks that pay dividends can provide income and growth as well. Usually the better income investments are in older and more established companies. The investor has the benefit of looking back at years of dividend history for the company. They can see if dividends have been steady, and growing, as well.

Johnson & Johnson is a great example of a company with a steady growth in stock price over the years, as well as constantly growing dividends.



That's quite a dividend history, and many a retiree has been enjoying these payouts for years.

Dividend Yield

It is not just about the amount of the dividend. Which is better: to buy stock at $90/share that pays $5.00/year in dividends, or to pay $50/share for a stock paying $3.50/year in dividends? To calculate the dividend yield of a stock, you divide the annual dividend amount paid by the share price.

$5.00 / $90.00 = 5.5% dividend yield
$3.50 / $50.00 = 7.0% dividend yield

Obviously, you can buy more shares of the lower priced stock and you'll end up with higher income. Dividend yield and consistency is important, but growth in that yield can be really valuable. The Johnson and Johnson example is a great one; from 1963 to 2004 they grew the dividend yield by 12% annually.

Be wary of companies with a recent large increase in their dividend payout. There can be good reasons for it, but are they permanent reasons or is there risk that the dividend will need to be decreased or even ceased later?

If you want to take a more diversified approach, mutual funds distribute profits to shareholders as dividends. Keep in mind though that these dividend payout rates can vary greatly year-to-year as the funds adjust their holdings. Mutual fund managers are not all-knowing either. They can, and do make mistakes.

Momentum Investing

To understand momentum investing, refresh your reading in the Technical Analysis chapter. That's because momentum investing is all about trends. The momentum investor takes advantage of trends, assuming that a stock is more likely to continue in a trend than to reverse it.

So if a stock is rising, and the faster the better, the momentum investor will buy that stock to ride the trend. On the other side, if a stock is falling, the momentum investor will sell it short to ride down with it for profits. The momentum investor can also use options to take advantage of trends, as we will discuss more in later chapters.

Hedge Investing

This is actually an investing style with "insurance" as a goal. Whatever other style of investing you may undertake, you can hedge your holdings to minimize risk of loss. Investing involves risk, and hedge investing is a way to insure against some of that risk.

Pairs Trade

Let's say that you are holding 100 shares of a stock at a cost of $70/share, or $7,000 invested. You are long in that stock, so you may decide to do what's called a "Pairs Trade" as a hedge against the stock dropping in price.

You would do that by selling short another stock in the same market sector. If it is an oil company, you would choose the stock of a competitor in that sector and short it as a hedge. To match the value, you would simply short the number of shares in the competitor that would be worth $7,000. If $35/share, you would short 200 shares.

Generally most of the stocks in one sector will follow each other in major market moves. So if this sector begins to drop in price overall, our shorted company's shares would be rising in value to offset some or all of our losses in the long position.

Just like any insurance, there is a cost here. Let's say that we called it right on our long position and it begins to rise in price. Our short position may sit still, may rise, or may fall in price. If it sits still, we can liquidate it when we sell our long position, and our cost of the hedge would be the commissions in going short and getting out.

We could get lucky if good news takes our long position up in price and the competitor goes down at the same time. Our hedge and our original position would both be making money. However, if our hedge goes up in price also, we are losing money on that trade and cutting into our profits on the long trade. A trader would want to go long on the stock with the higher quality fundamentals, and short the weaker stock of the same sector to make this strategy work. The concept is that the stronger company will provide superior price performance over its weaker counterpart.

Hedging with Options

A bit simpler approach (but with a definite cost) would be to hedge with options. Consider our previous example and our 100 share, $7,000 investment. We could buy some insurance for a specified coverage period with a "Married Put." Sometimes called a "protective put," you buy a put option to cover your 100 shares.

As buying a put is bearish, you are insuring against a drop in price of your stock with a Put that would rise in price at the same time. You protect against a short position loss by buying a put. There's much

more to it than this brief explanation provides, so we'll look at options for investment and hedging in detail later.

As you can see, there are many ways to profit in the markets, and you will probably engage in more than one trading style. In future chapters we are going to look at specific trading strategies and delve deeply into options trading.

Chapter 18
Money Management

"Money, like emotions, is something you must control to keep your life on the right track."

Natasha Munson

Joke: A man was working on balancing his checkbook when his wife said: "Honey, we're five dollars richer. I washed this blouse by hand instead of sending it out." He said: "Good, do it again!"

The quote and the joke both carry the same important message: We must control our money and take the actions necessary to protect and grow our assets. To do that successfully, we must remove emotion and substitute it with knowledge. Repeat what works well for you.

This chapter is about building a stock portfolio. We'll look at opening positions, protecting profits, and closing positions out in order to grow our net worth. This overview will help you get started the right way.

Stock Entry Points

The entry point is the price at which an investor enters a trade, either long or short. A proper entry point will be a carefully planned price at which the investor has determined that the stock is either overpriced or underpriced. The trade is entered at that price point with the expectation of profitable price movement.

So what does "carefully planned" mean? One thing it does not mean is looking at a stock chart and seeing a stock in an uptrend, and then buying because you are reading good news about the stock. For every uptrend there is a reversal, and you don't want to be caught in one. It works exactly the same, in the other direction. You don't

want to take a short position just because there's bad news out about a company and the stock is trading down.

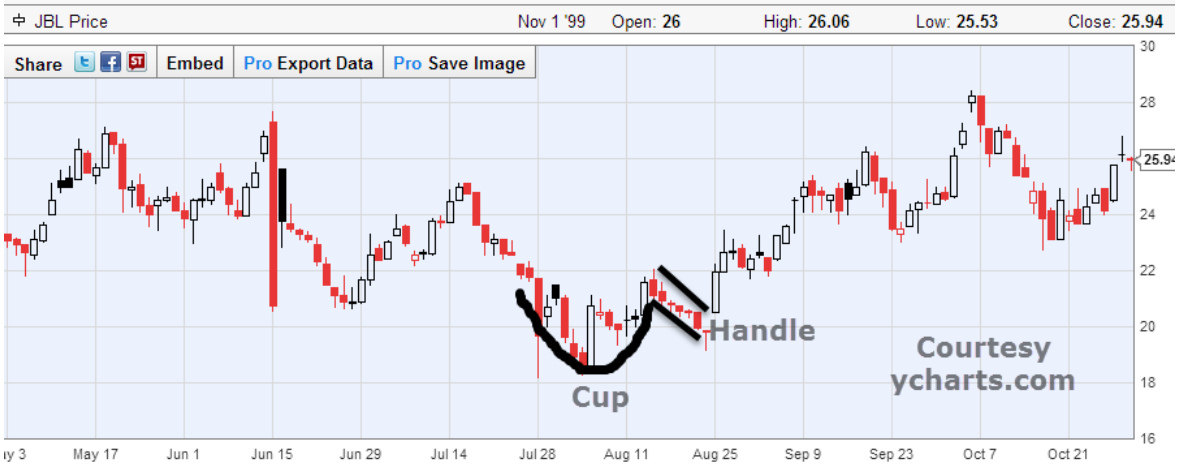
SHORT OR LONG TERM

Short or long term can vary greatly based on your own investment goals. Holding a stock for six months would seem like an eternity for some investors, while others think of holding for years. An important decision must be made early on and that is: When do you want to exit this trade?

It is tempting to say: "I am buying a stock, and I am going to hold it until it quits going up." If you knew precisely when the price will turn around and head down, you would not say this anyway. You'd just say that you'll sell at that price. So every entry point requires that we have a plan for an exit strategy.

Long Position – When to Enter

You have been exposed to a great deal of fundamental analysis education in this book already. You have also learned about chart patterns that technical traders use to enter and exit trades. So what do we do? Do we just use a favorite continuation pattern like a "Cup and Handle" or an "Ascending Triangle" to buy shares? Maybe…



However, I would suggest first that if your expectation is intermediate to long term, you'll want to buy a stock primarily based on fundamentals and intrinsic value. If you like the fundamentals of the company, understand what they do, and you believe the stock is currently undervalued, then buying based on a chart pattern to identify an entry point is probably a good decision.

Maybe it is not a continuation pattern, but a reversal. This takes a bit more confidence in your analysis skills, as the stock is not in an uptrend, instead falling in price despite the fundamental indicators. However, this is when you can also pick off a stock below its intrinsic value.



Perhaps you like the stock fundamentals and the price of their shares has been moving sideways in the long term, but it is now displaying a probable W Bottom or Head and Shoulders Bottom pattern. Now we have good fundamentals, reasonable or undervalued status, and a chart pattern that reinforces a breakout to the upside. It identifies a strategic entry point.

I am not suggesting these signals are one hundred percent predictive. What I hope to accomplish is to help you put together a bullish investment strategy using a combination of fundamental and technical indicators. Over time you'll find that you'll gain more confidence, especially when you are using technical signals. You'll recognize patterns more easily, and you'll develop a strategy combining the value analysis with the signals.

You'll need to educate yourself and make a few errors, but you'll figure it out. You cannot exit a trade unless you enter. Make a promise to yourself to execute when the pieces come together.

Short Position – When to Enter

All of the general information from the previous section applies to the short side. You are attempting to identify an overvalued stock and enter a bearish position. It could be short-selling the stock or an options trade. You'll still use some fundamental tools, maybe chart patterns, and try to enter the trade to profit from dropping share price.

In studying the fundamentals of a stock, you determine that earnings are slipping, perhaps there is a new competitor, and your overall opinion is bearish for this stock. It is probably not a good entry point to buy right after bad news, as there can be a whiplash effect, bringing a rise in price after an over-reaction to the news. The better approach is to either take a bearish position when you have either confirmation of a continuing downtrend or a strong indication of a reversal in an uptrend.



The trend is your friend, so continuation patterns can be more effective than reversals, but you will learn enough here to be confident with your decisions. However, before you execute that entry trade, you need to have an exit strategy, so let's talk about those.

Limit Orders for Entry

Let's assume you have determined that you want to buy a stock, but you are not happy with its $30 price today. You have been watching the stock and you see a chart pattern that shows it has been dipping to a support level of around $26/share. This would be a preferable trade if you could buy at that price.

So you place a Limit Order at $26.25/share. Your order will sit there and only become a market order when the stock drops to that price. You are guaranteed that it will not execute unless it is at that $26.25 price or lower.

It works for short positions as well. You place a limit order to borrow and sell short at a price higher than the current price. If our example stock has been bumping up against resistance at $35/share and we are bearish, we would place a limit order to short the stock at that price.

Just be prepared for some limit orders to never execute, as your price was either too high or too low, and the stock never trades at that price long enough for your order to execute.

Exit Strategies

Again, we are going to start by making a preliminary decision as to the duration of the position. Is the trade short, intermediate, or long term? And, understand that this definitely is a decision that can change and often does. Markets move, and some movement of a stock or a market can give you ample justification to change your outlook and your exit strategy.

Still, you need to begin with a solid idea for your exit plan for a position at the time that you enter it. So if you are working a long-term outlook on a stock and you like the fundamentals, how long do you plan to hold it if the trend continues? This decision is also influenced by whether you have a dividend income component. If

so, your exit strategy could be to sell when a better dividend return is available.

Of course, the answer could be simple: I will hold as long as it is trending up until a specified date in the future. Maybe it is when a child is graduating high school and you need to fund college. That is an exit strategy.

Another frequently used exit strategy is to liquidate a position when a specified profit goal is reached. That might be based on the stock's price or a return on investment goal that includes dividend income and price appreciation.

Another plan could be to exit a position when a combination of factors come together. Perhaps you make a plan to exit a short position when it is above a certain profit point and you have come across another opportunity.

It could be that a new chart pattern initiates an exit. You could enter the trade on a bearish or bullish pattern and plan to exit when a pattern strongly indicating a reversal appears in the stock chart. The point is to have an exit strategy, and to understand that it very likely may need to be adjusted in the future.

Limit Orders as Exit Trades

Rather than watching a stock yourself, in order to sell out of a long position when you have realized your desired profit, you can instead set that profit in advance with a limit order. If you enter a long position with a very bullish outlook on a stock at $15/share and your exit strategy is to sell when you have doubled your money, you could place a limit order to sell at $30/share. If and when the stock reaches that price, your exit strategy will become a market order and you'll be out of the trade with your profit.

Of course, like other strategies, it works on the short side as well. If you are short a stock, you can place a limit order to buy when it drops to a certain price in order to exit with your desired profit.

Protective Stop Orders

Though they are only one example of an exit strategy, stop orders are protective in nature. They are used to limit losses or protect profits. Also called "stop loss" orders, you are placing a resting order to buy or sell at a specified price to either limit losses or lock in profits. Let's use some examples to explain:

Long Position Stop (Loss) Order

You enter a trade by buying a stock at $35/share. Immediately, you want to protect yourself from significant loss, so you place a stop order to sell if the stock drops to $30/share. That's a significant loss of at least 14% if it executes, but it could be worse. Why not place it at $33/share to realize less loss? Because, if the stock has temporary swings, you could "stop out" of the trade unnecessarily.

The drawback here is that the order becomes a market order at $30/share, but that does not mean that it will execute at that price. If the stock is dropping fast, it can execute at any price of $30 or lower. So you are protecting yourself to a point, but you cannot be sure of the execution price.

Short Position Stop (Loss) Order

As always, it is the same as on the long side, but it is just in the other direction. If you shorted a stock at $35/share, you may want to place a stop order at $38/share to buy back the stock and limit your losses on the short position. Again, this instructs the floor trader or market maker to execute when the stock hits $38. If the stock price is bouncing around, the trade could be executed at a price higher than $38 (not good) or even lower (better) as it will execute at some point AFTER the stop loss price is reached.

Stop Limit Order

So, there's another type of protective order that's called a stop limit, and it sounds like it could be a better protective tool. That's because you are not only telling the broker to execute the order if the stock touches a certain price, but also ONLY at the limit price or better. ("Better" meaning higher on a long position stop, or lower on a short position stop.)

Though it may seem like a more protective approach, it may actually be a worse strategy. Let me illustrate my point: You purchase a stock at $25/share. You want to limit your losses and place a stop limit order at $19/share. If you'd used a stop loss order, and the stock drops quickly below $19 to $16/share, your order would not have executed, because $19 or better was not available at the time. That's because it did not trade long enough at $19 to get you an execution. It will execute as quickly as possible after touching $19.

When you use a stop limit order, you are telling the broker to sell if the stock drops to $19/share, but only at a price of $19 or higher. Now this sounds better, in that you seem to be locking in less of a loss. However, if the stock drops through $19 and stays lower, you are not going to execute at all, no matter how low it goes.

The Trailing Stop

Now that you understand stop orders, limit and stop limit orders, let's talk about how to trail them behind your positions. You see, if you buy a stock at $20/share and you place an immediate stop order at $15 to protect your profits, you must keep changing it to protect profits should the price of the shares rise. As your stock moves up, your stop order does not change. You don't want to be sitting there with your stock at $30 and a protective stop at $15.

You want to protect your profits as your stock moves up. You can place a protective stop as a trailing stop, following your stock up as it increases in price. So when you buy a stock at $20/share,

you can place one of two types of protective trailing stops: a dollar amount or a percentage.

If you decide to place a $5.00/share trailing stop, you would be telling your brokerage to sell your long position anytime the stock is trading at $5.00 below the current price. So if the stock price is rising, and one day reaches $30/share, you would be telling your brokerage to sell if it drops to $25, locking in a $5.00/share profit.

Your trailing stop will follow your stock price as it rises, protecting your profits along the way. Using a percentage instead, you would place an order to sell your stock at some stated percentage below the current price. So if you want to protect yourself by 10%, set a trailing 10% stop.

MANAGING MONEY – MAKING IT AND PROTECTING IT

In this chapter you learned that managing money is not just about making it. Using protective stop and limit orders can help you lock in profits and/or limit losses. Even if you watch your positions daily, you would still have occasions when you would want to place temporary protective orders, such as when you are away on vacation.,

In My Experience
The biggest mistake I see investors make over and over again is having no exit strategy. As a result, they ride their losers too long. By simply avoiding the big market dips, anyone can average 15% to 20% each year in quality equities.

Chapter 19
Tools That Make Investing Easier

"Getting information off the Internet is like taking a drink from a fire hydrant."

Mitchell Kapor

The quote from Mitchell Kapor is very true, in that technology has advanced so much, including in stock and options markets research. It is easy to get overloaded. Just because a certain software or online solution can perform 30 different oscillators and indicators, does not mean that you need to use them all.

SOFTWARE OR ONLINE

Software

A decision you may need to make early on, is whether you will need or want to use onboard software installed on your computer or rather, use web-based solutions. There are many software solutions for stock and options market research and charting. It is not within the scope of this chapter or book to tell you about all of them.

However, you may want a hard-drive-installed software solution, as some features may be offered that you cannot get in an online environment. Of course the software must work on your operating system. While almost all work on Windows computers, some are not available for Apple systems.

The downside of software is that you'll need to have your computer with you if you want to use it. If you travel a lot, this may not be a problem if you carry a notebook or tablet that runs your software. Software also requires periodic upgrades.

Online

Many consumer and business tools have moved from software to the Internet. Bandwidth available to consumers has grown and Internet access speeds are getting faster all the time, so complex activities can be performed online in real time.

The ability to access your trading tools from any computer, anywhere, is of value. Many online tools are also "mobile-friendly," using apps or mobile site design to provide the investor with tools on their tablets or even on their smart phones. . The ability to monitor your positions or do research for new ones wherever you are, is quite valuable.

Portfolio Management versus Research

Look back at the chapter on online brokerages. Your brokerage will provide the tools necessary for ***tracking and managing your portfolio*** online. Doubling your effort by duplicating your holdings in another piece of software or online solution to track performance probably is not an efficient use of your time. So portfolio tracking software is really not a resource you would search for separately.

That said, you may find that your brokerage firm does not offer a sufficient online solution, nor do they provide research and charting tools robust enough for your needs. If this is the case, you will need to use a separate online or software research and charting solution.

In this chapter I will give you an overview of research and charting software and online tools. These are tools you can use to track and analyze markets, stocks, and options. You'll be able to apply fundamental and technical analysis with these research tools.

These are not all of the options available, but they are some of the most widely used. Do all of the research you need before making a selection. Once you get your trading business up and running, you don't want to be distracted by having to switch tools.

I am not going to backtrack and discuss the research and charting tools offered by the online brokerages we have already covered. Just make sure to review those as you work toward a brokerage selection.

Stock Market Analysis Software

Let's look at installed software. The ratings of these packages is somewhat subjective. Also, as only three of these packages will operate on a Mac (Telechart TC2000, E-Signal, Elmwood Data) assume that any others mentioned work only on a PC. Some of these platforms have been around for some time, so you will need to check to see whether they operate on Macs, tablets or smart phones.

I am going to use information from LiberatedStockTrader.com to help me with overall ratings of these software packages in several categories. This is far from an in-depth analysis of these software tools, and what may seem less valuable to one investor may be much more valuable for you.

Use this chart to give you a jumping off point into more research for each of them. Of course, if you intend to use an online solution, you can jump right into analysis of your chosen brokerage's tools. If they meet all of your needs, you are done. If not, look at the following online resources.

I am going to rate them H, M, L, for High, Medium or Low ratings. Again, what one rater may rank as Low may be great for you and more highly ranked by another rater.

To keep the chart a reasonable size, I am using the lettered column headers, which are representing:

A = Pricing and overall software rating.
B = Fundamental Analysis Tools
C = News reporting and timeliness
D = Technical analysis and alerts
E = Ease of use (user interface)

The score is based this way:

H = 9 or 10 out of 10
M = 6, 7 or 8 out of 10
L = Below 6 out of 10

Vendor	A	B	C	D	E
Telechart TC2000	M	H	H	H	H
TradeStation	H	H	M	H	M
E-Signal	H	M	M	M	M
MetaStock	H	M	H	H	M
EquityFeed	M	H	H	M	H
Ninja Trader	M	L	M	H	M
ProfitSource	L	H	L	M	M
Echartar	M	L	L	M	M
VectorVest	L	M	L	L	M
Elmwood Data	L	H	L	L	M

That's it for software. It is a research project for you if you wish to take the software route for analysis, news, and research.

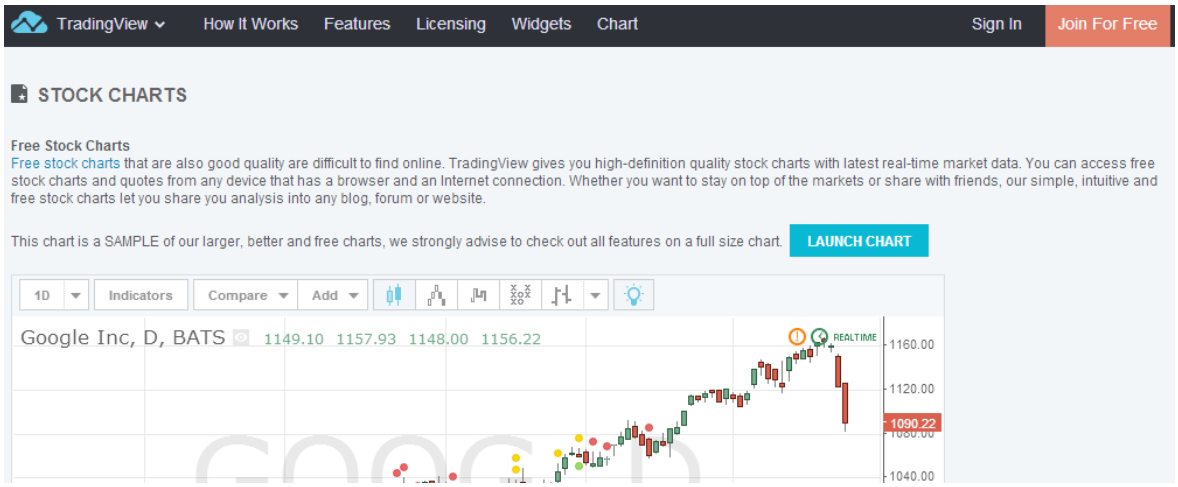
Online Market Research and Analysis Tools

You'll probably find that by working through an online brokerage you'll get some pretty good tools. I will refer you back to the ratings and information in the online brokerage section of Chapter 8. There is some pretty good information there to get you started in evaluating the tools offered by each.

While you may decide on an online brokerage and may like their tools, you may also want more functionality or features. You can always supplement their tools with a charting or analysis site that provides some or all of the analysis, charting and news tools, but not

brokerage services. Let's take a look at a few, with the knowledge that you can find others by doing some research.

TradingView.com



These are free charts, with some technical indicators available.

Bigcharts.MarketWatch.com



This is another chart service that is free, basically and which has some analytical capabilities.

Stockcharts.com

This online charting solution offers a good suite of customization options, moving average overlays, and dozens of indicator analysis tools and alerts.



YCharts.com

(You may have noticed that many of the charts used as illustrations in this book are courtesy of ycharts.com. They were the first to respond to a request for permission to use them in this way.)

They have a very robust charting system with fundamental and technical charts and a great many tools for analysis and alerts. These charts were created using the free level of service, but there are additional paid services available.



Options Specialty Services Online

In the brokerage discussion earlier, I featured two options brokerages: TradeMONSTER and optionsXpress. They both offer options-focused charting and analysis tools. They also offer paper trading/virtual trading for practice and learning. If your focus is on options, one of these brokerages may just satisfy all of your trading and analysis needs.

Though their focus is on options, you can trade stocks, commodities, and currencies with these brokerages as well.

The Tools are Available, so Use Them

Don't over-analyze, but do take advantage of the brokerage, software, and online tools that fit your investment goals and trading

style. You can find others not mentioned in this section, by doing Web searches.

When you are done, you should have easy-to-use and comprehensive stock, market and options analysis and charting tools in your toolbox.

In My Experience
Thanks to the Internet, everything you need to know about a stock, an option, or the economy is at your fingertips. There is no excuse for ignorance any longer.

Chapter 20
The World of Options

Can trading options be risky? Sure…but so can trading stocks. Are there less risky ways to use options to reach your investment goals? Of course. . We mentioned in a previous chapter that Warren Buffett has indicated that he is not fond of options as an investment. You should be aware, however, that, at one point, Warren Buffett had Berkshire Hathaway in short put options totaling more than $37 billion, according to an article at Morningstar.com. He may say that he does not love them, but he sure uses them.

Options are About Control – Not Ownership

The definition of an option in all areas of endeavor, is that it is a choice. We have options in every facet of our lives. There are choices of brands in products and services, and in investment strategies and asset classes, to give just a few examples. So an option is a choice, but it is not an obligation.

Options in the stock market offer choices but not ownership. Instead of buying a stock, we can buy an option contract (a Call Option) which gives us the option to buy the stock at a specified price, though we are not obligated to do so.

Example:

Let's say you expect a stock currently selling for $38/share to go up in price soon, maybe in the next month or so. You expect the rise in price to be significant because earnings are going to be excellent in the coming report. You are bullish on the stock, betting that it will go up in price, but you don't have $3,800 to buy a hundred shares.

What if you could control 100 shares, having the option to buy the stock at $40/share if, and only if, you want to do so. I will get into greater detail later about various option types and strategies, however for this simple example, you would buy a Call Option (controls 100

shares) at a $40 strike price. This gives you the option to buy the stock at $40 on or before the expiration of your option.

Should the stock perform as you expect and run up to $45, you'll be able to buy it at your option price of $40/share. There's more to it than this simple example, but right now we are just talking about ***control versus ownership.*** You control 100 shares of stock, but you did not have to buy them. In fact, you can never buy them and still reap your $5.00/share profit at option expiration.

The downside of this example is that, if the stock does not go up above $41.50/share, then you will not generate a profit. Because we paid $1.50 for the option, our "break-even" has risen to $41.50. If it does not reach $40/share, we lose out entire $150 investment. So, you see, there is a cost for this control. This assumes that you hold the option until expiration. A smart trader will normally sell their position at least 30 days prior to expiration to capture a significant portion of time value.

Another major advantage of being bullish on a stock and using options to control instead of buy it, is that our maximum risk is the premium paid for the option. We have invested our $150, and if the stock plummets to $30/share, we are still only going to lose a maximum of $150.

Control and Flexibility

This section provides a very brief introduction to options trading. By reading this entire book, you will receive a detailed and comprehensive education on how to profit trading options.

Using control instead of ownership, you can employ a lot more leverage with more control over risk. In our example above, you used $150 (plus commission) to control $3,800 worth of stock with a theoretical unlimited upside potential profit. Your risk was limited to $150 (plus commission).

In My Experience
Don't be afraid of options… embrace them. Options are designed to help investors mitigate or eliminate risk. They can be your best friend.

Chapter 21
Advantages of Trading Options

"Look at market fluctuations as your friend rather than your enemy; profit from folly rather than participate in it."

Warren Buffett

PROFIT IN ANY DIRECTION

One of the major advantages of trading options is the ability to create option strategies for bullish, bearish, or sideways movements of a stock or market.

Additionally, you can tailor your position to reflect how bullish or bearish you are about a particular stock or about the market in general. There are even strategies to profit from a modest price movement up or down.

In future chapters I will show you how to use specific options strategies to take advantage of up or down price movements of a stock, or even to profit from a stock that's in a sideways trend, when you expect little in the way of price movement in the near future.

Hedging – Position Insurance with Options

If you are long or short stocks, you can use options to insure against losses if the stock price moves in the wrong direction. Buying Puts (when you are long) will offset losses if the stock drops in price. Buying Calls (when you are short) will protect you from sudden stock price increases.

Quantified Risk

Option strategies can be employed that limit your risk. Buying options, your risk is the price you paid, no matter how the market or

stock moves. Your risk is the premium you paid for the option, but your profits are not limited. In future chapters, you'll learn combinations of options strategies that give you a ton of flexibility in balancing risk and reward in your positions.

Leverage

Using options, you can control a much larger dollar value of underlying stock. Instead of buying 100 shares of a $98 stock for $9,800, you can buy an at-the-money or in-the-money call if you are bullish on the stock. You may pay a premium of $20 for the call, which is $2,000 to control 100 shares. Even if you have the $9,800 cash available, you can now use that other $7,800 toward other investments.

Higher Potential Returns

Using that leverage information, you can easily see that the Return on Investment of a gain on our example $98 stock would be much higher when your initial investment is only $2,000. If that stock rises $5/share, that $500 is only 6.4% of $7,800, while it is 25% of $2,000.

Income Enhancement

Let's say that you are holding a stock long. You can sell call options to other investors for income. Estimates are that 70% to 80% of all options expire worthless. Some of those are part of larger strategies and allowing the options to expire worthless is the intent of the options seller..

The investor holding 500 shares of Yahoo in January 2014 at a value of $37/share could have sold a March expiration $40 Call for around $1.06. This means that he is selling the right to another inves-

tor to take the stock at $40/share up to the day of expiration, roughly 60 days away. $1.06 X 500 = $530.

The shareholder gets to keep that $530. The chart for Yahoo showed that it had reached $40/share recently, but had been in a short-term decline. So our investor was willing to risk having the stock taken away from him if it reached or exceeded $40/share in price by expiration day. If the investor purchased the shares at $35/share, that $530 would be a 3% ROI for a two month period ($35 X 500 = $17,500 invested; $530/$17,500 = .03).

As the stock rises in price, the shareholder is increasing his investment value, but he can sell calls every two or three months and potentially increase his ROI by around 7% to 10% per year.

Diversification

Options are not just traded on individual stocks. There are options on major indices as well. An example would be options on the S&P 500 Index, which is essentially 500 companies in one basket. That means major diversification. Many options traders specialize in trading options only on major indexes rather than on individual companies.

Predictability is an advantage associated with this diversification. Though individual stocks may be volatile, the overall index would show less volatile fluctuations.

Adjusting Trades

When you buy 100 shares of stock, you are locked into a bullish strategy. If you want to make a change, your only option is to sell your shares. Sure, you can take out insurance in the form of options, but you still own those shares.

With options, you can adjust trades by buying or selling offsetting or supplemental option contracts. If you have entered a bullish option trade and see the market turning against you, it may be more

prudent to adjust the existing trade than to liquidate it and take an immediate loss.

In My Experience
In many respects, trading options may be easier than picking stocks. In the entire universe, there are only two types of options; puts and calls. Once understood, you have a solid foundation for a lifetime of trading.

Chapter 22
Basic Calls and Puts

"I believe each contract we own was mispriced at inception, sometimes dramatically so."

Warren Buffett

Warren Buffett is not averse to trading options, but he wants to buy below intrinsic value, just as he does with stocks. If an option is dramatically mispriced, it is just like a stock, in that it may be an excellent purchase opportunity.

Calls and Puts Rights and Obligations

An option conveys the right to do something without the obligation. Basically, the right to buy or sell the underlying stock is conveyed by the option but not the obligation to enter the transaction. If the stock price has moved as desired, then it is likely that the holder of the option will exercise their right or liquidate the option to take their profit. If not, then the option will expire worthless because it had a finite life when purchased.

As many as 70% to 80% of all options expire worthless. This may have been part of a strategy, with one leg of a trade being exercised while the other expires worthless. We'll take a more in depth look into how these strategies work when we talk about spreads in a later section. Briefly, many options are purchased either as a bet on a price move or as insurance against an undesirable move. Those expire with no value. If purchased as insurance, then the premium for the option was the cost of the protection. If it was purchased with the expectation of a price move and the move never happened, then the entire investment is lost. The seller of the option keeps the premium paid in both cases.

Calls Introduction

Buying Call options is the preferred strategy of speculators. When you buy a Call, you are leverage your money significantly. If you buy 100 shares of a stock at $65/share and it goes up to $68, you are up by $300 before commission costs. That's a 4.6% gain on your invested $6,500.

If you can buy an "at-the-money" Call option on that stock for $11/share, that same $300 is a 27.2% return on the $1,100 invested. It is easy to see why speculative investors would like Call options. In this example, the investor has an extra $5,400 to reinvest into other strategies. You are highly leveraged.

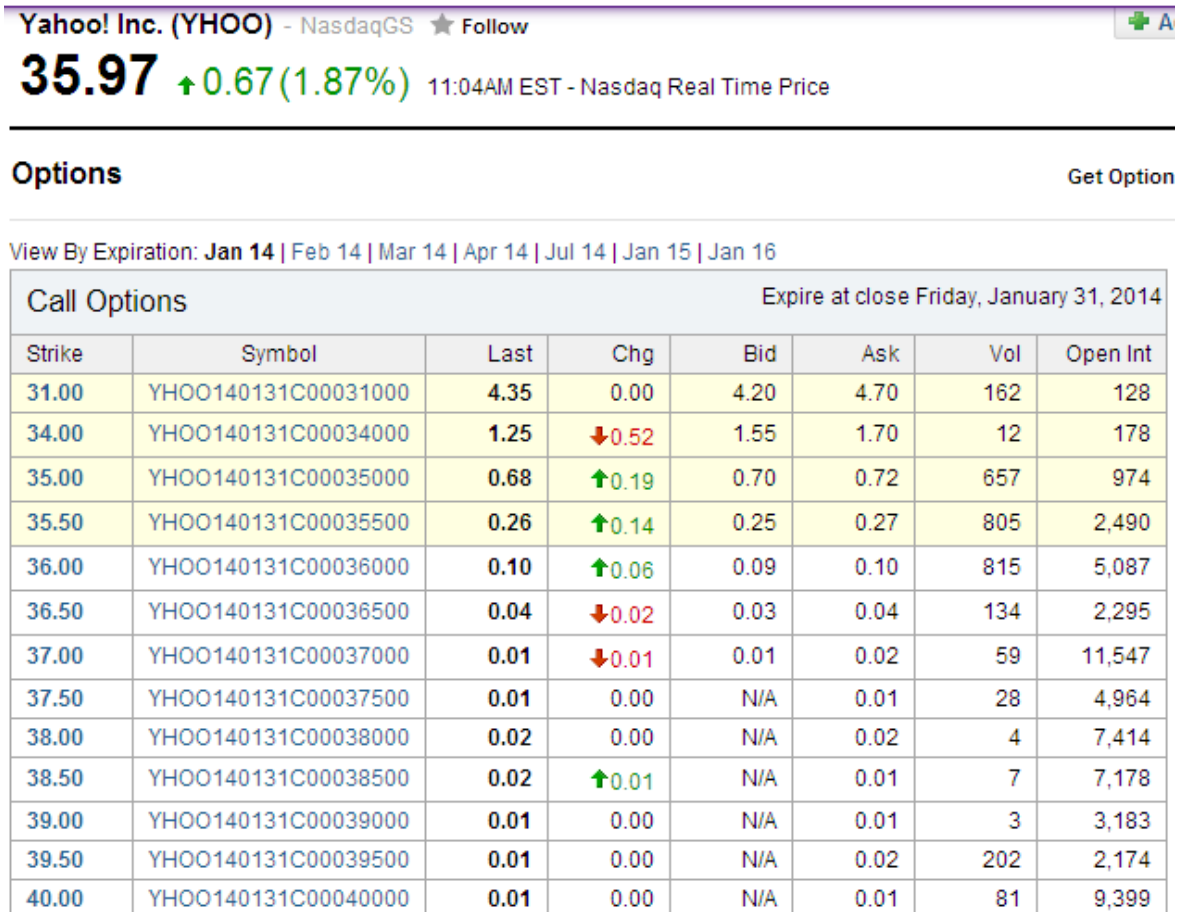
What's the trade-off? I have already mentioned how many option contracts expire worthless. In this case, if you allowed the worst to happen and the stock dropped or did not rise at all, you'd lose your entire $1,100 plus commission. Of course, you would not do that. You'd sell it at some point before expiration once you were reasonably sure your trade was in trouble.

Of course, in this scenario, you would sell at a significant loss the closer you get to expiration date. Options have a finite life, and their value is related to how much time is left before expiration. So if you decided to sell this option before expiration, you would lose money. If the stock is at or below $65, you could lose most of your money, but you could salvage some depending on how close to expiration you take action. Again, I will go into greater detail on this topic later, in chapters on The Greeks and valuing options for purchase.

Reading a Stock Option Chain

Before we get into some basics of trading options, let's give you an overview of how you know what you are going to pay if you are buying, or what you are going to get if you are selling. You would consult an option chain quotation for the underlying stock. I will use

the Yahoo Stocks screens for examples, but the information will apply to all chain quote resources.



Yahoo! Inc. (YHOO) - NasdaqGS Follow

35.97 ↑0.67 (1.87%) 11:04AM EST - Nasdaq Real Time Price

Options Get Option

View By Expiration: **Jan 14** | Feb 14 | Mar 14 | Apr 14 | Jul 14 | Jan 15 | Jan 16

Call Options — Expire at close Friday, January 31, 2014

Strike	Symbol	Last	Chg	Bid	Ask	Vol	Open Int
31.00	YHOO140131C00031000	4.35	0.00	4.20	4.70	162	128
34.00	YHOO140131C00034000	1.25	↓0.52	1.55	1.70	12	178
35.00	YHOO140131C00035000	0.68	↑0.19	0.70	0.72	657	974
35.50	YHOO140131C00035500	0.26	↑0.14	0.25	0.27	805	2,490
36.00	YHOO140131C00036000	0.10	↑0.06	0.09	0.10	815	5,087
36.50	YHOO140131C00036500	0.04	↓0.02	0.03	0.04	134	2,295
37.00	YHOO140131C00037000	0.01	↓0.01	0.01	0.02	59	11,547
37.50	YHOO140131C00037500	0.01	0.00	N/A	0.01	28	4,964
38.00	YHOO140131C00038000	0.02	0.00	N/A	0.02	4	7,414
38.50	YHOO140131C00038500	0.02	↑0.01	N/A	0.01	7	7,178
39.00	YHOO140131C00039000	0.01	0.00	N/A	0.01	3	3,183
39.50	YHOO140131C00039500	0.01	0.00	N/A	0.02	202	2,174
40.00	YHOO140131C00040000	0.01	0.00	N/A	0.01	81	9,399

This is an option chain for Yahoo stock on January 31, 2014, with Yahoo stock trading at $35.97/share. The chain of Call options is long and there are many because we are looking out in time based on the month of expiration and across a wide range of possible strike prices. Let's get some key definitions out of the way first.

Expiration (month): Across the top of the chart we see a series of months. Option contracts expire on the third Friday of the expiration month. Clicking on the month changes the numbers in the chart for quotes on the option contracts.

Strike (price): This is the price at which the stock will be bought or sold when (or if) the option is exercised. In our Call option chain

above, the prices in the Strike column are prices at which we can buy or sell Calls. Notice that they start well below the current price and move to well above it.

Symbol: Different option chain providers may use different symbols for options. They are used as identifiers like the stock symbol, and in fact contain the stock symbol as a portion of the option symbol. Other portions of the symbol tell us whether it is a Put or a Call, the month of expiration, and the strike price.

Last: This is the last price at which the option traded. Depending on how active a contract is, this could be anytime from seconds ago to days or even weeks in the past.

Change: This gives you the change in price between the Last trade and the previous day's closing price.

Bid: This is the price a buyer is willing to pay for an option, so it would normally be the price you would get as the seller.

Note: Remember that each contract controls 100 shares of stock, so the actual premium paid out of your account would be 100 times the prices quoted in the chain.

Ask: The price which a seller is willing to accept for the option contract. If you are buying, this is normally the price you would have to pay for the option.

Note: The difference between Bid and Ask is called the Spread. Options are not traded in anywhere near the volume of stocks, so the Spread is greater for an option than for the underlying stock.

Volume: The number of contracts traded during the day.

Open Interest: This is the total number of outstanding contracts, meaning those contracts that have not been exercised, closed, or expired.

At-the-Money: The strike price is equal to the current share price.

Out-of-the-Money: Concerning a Call option, this means that the strike price is above the current share price. Concerning a Put op-

tion, this means that the strike price is below the current share price. The option has no intrinsic value in this price situation. This is the price situation many speculators buy into. They will buy an Out-of-the-Money Call to bet on a price increase, or an Out-of-the-Money Put betting on a price drop.

In-the-Money: The Call strike price is below the current stock price; the Put strike price is above. For the Call, the intrinsic value is the amount that the current share price is above the strike. An example would be a $55 Call on a $57 share price, thus intrinsic value of $2/share. For a Put, just reverse the numbers.

Now let's take a look at an example of a seller and buyer of Call options.

Call Example

Short Side: Jane is holding 500 shares of a stock selling at $49/share. She is anticipating that it will be trading in a sideways pattern for a while, but she does not want to sell it. However, she does want to increase her income a little. She is going to enter a "Covered Call" trade. The trade is constructed by selling a Call option that is covered by owning shares of the underlying stock.

So she can sell five contracts covered by 500 shares as a Covered Call. In a later chapter I will go into more detail on Covered Calls. For now, we need a buyer interested in purchasing her call options. If this buyer does not currently exist, the floor trader or market maker will fulfill this function. That is their role in the options market.

It is February and Jane sells a May Call with a strike price of $55 for $1.20. She is "short" a May $55 Call. She is either not anticipating the stock to rise to $55/share or higher or she is willing to let it go at that price. At $1.50/share, she receives a premium of $600 (500 shares X $1.20) less commission from the Call buyer. If the stock does rise to that price and she does nothing, her stock will be "called" and she will no longer own it. She can avoid this by buying back the Call, however she will pay more than she initially received and lose

money on the options trade. She will however still own the stock at a profit.

If she lets the stock be called, she will still keep the option premium plus the $6.00/share profit from the $49 to $55, less commissions. She knew this going into the trade and made this decision rather than buying back her Call to keep the stock.

Long Side: John buys the same Call option Jane sold, so he is "long" the May $55 Call, and he paid that $600 premium plus a commission. He thinks he knows something about the future of this stock in the near term, or perhaps he is a technical trader who anticipates a significant increase in share price by the May expiration date of the option.

John has the right to take the stock at the $55 strike price if it rises to that price or higher by the expiration date. If it does not reach that price, John can close out his option trade before expiration by selling his Call, but it will be worth less money, resulting in a loss on the trade.

Should the stock rise to $58/share, John can exercise his option and actually take ownership of the 500 shares at $55 each for a profit of $1,500 - $600 (option premium) = $900 minus commissions at that time. He can sell the stock to realize his profits.

In most cases, at expiration, the brokerage will "auto-exercise" the option on behalf of the holder so they don't forget. They will exercise it and simultaneously sell the stock to lock in the profits. In this way the option holder can realize their gain without having enough money in the account to actually buy the shares.

Put Example

Long Side: Jane owns the same stock in February at $49/share as in the above example. She is concerned about an approaching earnings announcement and a possible decline in the price of the stock. Or she could be a regular buyer of Puts as a protective insurance measure. Let's assume that in this case.

She bought these 500 shares at $40/share, so she is sitting on a significant potential profit at the current price. She really wants to protect some of the profits in the event the stock takes a dive. She buys a May Put with a $45 strike price for $0.90. Her cost for this profit protection is $450 (shares X cost/share for the Put) plus commission. This will allow her to "Put" her shares to the seller of the Put at the $45 price, even if the stock drops well below that value. This locks in around $5.00 of her profit since she purchased at $40/share.

If the stock is above the $45 price at option expiration, her Put simply expires worthless, and she can then do this again if she wants to initiate a new insurance policy. Another option would be to sell her Put before expiration if the stock price is above the strike. She will get back some of her premium.

This could be what she would do if the stock has been rising in price. If it is up to $53/share a month before expiration, she could sell her Put and buy another one at a higher price, say with a $50 strike price to continue her insurance with more profit protected.

Short Side: John sold that May $45 strike price Put and received the $450 premium less commission. He is betting on the stock staying above the $45 strike price. He sold an insurance policy to Jane, and his premium is the $450 to cover her against a large loss.

This is something we'll talk about in a later chapter- the selling of Naked Puts. John has no offsetting short stock position to protect him from loss, so his potential for loss is all the way down to a stock price of $0.00. There are other reasons for selling Puts, and some involve short positions so losses are controlled.

Option Trading is an Honorable Business

Option traders benefit the markets considerably. They help in creating hedge methods so that stock traders can protect their positions. They provide offsetting positions for speculators who want to

invest with leverage. So far, we have just begun learning about the many strategies employed by options traders.

In My Experience
There may be no easier way to make big money in the financial markets than by purchasing call options on rising stocks and put options on stocks in decline. The most you can lose is the cost of the option, and if you play your cards right, you can eliminate at least 50% of that risk.

Chapter 23
The Greeks

In this chapter, when we refer to "the Greeks" we are referring to the use the Greek alphabet to designate a set of risk measures in trading options. You will need to learn these measures and how they influence option values.

VAT INFLUENCES ON OPTION PRICES

There are three primary influencers on the price of an option:

Volatility: This is the volatility of the price movement of the underlying stock. Higher volatility is generally good for the option buyer (long) but not so good for the seller (short).

Asset Price: This refers to the proximity of the stock price to the strike price of the option. Far *out of the money* options are less valuable. *At the money* is more valuable. *In the money* options are the most valuable due to intrinsic value.

Time: The time left before expiration of the option influences the price. The closer the option is to expiration, the greater the influence. So the time to expiration would have a greater effect on the price of an option expiring in two months than one expiring three months later.

As we discuss the Greeks in this chapter, you'll see how these factors influence option prices and how traders who understand the Greeks can tailor their positions with a greater expectation of profit.



Delta

Delta is a measure of the change in an option's price (the premium) as it relates to the underlying security's (i.e. stock) price. As

the price of a stock moves up or down, the Delta of an option tells us how that price change influences the price of the option.

- Call options have a Delta between 0 (zero) and 100. The call has a positive relationship to the underlying security. Call prices rise as the underlying stock rises in price. We have multiplied the true Delta by 100 to make it a positive integer. So a Delta of 50 is really 0.50, meaning the option's price will rise at half the rate of the stock's price.
- Put options have a Delta between -100 and 0 (negative). This is because a put has a negative relationship to the underlying security. Put prices drop when the underlying stock rises in price.
- The option contract represents 100 shares, so using the 100 multiplier helps us to quantify in dollars. With an at-the-money delta of 50, if a stock rises by $1.00 in price, the call option will rise by $0.50, but that's equivalent to $50 for the 100 share position.

Let's take a look at Delta in our three option statuses: at-the-money, out-of-the-money, and in-the-money.

At-the-money, both Puts and Calls have a delta value of 0.5, meaning that the price of the option will move up or down by one-half of the movement of the stock. Common trading vernacular multiplies the Delta by 100, so that .50 becomes 50, or a "Delta of 50".

This is logical, in that a strike price *at-the-money* (that is, equal to share price) has a 50/50 chance of the option expiring in or out of the money.

Calls: An at-the-money call option will increase in value $.50 for every dollar that the price of the stock moves up. At-the-money Calls have a delta of 50.

In-the-money Call options have deltas between 50 and 100, and at some point the delta reaches 100 and the Call price moves in the same magnitude as the stock price, dollar-for-dollar. An example might be a Call with a strike price of $60 and a stock currently trading

at $85/share. If our delta is 100 in this situation, then the stock rising $1.00 to $86/share would increase our option by the full intrinsic value change of $1.00.

Out-of-the-money Call options (strike price is above the stock price) have deltas from 50 dropping to zero. The farther out-of-the-money the strike price gets, the closer it comes to zero delta, and the option price will not move at all in relation to the stock price. An $85 Call on a $50 stock price is out of the money by $35 a share. The stock can move up by $1.00 and the option price will not move at all.

Simple Example: An April 50 Call has a value of $2.50 and a delta of 45 (0.45). If the price of the stock rises from $48 to $50, the price of the option would rise to $3.40 ($2.00 share rise x .45 = $0.90 plus the $2.50).

Puts: This would be the opposite of the above example. If the strike price of the Put option is at-the-money it has a delta of -50. So if the stock drops by $1.00, the Put option's price rises by $0.50.

As the stock drops farther, the Put delta moves from -50 toward -100. At some point the Put premium will move with the stock price, as it has reached a -100 delta. Then the Put price moves dollar-for-dollar with a drop in the stock price.

Out-of-the-money Puts (strike price above the share price) have deltas between -50 and zero. As the stock price rises, the Put price moves less and less in relationship to the stock price. At a delta of 0 (zero) somewhere well above the share price, the Put price will not change at all in relation to the share price.

Example: The May 50 Put is valued at $3.10 with the underlying shares selling at $48 and a delta of -.60. If the shares drop to $47, the Put would rise in value by $0.60 to $3.70, or $370 on the entire 100 share position.

Common: As an option moves closer to expiration, the delta tends to increase if the option is near or at-the-money. Delta is subject to change in relation to implied volatility, a topic we'll discuss later in more detail. Delta is not a constant, as we'll see in our next Greek discussion about Gamma.

Γ

Gamma

Gamma is also known as "the first derivative of delta." It measures the rate at which delta changes. It is an estimate of how much the delta of the option will change with a $1.00 change in share price. Long Calls and long Puts always have positive gamma, while short Calls and short Puts always have negative gamma. Notice that this is different from delta, as gamma is positive or negative based on whether you are long or short in the position, regardless whether it is Calls or Puts.

Remember that we are using gamma to measure the rate of change of delta, so a positive gamma can mean an increase in negative delta. (Huh?) Think of it as acceleration of your car. Whether you are going forward or in reverse, the faster you go the farther you get in the same amount of time. So gamma tells us how fast delta is going to change whether we are going forward or backward.

Gamma is smallest for deep out-of-the-money or deep in-the-money options. This is logical, as the farther the option is in either extreme, the less the delta is changing in relation to the underlying stock price.

If it is deep out-of-the-money, such as a Call well above the strike price, the stock is going to have to move considerably to get the Delta to begin changing. If the Call strike price is well under the share price, it is at the other extreme of delta, and moving with the share price. Delta will be slower to move downward with small incremental changes in share price.

Gamma is positive for long positions and negative for short positions. Also, it is highest when options get near the money. Understanding Gamma can help you to make decisions about liquidating or adjusting positions.



Theta

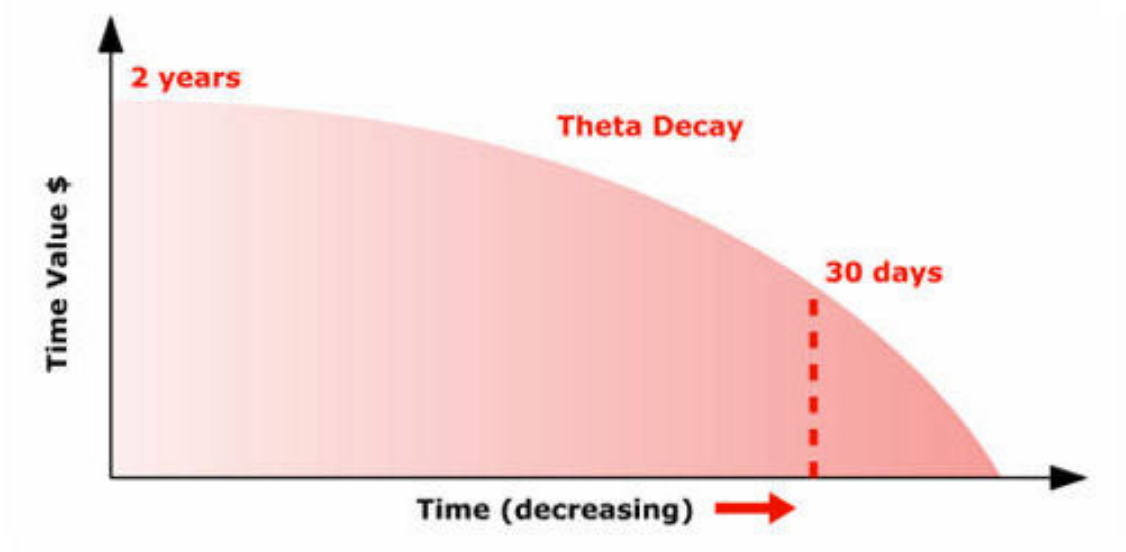
Theta is all about time. An option has a lifespan, and we know its expiration at the time that we buy it or sell it. Time value of an option is a part of Extrinsic Value. Intrinsic Value is the amount the option is ITM (In-the-Money). A $48 call option with the stock trading at $50 has Intrinsic Value of $2.00.

However, there is also the time value component, as there is time left for the option to move more ITM or more OTM (Out-of-the-Money). The underlying stock has a Theta of zero as it is not losing or gaining value based on time. However, when you are long Puts or long Calls, Theta is a negative number because your option is losing value every day that it approaches expiration.

Short Puts and short Calls have a positive Theta. That's because you are short the option, meaning you sold it and collected the premium. The closer it gets to expiration, the closer you are to locking in some, or all, of that premium. There is less time for the option to move against you.

To help illustrate how Theta works in a long position, let's say that you bought $50 Calls on a stock ATM (At-the-Money). It is easier to use ATM options because there is no intrinsic value when the strike equals the underlying stock prices, so we are just dealing with time decay from day to day.

In any event, it almost always makes sense to sell a long option at least 30 days prior to the option expiring in order to avoid the rapid time decay experienced during the last month, or whenever you have hit your profit or loss target, whichever comes first.



Amateur traders typically hold an option until it expires. Pros are out early to capture additional time value. Conversely, pros typically buy options that expire at least 90 days out, whereas amateurs buy front month options (expire in current month) due to their lack of knowledge with respect to Theta.

In this long position, one Call will lose value equal to the negative Theta number by tomorrow if nothing else changes.

Call strike and share price ATM at $50

Call value today is $2.75

Theta is -.23

Tomorrow the call will be valued at $2.52

$2.75 - $0.23 or $23 loss on the position of 100 shares

So we can see that Theta is the enemy of the option buyer, eating away at their option value (Put or Call) every day. The seller on the other hand, short the position, is happy to see each day pass, as their option is closer to expiring and liquidating their short position.

Time decay accelerates as the option nears expiration, markedly so for ATM options. ITM and OTM options lose value in a more linear way. It is logical, as an ATM option has one less day to move

in the desired direction for the Call or Put buyer, but is at the money with more impact from a move for or against the option buyer. Each day closer to expiration, the chances of such a money-making or losing move is diminished significantly.

While ITM and OTM options are in the same situation, there is less chance of them moving for or against the option buyer in a significant way, so Theta is smaller and the acceleration at the end of the options life is not as great.

ν

Vega

Vega is volatility. It is really important and needs to be clearly understood because too many options traders find themselves calling the direction of a stock's price movement correctly, but then they still lose money on the trade due to a drop in the IV (Implied Volatility) of the option.

Implied Volatility: Implied volatility is calculated from the current option price using a model such as Black-Scholes, Cox-Ross-Rubinstein, or others. It is what the current market prices are ***implying*** future volatility of the underlying stock to be.

This is different than historical volatility, which is calculated from actual past price movements of the stock, which may be called statistical volatility. It is past history, while implied volatility is a future prediction.

Vega is the amount a theoretical option's price will move for a corresponding one-percentage-point move in the implied volatility (IV) of the option contract. It is a predictive tool, and not a guarantee of what's going to happen. Whether calls or puts, Vega is a positive number when you buy options and a negative number if you are short options.

Example: You buy a $100 strike price call option and it is 30 days until expiration. The implied volatility of the option is 22% and the current price is $2.75. The Vega is .145, or 14.5 cents.

Now if tomorrow nothing else changes except that the implied volatility increases one percentage point from 22% to 23%, the value of the option would increase: $2.75 + $0.145 = $2.895.

If the option's IV dropped by one percentage point, it would result in this theoretical price: $2.75 - $0.145 = $2.605.

More on Vega

Vega is typically larger the farther out in time before expiration. This is logical because there is more time for implied volatility to fluctuate. More expensive underlying stocks also typically have higher Vega.

So how do you lose money on a trade if the stock is moving in the direction you predicted?

Example: You buy an ATM $55 call option with an expiration two months away at a price of $11.50. The Vega for the option on the day you buy is 0.23 with an implied volatility of 20%. The stock begins to go up in price – good for your call option because it was ATM. In 20 days, the stock is trading at $59/share. Theoretically, you would be up in the trade by about $4.00 in intrinsic value plus remaining extrinsic time value (less loss for time decay).

However, during this period the IV drops from 20% to 14%. That's a six percentage point drop, so with a Vega of 0.23, you will have a theoretical drop in the value of your call of $4.60 just due to IV and Vega. ($0.23 x 20 days).

Though you are not necessarily in an overall loss position yet, you could be headed that way as more time passes. This is a theoretical example, as Vega can change over time as well. However, you can see how dramatic an effect implied volatility can have on the value of an option.

Greeks Bearing Gifts

Understanding the Greeks will help you to craft options trades that have a greater probability of making a profit. Taking advantage of time decay in selling options and avoiding too much volatility risk in buying options can increase your success dramatically.

Now you can begin to see how speculative Call and Put buyers can get into trouble even when the underlying stock moves in the desired direction. It may not move fast enough or far enough, or the underlying stock's volatility may go against them.

In My Experience
If you find the Greeks confusing, welcome to the club. My focus is on the Delta. It tells the investor how much they will make or lose based on a $1 move in the price of the stock. It can be useful in determining the probability that the option will finish in the money. That's not too hard to understand.

Chapter 24
Buying Options

"I used to go to Vegas and play the horses, and then I realized how ridiculous that was. There is no winning in gambling, but there is in the stock market."

Josh Brolin

The quote and image are appropriate for this chapter, as too many novice options traders act more like gamblers in Las Vegas than prudent business people.

The leverage component of buying Puts and Calls is very alluring. Where else can you invest $500 in a Call or Put option and control 10 times or 20 times more than that value in the underlying stock? There's nothing wrong with leverage… if it is used properly and with care.

In this chapter, we'll get into the nuts and bolts of opening your options account and placing your first and most basic trades: buying Puts and Calls.

Setting up the Account

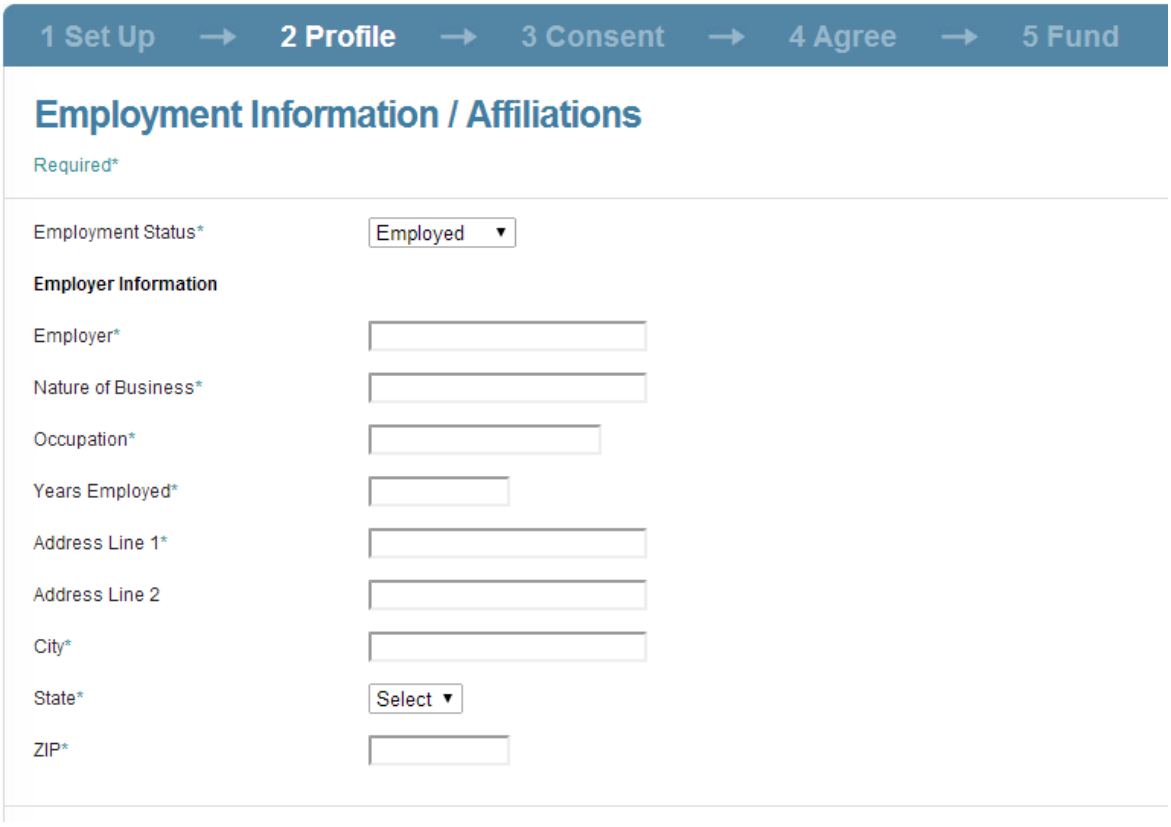
Back in Chapter 8 we took a look at a number of regular, and options specialty brokerages. One of my recommendations for an online options brokerage is OptionsXpress.com. Opening an account there takes only around 15 minutes online.

A free account without any required immediate funding can be opened, and you will have a 30 day trial during which time you can use their virtual trading. If you are going to start out with just buying options, you do not need to open a margin account yet.

For 30 days free virtual trading, you will not need to fund the account at all. However, when you decide you are ready to fund the account, you can set up ACH transfers from your bank account, with which you will be able to move money back and forth in the future.

The free virtual trading account loads up with a fictional $25,000 balance, and you can begin placing practice trades and doing research immediately. I encourage you to wait until you have some available free time in order to take advantage of this trial account, and not waste your free 30 days.

You'll be asked questions about your trading experience and net worth. You will not be required to have trading experience if you set up the cash account for option buying, without margin.. Once you fund your account, you may do as much virtual trading as you like. . You'll also be asked about your employment and income.



Once you have completed the five-step process, you will be ready to do practice trades.

Out-of-the-Money Options Buying

The majority of new options traders are drawn to the options market to take advantage of the leverage offered in buying options. Instead of buying 100 shares of stock at $100/share, it is very attractive to buy a call option at $2.00, which controls that same 100 shares for $200 plus commission. The $2.00 premium is just an example, as the options on any stock will range in price based on the option's strike price and whether it is in-the-money, at-the-money, or out-of-the-money.

Despite the fact that the vast majority of options expire worthless, there are still a lot of people trying to make money in spite of these odds.

Don't Buy on Price!

The Las Vegas syndrome is employed as a trading strategy by buying far OTM (Out-of-the-Money) options, which is betting on a big move in the stock's price in a relatively short period of time. Do not make a decision to buy an OTM option because it seems cheap and you are hoping that the leverage could result in a big payoff. It is far more likely to result in a 100% loss of your investment.

Let's go to the supermarket for an example. If you are buying baked goods, you can save a chunk of money if you buy day old or even two day old bread. However, the shelf life of bread is short, so you have immediately experienced "time decay" the same as you would with buying shorter term options. You could lose a significant portion of your investment when the bread is moldy well before you were able to eat it.

With an OTM option, you will know when your investment is going to expire. However, as I explained earlier, if there is a drop in implied volatility, while you still own the option, a lot of your value can disappear overnight.

Too many novice option traders buy a far OTM option just because they can get it cheap. With a $55 strike price on a stock trading at $35/share, they feel great about buying five OTM calls for $0.50. They only invest $250 and control 500 shares. Of course, the problem here is that the option is very cheap because there is a very low chance of it expiring ITM (In-the-Money). Buying with a closer strike or ATM (At-the-Money) they would have to invest considerably more up-front money.

Note: I will assume that by now you have become familiar with the acronyms, ATM, ITM, OTM, so I will quit expanding them in the future. The same goes for IV (Implied Volatility).

Implied Volatility and Value

In general, if you are buying an option trading at high implied volatility levels compared to historic levels, you could be buying an overvalued option.; In other words, you are paying too much. If IV drops while you own the option, we explained previously how you can lose money even when the stock moves in the right direction.

Delta Should be Considered

We know that an option's Delta is approximately 50 for Calls and -50 for Puts when the strike is ATM. If we are buying a call, we see that, as the stock rises, the Delta goes up from 50 toward 100. If we are buying a put, as the stock drops, the Delta moves from -50 toward -100.

We also know that Delta represents how the theoretical option price will move in relation to the underlying stock price. So ATM, Call and Put option prices will move approximately $0.50 when the stock moves $1.00.

When evaluating a couple of strikes, it is possible that you'll have situations with equal IVs but different Deltas; you could decide

to buy the one with the higher Delta to get more value appreciation with stock price changes.



Courtesy of ycharts.com

In order to provide an actual trading example, I will use the chart and options chains for AON. It is the first trading day in February, and the stock closed just over $80/share the previous trading day. This morning it is down and trading around $78. Just a week or so ago it was bumping $85/share.

I picked this example to show some charting patterns of bullish indicators. You should also have a grasp of the fundamentals of this stock to be sure that it is worthy of a bullish position. You are in the market to buy an OTM Call because you expect the stock to return to an uptrend after this minor reversal.

Notice the Full Stochastic and MACD graphs, as they are both indicating possible positive breakouts to the upside. We are employing both fundamental and technical analysis. You want to buy a Call at somewhere around the $85 strike price or higher, expiring in April.

As the stock is down under $80 right now, we want to move farther OTM for our example, so we are going to look at two call option contracts available with April expiration: the $85 and $87.50 strike price Calls.

There are various websites offering free and more detailed historical volatility charts, and we want to get the historical volatility for AON as one data set. Based on a quick lookup chart from www.optionstrategist.com/calculators/free-volatility-data, I see that the 100 day historical volatility for AON is 20% measured back 600 days.

With that information, I want to look at the Call option chain for AON to place an OTM Call purchase trade. With that information, I want to look at the Call option chain for AON to place an OTM Call purchase trade. With that information, I want to look at the Call option chain for AON to place an OTM Call purchase trade.

Aon PLC

Symbol	Last	Change	Bid	Ask	High	Low	Volume	Chart
AON	77.55	-2.91 ▼	77.50	77.55	80.46	77.49	1,230,798	

AON Expiration Months: Feb14 | Mar14 | Apr14 | Jul14

Calls

Strike	Last	Chg	Bid	Ask	Day High	Day Low	Vol	Opint	A
April 2014							(74 days to expiration)		
70.00	9.60	-0.60	8.40	8.90	9.60	9.60	10	251	Detail
72.50	12.40	0	6.50	6.90	0	0	00	448	Detail
75.00	6.30	0	4.70	5.10	0	0	00	203	Detail
77.50	4.40	0	3.20	3.50	0	0	00	410	Detail
80.00	3.60	0	2.15	2.30	0	0	00	2,954	Detail
82.50	1.85	-0.25	1.30	1.45	1.85	1.85	11	1,048	Detail
85.00	1.25	0	0.75	0.90	0	0	00	2,402	Detail
87.50	0.90	0	0.45	0.55	0	0	00	937	Detail

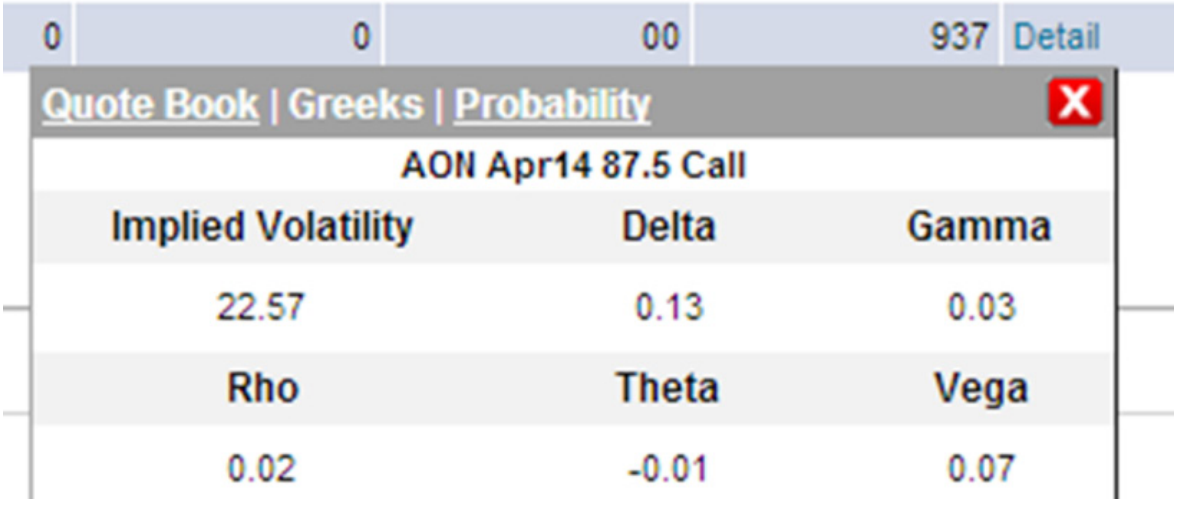
You are expecting the stock to reverse and get back to a significant uptrend. You note on the stock chart that prices retreated in October and then a nice uptrend resumed with roughly a $10/share gain in a couple of months into December. You are expecting the same thing to happen again, and your target is for the stock to reach $90 or so by April.

Bid/Ask Spread is a Factor

While there is a $90 strike price and the Ask price is only $0.30, we are not going to consider that for this example. The Bid price is $0.20, so we are seeing a major price percentage difference between Bid and Ask. If we buy at $0.30 and have to sell immediately for some reason at $0.20, we are being discounted by 33%. It is like the instant depreciation we incur when we drive a new car off the lot. Our decision is also validated by Open Interest of only 94 contracts. It is obvious that very few others are interested in these particular options.

So let's concentrate on the 85 and 87.50 strikes. We have 74 days before expiration, and we believe the stock will reach $90 or higher.

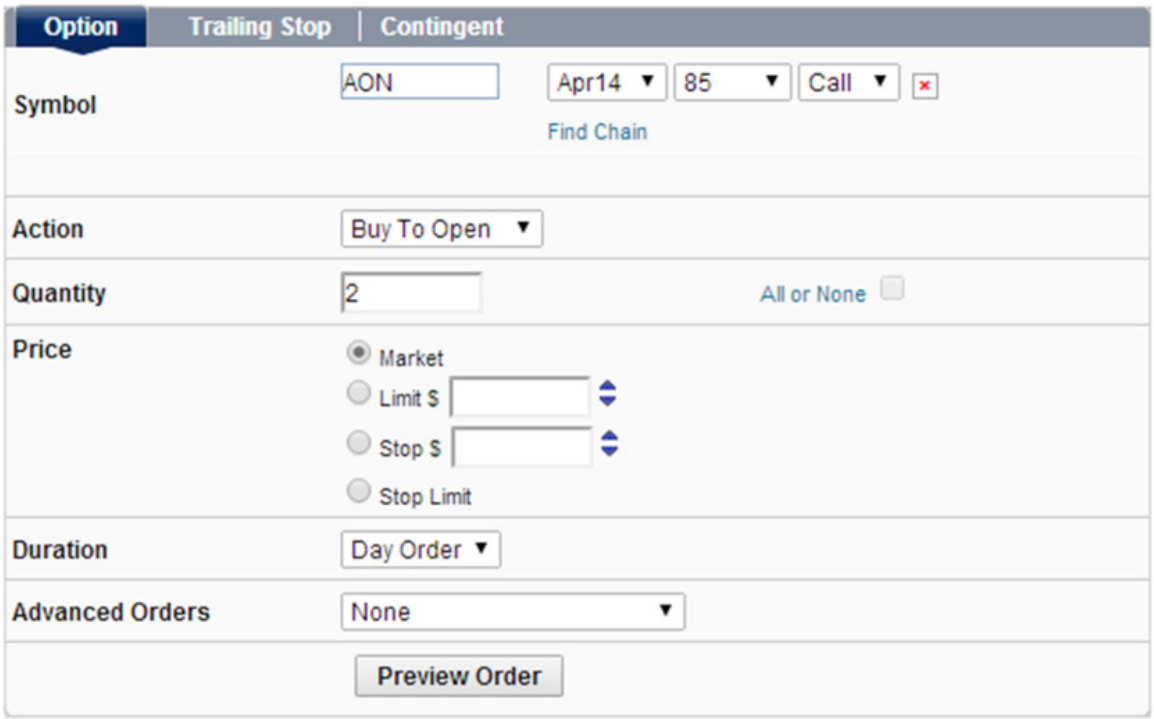
A neat feature in the option chains at OptionsXpress.com is the ability to hover your cursor over "Detail" at the end of the chart to see the Greeks for the option. This is the 85 Strike Call, and we see that the Open Interest is 2402 contracts. We also see that the IV is not that much higher than the 100 day average, so this infers that we are not buying an overvalued option. Delta is 0.19, so at this moment, the option will rise in price by 19 cents for each dollar of stock price movement to the upside.



Now we are looking at the 87.50 strike Call. We have a little higher IV, but not much. Delta is lower, and the Gamma indicates Delta will change more slowly.

In checking the option chain chart, we see that the difference between the Bid/Ask spread for these two options is a nickel, which is not significant percentage-wise (16.6% of Ask on the 85 Call and 18.1% of Ask on the 87.50 Call).

Of course, you can buy the 87.50 strike Call for $55 plus commission instead of $90, but if you have predicted right and the stock goes to $90/share, that extra $2.50 intrinsic value will have a nice effect on the trade profit. So let's decide to buy the 85 strike and see how that looks.



We enter our order and we are going to purchase two contracts. A decision could be made here to try and "split the difference" by placing a limit order to buy at less than Ask. However, the decision is to go for the more certain execution of a market order.

Symbol	Description	Last	Change	Bid	Ask	Volume
AON	AON PLC	77.09	-3.37 ▼	77.06	77.09	1,595,934
AON Apr14 85 Call	AON PLC	1.25	0.00	0.70	0.85	0

Action	Qty	Symbol	Description	Contract Size	Price	Duration	All or None
Buy To Open	2	AON Apr14 85 Call	AON PLC	100	Market	Day Order	Off

Estimated Commission	$14.95
Estimated Order Total	$184.95
Time	2:30:58 PM ET

This Preview is provided for your protection, so please review all order details carefully. Clicking the "**Place Order >>**" button will transmit this order to the exchange marketplace for action.

Cancel << Change Place Order >>

We preview our order. See the $14.95 commission and the fact that the option is currently quoted at $0.85 for the Call because the stock is trading down a little more.

My View Default

SYMBOL▲	DESCRIPTION	STOCK	QTY	AVG PRICE	PRICE	CHANGE	VALUE	GAIN/LOSS	ACTION
AON Apr14 85 Call	AON PLC	$77.09	2	$0.85	$0.70	0.00▲	$140.00	-30.00▼	Trade Roll Chain ▼

We see in our positions that the order executed quickly at the $0.85 Ask. Our trade is down $30 in value, which is the difference between the Bid and Ask. Congratulations! You have entered your first options trade.

The process works the same for placing OTM buy orders for Puts, so we don't need to review that process also. However, there are some contingencies you can put on your orders. Let's look at those.

Order Contingencies

Day Order

You saw in our AON call example that we placed a Day Order. It is pretty much self explanatory; an order to be executed today. If it cannot be executed by the market close, it will be automatically

canceled. It is the most common type of order, as you are not taking overnight risk with unexpected market movement.

Good 'Til Canceled (GTC) Order

This one is pretty self-explanatory as well. You want the order to remain open for a fill until you cancel it. It will roll over into the next day and so on. You might use this order if you are placing your buy price below current prices. In our previous example, perhaps you still have the overall bullish attitude, but you expect the stock price to fall another dollar or so before it turns around. You could place your option order to buy at $0.70, which is the current bid price.

It is unlikely that your bid offer will be executed, however if the price of the stock should fall, then the price of the options will fall as well. At that point, your order may be executed.

Limit Order

We touched on limit orders when we placed our order. I could have entered the trade at a price between the Bid and Ask in an effort to get a better price. If you can monitor an order and change it when appropriate, you may want to try this cost saving measure. Also, on options with wide spreads between Bid and Ask you'll want to try to get a better price than the Ask if there is reasonable Open Interest.

In our example trade, I did go in and place a second order below the Ask. I placed an order to buy with a limit of $0.80. It did not execute by the end of the day.

ITM Options Buying

Some traders replace buying stocks with options. Rather than tie up cash in the shares themselves, if they have a short-term attitude about a stock's price, they would buy ITM options to mimic the movement of the stock's price and receive higher percentage returns. You may be bearish and not want to short shares, instead buying Puts. The more ITM the option strike, the higher the Delta, and the more

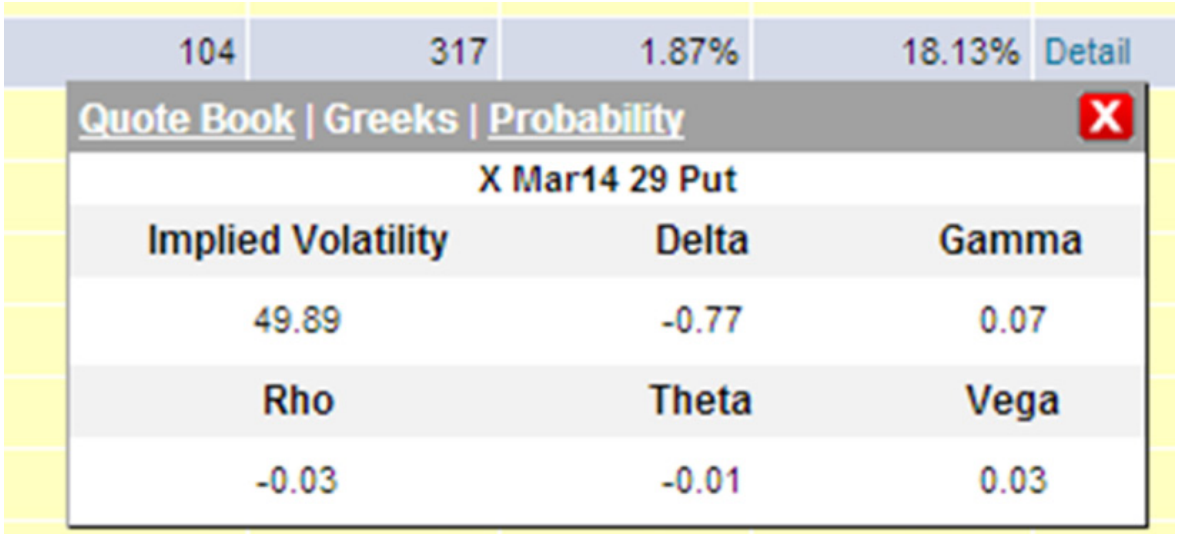
the option price will move in relation to the stock price. Let's do a Put option example to illustrate this type of trade.

28.00	3.54	+0.78	3.65	3.70	3.54	3.41	04	1,533
29.00	4.80	+1.45	4.45	4.55	4.80	4.75	104	317
30.00	4.80	0	5.35	5.45	0	0	00	2,564
31.00	5.96	0	6.25	6.35	0	0	00	415
32.00	2.94	0	7.15	7.40	0	0	00	19
33.00	7.75	0	8.15	8.25	0	0	00	11
34.00	4.30	0	9.10	9.45	0	0	00	81
35.00	6.15	0	10.05	10.45	0	0	00	20
36.00	7.10	0	11.05	11.45	0	0	00	30

This is a portion of the Put option chain for X (US Steel). We'll assume you have a short term bearish outlook for this stock and you want to take a position, but with options rather than shorting the shares. When this screenshot was taken, the stock was trading around $25/share, down about a dollar from the previous close.

All of these exhibit implied volatility of between 49% and 54%, higher than the 36% 100 day historical volatility. However, for your own reasons you believe that US Steel's stock is going to drop some more, and possibly down to the 200 day moving average for support.

The 200 day moving average is just under $22/share. By taking an ITM position, you want to participate in the stock's price continuing to drop to the support level at $22.



The decision is to buy the $29 put, as it has the lowest IV and other nearby strikes are similar in every other way but have higher IV.

Symbol	Description	Last	Change	Bid	Ask	Volume
X	US STEEL CORP	24.99	-1.12 ▼	24.99	25.00	8,228,750
X Mar14 29 Put	US STEEL CORP	4.80	1.45 ▲	4.45	4.55	104

Action	Qty	Symbol	Description	Contract Size	Price	Duration	All or None
Buy To Open	1	X Mar14 29 Put	US STEEL CORP	100	Limit 4.50	Day Order	Off

Estimated Commission	$14.95
Estimated Order Total	$464.95
Time	3:44:22 PM ET

Here we see the order, and it was placed as a Day Limit order between the Bid and Ask. The spread is small, so it is unlikely that it will execute, but the stock's price could run up before the trading day closes and the trade may execute.

Buying Options as a Regular Trading Method

Straight buying of options is usually not something you want to do regularly. The strategy will normally result in many small losses that offset your gains. However, when the market and a stock's conditions seem right, you can make money if you are careful.

In My Experience

When I am speculating, I buy OTM (out of the money) options with a Delta of around .25. When I am investing, I use options with a Delta of .80. The higher the Delta I use, the more confident I am in the underlying security moving in my favor.

Chapter 25
Selling Options

"I am my own salesman. I cannot let anybody do anything for me."
Fred Durst

Option selling strategies range from low risk to extremely risky. In this chapter, we'll take a look at why investors and traders sell options. Few stockbrokers will give you guidance, and they will rarely tell you that selling options can be a better way to buy and sell stocks.

There are two exposure profiles when you are selling options: the naked position and the covered position. When the sold Puts or Calls are backed by a short or long position in the underlying stock, you are "covered." When you just sell options without the backing of a long or short position, you are selling "naked."

Margin Requirements

Buying options limits risk to the amount paid for the options, so no residual margin value is required in the account. However, selling options can require significant margin requirements, meaning a balance must be in the account to handle the situation if the market moves against your position.

Before we get into selling Calls and Puts and related strategies, you should know the margin requirements for selling options. Different brokerage firms have different requirements, so you'll need to be very familiar with your brokerage's rules. In most cases, you will not be able to place a trade if you don't have the required margin, but it is better to not even consider strategies that require a margin in an underfunded account.

OptionsXpress has their margin requirements posted on the site, so we'll use a portion of their margin explanation for our example:

A $2,000 minimum account value is required for margin accounts engaging in leveraged transactions including short Puts, short stock and stock purchases on margin.

For accounts engaging in uncovered (naked) equity or index call writing a minimum account value of $5,000 must be maintained.

Important: *If your equity drops below the minimum required, or a margin call is issued for any other reason, you may be required to deposit additional funds by wire, check (sent by overnight courier), or a deposit made by other prompt method of payment.*

Covered Call Writing	Requires a long stock position equal to the amount of exercisable calls. On a single order combination transaction, the long stock position requirement is not offset by the proceeds of the call until after the transaction.
Equity Short Puts & Naked Calls	20% of the underlying market price + the premium – amount out of the money **OR** 10% of the underlying market price (or strike price for O-T-M puts) + the premium, whichever is greater.*

The "underlying market price" is the current price of the stock on which the option is written. You'll want to ask questions and understand the margin requirements before you place trades. Some brokerages will have much stricter requirements than these, so do your homework.

Selling Call Options

The Covered Call

Part of Investopedia.com's definition of a covered call is: *"An options strategy whereby an investor holds a long position in an asset and writes (sells) call options on that same asset in an attempt to generate increased income from the asset."*

In other words, you are selling (writing) a covered call if you own 100 shares of the stock for each contract sold. It is covered by the stock ownership. One call is one hundred shares. You sell the call to a buyer who, as you saw in the previous chapter, is expecting an upward movement in the stock and hopes to profit using the leverage of options rather than buying the stock.

Many investors buy-and-hold their favorite stocks for years. They have no real intention to sell them in the short term, and they expect long-term capital gains as the stocks rise in price. Some are also dividend-paying stocks, so the investor is getting income from holding the shares. There are two basic approaches to selling covered Calls:

1. Using Call writing to sell your stock instead of using a limit order.
2. Selling (also called "writing") the Call option for extra income on a regular basis, even though you really want to keep the stock.

The Buy/Write Strategy

This is still a covered Call, though you don't own the stock. You can execute a simultaneous transaction to buy the stock shares and sell the Call option(s). An example would be buying the stock at $45/share while selling the $50 strike price call.

This is a good strategy to lower your cost basis on the stock. If you want to own it anyway, not just realize income and have it called away, you could do a buy/write with an option with a strike price that is further out of the money. You'll get the stock at a lower net price and have a better chance of the options expiring worthless, while you keep the shares.

Other traders execute buy/writes totally for the income, and they are not concerned about the stock being called away. They simply do the math to realize the desired return on investment. Of course, there are some considerations when writing covered Calls:

1. What is the targeted yield of your trade?
2. Select the appropriate expiration date of the option.
3. Combining 1 and 2 above, you may be making a purchase of 300 shares of XYZ Corp at $40/share, and selling 3 Call options. Your investment is $12,000 plus commissions, and minus the premium you take in on the options less commission.
4. In all of these strategies you would want a medium volatility situation. If volatility is too low, you will not get decent premiums and return on investment. If the volatility is too high, you could experience a major move in the stock, adding risk to the position.
5. OTM – If you want to keep the stock and would rather have the options expire worthless, you would sell OTM Calls, choosing an expiration date that yields a good premium but does not go too far out into the future, which would increase your risk of having the stock called away.
6. ATM – At-the-Money options would probably yield the highest premiums, but would also increase your risk of having the stock called away. If you are ambivalent about losing the stock, this could be your best ROI.
7. ITM – With In-the-Money options, you are expecting to have the stock called away, and you have calculated your yield to be sufficient for the short duration of the trade.

Buy/Write Example

It is February 2014, and you have located a possible opportunity for a buy/write on Questcor Pharmaceuticals, Inc. (QCOR). We have some choices for Call options to sell at the same time we are buying the stock at approximately $69.28/share. These are real numbers for the March Calls expiring in 36 days.

We'll take a look at some of our choices for Calls to sell and the return on investment for each, depending upon the movement of the stock. This is not a recommended trade, but it is a good example of

how we would evaluate our choices, as there are five strike prices we can consider.

STRIKE	OPTION BID	NET DEBIT	DOWN PROTECTION	RETURN IF UNCHANGED	RETURN IF ASSIGNED.
77.5	$2.80	$66.48	4.0%	4.2%	16.6%
72.5	$4.90	$64.38	7.1%	7.6%	12.6%
70	$5.80	$63.48	8.4%	9.1%	10.3%
67.5	$7.20	$62.08	10.4%	8.7%	8.7%
65	$8.60	$60.68	12.4%	7.1%	7.1%



The chart for the stock shows reasonable support at around $60, so you may decide that this trade is worth 36 days of downside risk for the ROI. We are looking at five strike prices, from OTM to ITM. Here are what the columns mean:

- Strike – the strike price of the Call we are selling.
- Option Bid – the bid price of the Call; what we can expect to receive (or better) when we sell it.
- Net Debit – the net out-of-pocket investment considering the price of the stock less the premium we receive for the option (commissions not included).
- Down Protection – how much protection to the downside we have if the stock drops in price.

- Return if Unchanged – return on our investment if the price of the stock remains unchanged.
- Return if Assigned – return on our investment if the stock moves up to or higher than the strike price.

We can see that the 65 ITM strike gives us approximately 12.4% in downside protection, which would be down to just over $60. If the stock does not move up to the strike, we would realize a 7.1% return on our investment. That's not bad for approximately one month. Many investors are fighting to find 3% to 4% annual returns.

Of course, if the stock goes to or above the strike price, our ITM choice will still only earn us 7.1%, but we may find it worthwhile in order to get the downside protection. If we are bullish on the stock, we may decide on an OTM strike price to maximize our return if the stock trades up to or above the strike price. Our downside protection is not as good, however, and we could suffer if we are wrong in our bullish assessment.

Writing Calls to Sell Your Stock – Out of the Money

Let's say that you are holding 300 shares of XYZ Corp at a current price of $55/share. It has been trading in a range, not quite hitting your initial goal to sell at $60. You could place a GTC (Good 'Til Canceled) limit order to sell at $60 or better. In this situation, if the stock trades through the $60 price, you'll probably sell at $60. Of course, if the unexpected were to happen with a gap up opening at $62, you would possibly make that extra $2/share with a straight stock sale order.

However, let's say you decide to write Calls instead because you don't expect the stock to jump; you expect it to just reach $60/share. You can sell three Calls at the $60 strike price. In this case, you are limiting your upside to that $60 strike price even if the stock jumps up suddenly. You'll only get $60/share. However, you'll also get to keep the premium from selling the three Calls.

In this example, you find that you can sell these Calls at $1.95 in the next expiration month. You collect the $585 premium for three Calls less commission. If the stock rises above $60 and is called away, you'll have sold the shares for $60 plus the option premium, so around $61.95/share.

If the stock continues to trade below the $60 strike price, you get to keep the premium and do the same thing again once the current Calls expire. If you have more of a desire to sell the stock, you change the strike price and sell ITM Calls, which would make it far more likely that the options will finish in the money and you'll have sold your shares but increased your profit by the option premium.

Writing Calls to Sell Your Stock – ITM or ATM

In the Money: Let's say that we are not as much in love with this stock as when we bought it. We definitely want to sell, but we want to eke out a bit more in profit. Theoretically, we could sell three $50 ITM Calls at $5.90. The strike price is currently $5 ITM (intrinsic value) with the shares trading at $55, and the other $0.90 is the extrinsic time value of a near month call expiration.

The stock has been trading around $55 for a while, which is why you have decided to sell and look for opportunity elsewhere. By selling the $50 strike price Call, you are reasonably sure to have the stock called away at $50. However, you actually got your $55 current price plus the $0.90 extrinsic value portion of the premium.

At the Money: You'll get more upside gain selling an ATM Call. In this example the $55 Call is selling at $1.65. So you'll lock in your selling price of $55 and the extra $1.65 extrinsic value in the Call option price. Instead of the $55.90 in the ITM example, you'll get $56.65 in this case. However, should the stock continue to trade below $55/share, you'll get to keep the option premium at expiration and try again. If you are nervous about holding the stock, you may not want to use options to sell, instead of just selling the stock outright.

Covered Call Risk: Of course, as long as you are holding stock you have a risk of it dropping quickly in price. You could have a stop order to sell at some price below $55 to protect yourself, and move the stop up as the share price rises in order to protect more of your profits.

Should the stock trade down and you choose to sell, you'll have a naked Call position because you are no longer covered by owning the stock. Of course, the price of the Calls will have dropped as well, so you can buy them back below the price at which you sold them. You can even place a GTC (Good 'Til Canceled) option order to buy back the Calls at a specified price or at a specified price for the underlying stock. In this example you could have the option order to buy back the Calls and close the position if the stock trades down to $55/share.

Many traders avoid covered Calls as a strategy because the downside risk of owning the stock is all the way to zero, while you are limiting your upside reward to the strike price of the Call plus the premium. However, if you are interested in holding some stocks for the long haul, covered Call writing can add to your overall return.

This is particularly true if you are holding dividend paying stocks, because many are less volatile than growth shares. For this reason, the option premiums will be low, but they can still be a significant addition to your income stream. If you are enjoying a quarterly $1.00/share dividend and you can sell Calls out three months for $0.40, you are increasing your income by 40%.

The Naked Call Sale

As we have learned that the vast majority of option contracts expire worthless, we know that the Call buyer loses their entire investment and the seller keeps the premium. Some investors may be attracted to short Call positions, but without the shares owned to cover it, the risk is theoretically unlimited.

If you simply want to sell a call option that is far OTM, say a $65 strike price on a $50/share stock, it could seem pretty safe that you

will not get your stock called way. If there is significant resistance at the $60 price, you could assume that there is little chance of the stock reaching $65 before the option expires. You get to keep the premium, let's say $1.78 in this case. So, you sell three Calls for a gross premium (commissions not deducted) of $534.

Now let's analyze this trade. The most money you can make is $534 less the commission. How much can you lose? Theoretically, that amount is unlimited. The stock can rise to the moon and beyond overnight, leaving you in a position of having to buy the shares at the market price and deliver them to the option holder at the strike price.

Let's say that over the weekend a takeover is announced for this company and the stock opens at $70/share on Monday. The option holder exercises and you must deliver the shares at the $65 price, but you have to buy them at $70 plus the commission. You are down around $5,000. You get to keep your $534 premium, but it is not much consolation.

Is not buying a Put the same as selling a Call? It is certainly betting on a stock going down instead of up in price, but it is very different when it comes to risk. When Buying the Put, you are only at risk for the premium you paid, and your reward could be great if the stock drops significantly in price. Selling the Call with a big drop in stock price would result in only profiting the amount of the premium you collected. However, the risk is extreme in comparison, as the stock can go up as easily as down.

Some investors with large and diversified portfolios may do some naked Call selling, as they have plenty of margin ability if a trade goes against them. If they are selling far OTM calls, they may make a little money on a number of trades. However, one major loss can wipe out all of those gains very quickly.

Selling Put Options

You are the Insurance Company

We discussed Married and Protective Put strategies in the previous chapter. Investors who hold stocks frequently purchase Puts to insure against losses if their long stock position suffers a price setback. You can be the insurance company, selling them the coverage by selling Puts naked.

The naked Put has a similar risk profile to the naked Call. However, a stock can only drop to zero in price, so there is a bottom, while on the Call side, theoretically a stock can climb to infinity. In selling these naked Puts, you are taking over the risk the long holder of stocks wants to avoid.

Example: A holder of XYZ Corp stock at $70/share bought their 200 shares at $50/share. They are happy with the performance of the stock, and they want to hold with more bullish expectations. However, they are concerned about protecting some or all of that $20/share profit. So they buy a Put with a $65 strike price at a theoretical price of $2.95. The expiration is three months out.

If you are selling that Put, you collect 200 x $2.95 = $590 less commission. You are now insuring the stock owner for any downside risk below $65/share for three months. If you are also bullish on this stock, you may consider this an acceptable risk profile. After expiration, you keep the insurance premium and have no further risk unless you repeat a naked Put sale on this stock.

In a bullish market or market segment, such as when the technology stocks were booming, you may be able to sell Puts behind rising stocks for significant percentage returns on your account. However, while "a rising tide floats all boats," a market reversal such as one of those famous "October surprises," can land you in a really tough spot.

Hedging with Short Position

You can protect yourself by hedging the position and changing it to a covered Put strategy. If you have significant margin ability, you can sell the stock short by 100 shares for each Put you are short. So selling that stock short with a GTC order at $65/share could protect you as long as it does not gap down or move through that price too quickly. If the stock drops in price, passing through that $65 strike, you'll be losing money on the Puts you sold, but gaining money on the short stock position that executed at around $65/share.

Let's reverse the strategy, though. Let's say that you are bearish on a stock and expect it to drop when earnings are announced. You sell it short at its current $70 price. However, you want some insurance against a rise in the price of the stock. You could sell an ITM Put, say at the $75 (or $72.50) strike price. The premium you collect would offset some of the loss in your short position, but only by the amount of the premium. You are buying insurance to limit losses.

Buying Stock by Selling Puts

Let's say that you have been watching a stock you want to own trade in a sideways price pattern, currently selling for $55/share. You would love to own this stock, but only if you could buy it for $40/share. You can just place a GTC order to buy at $40 or better. If the stock never trades that low it will never execute, but if it does, you'll own it. The problem is that you have had an order in like that for months, ever since the stock was trading at $45/share.

What if months ago you had sold Puts at a $40 strike price? You would have been collecting premiums to increase the ROI of your account, and you would still be positioned to buy the stock if it drops to your $40 target. Instead of a non-income-producing order to buy, you are collecting income with naked Puts. It is simply another way to buy stock.

Sure, some would say that selling naked Puts is extremely risky, as you are going to lose a ton of money if the stock drops dramatically,

possibly all the way down to zero. However, you take the same risk with a $40 Limit Order to buy when the stock is on the way down.

In My Experience
Never sell naked calls… period. Only sell naked puts when you want to purchase the underlying security at the strike price. It insures that you will purchase every stock you buy on sale.

Chapter 26
Advantages of Index Options

When you speak to investment advisors for almost any asset class, you'll invariably hear that you should diversify for protection of your portfolio and for better returns. It is the "don't put all of your eggs in one basket" discussion. This reduces or evens out your risk across different assets and classes.

A stock index is a compilation of many stocks. There are different groupings, some by market, others by industry group, and some based on selective criteria to create a diversified basket of stocks.

The S&P 500 is a portfolio of 500 individual companies. This gives investors the opportunity to construct option trading strategies and techniques to bet on, or hedge the entire market, rather than individual stocks. The Russell 2000 is made up of 2000 small cap companies.

There are three major benefits of using indexed options rather than investing in individual stock options:

Predictability

One of the benefits of diversification is spreading the risk amongst a variety of investment products. While individual stocks can be quite volatile, once they are a part of an index, the group as a whole is less volatile.

Earnings reports, news releases and other market events can have a big influence on individual stock prices. An index tends to smooth out the ups and downs of the individual stocks, which means that the index options will have lower fluctuations.

Liquidity

Index options are very popular for other reasons that will be noted in this chapter. These securities are heavily traded. This creates a very liquid market with tighter spreads between bid and ask prices. An index's options can frequently trade with only a penny or two as

the spread, while an individual stock's options can trade with spreads ten to twenty times that.

European Style Expiration

Standardized individual equity options are American-style options. This means that they can be exercised on any day the market is open, up to the expiration date. The last day to exercise an American-style option is usually the third Friday of the month in which the contract expires.

Most index options use European-style options. The only time you can operationally exercise your contract is on the last trading day before expiration. This does not mean that you cannot exit your position. You can close out your position at any time by selling long options or buying to close short options.

Some Strategies Best for Index Options

Most spread strategies can use either equity or index options. Index options are far superior to individual equity options when it comes to certain types of spread trades. The tighter spreads and greater liquidity create better risk and performance profiles for certain strategies. We'll discuss those in other chapters on trading options and specific strategies.

In My Experience
Index options are the perfect choice for beginning credit spread traders. It takes earnings surprises and news that's specific to a company, out of the equation.

Chapter 27
Collar Trades

"Should you protect profits? Yes. But run for the hills? No."

Philip Roth

Think of a collar trade as "circling the wagons" around a stock's profit. Let's say, you have been holding 300 shares of a stock for several months. It is currently selling at $47/share, and you bought it a long time ago for $28/share. You have made a great profit, and you are still somewhat bullish on the stock, but you are beginning to think it may be time to take your profits and run.

However you really want to get $50/share before you sell it. You are concerned enough about possible downside risk that you want to buy a Put to protect most of your profits. This is when it is a great time to consider a Collar Trade.

When you execute a collar trade, you sell an OTM Call and buy an OTM Put. The Put protects your profits and the Call premium offsets some or all of the cost of the Put and could result in the sale of your stock if it rises to your target price. So here's the strategy in this example:

You want to buy a $45 strike price Put.
You want to sell a $50 strike price Call.

This will be a combination trade, with both positions opened at the same time.

You want both of these positions to have the same expiration date, and here are the possible outcomes:

- The stock continues to trade in a range between $45 and $50 until expiration. In this case your two options positions expire worthless and you can do it again if you want.
- The stock drops to $45 or lower in price before or by expiration. You will be protecting your profits through the

increase in value of the Put, offsetting the drop in the stock's price.

- The stock rises to $50/share or higher. Your stock will be called by the Call owner, and you will have sold at your $50 target price.

What is this going to cost you? The premium you take in for selling the Call will offset some or all of what you pay for the Put. In some cases, you can initiate this combination trade at a credit, actually adding cash to your account.

Let's look at two different cost scenarios.

1. **The Put is more expensive than the Call:** Let's say that for volatility and other reasons, you must pay $1.50 for the Put, and you can only sell the Call for $1.00. Your account is debited for the difference of $0.50. You have cut the cost of your downside protection with the premium from the Call sale.
2. **The Call is more expensive than the Put:** Let's just reverse the numbers, and you'll actually take in $0.50 more for the Call than you are paying for the Put. It is a "credit" transaction, adding $0.50 to your account.

The collar trade is a very straightforward strategy. You are sitting on a nice profit in a long stock position, and you want to protect as much of that profit as possible. You are also thinking that the run-up in price is coming to an end, and you'd like to sell and take as much profit as possible.

If this is your situation, the absolute best outcome is for the stock to be taken from you at $50/share, after you received a credit for putting on the collar trade. It is like getting free insurance. If you had put that $0.50 credit into the account by selling the Call for more than the cost of the Put, your trade would look like this (commissions not considered for simplicity):

You held 300 shares.
Cost of 3 Puts = $300.
Income from sale of 3 Calls = $450
Shares sell for $50, so $15,000 for 300 shares.
That's $15,150 with the credit from the collar trade.
You paid $28/share, so your cost was $8,400.
That's a $6,750 profit.

In a collar trade, we are working with a profit in the long stock position, from the beginning. All we want to do is get a bit more from the sale of the stock at our target price and protect ourselves from a reversal while the trade plays out. We have eliminated most of the downside risk with the Put purchase. The Call side simply reduces the cost of the protection or even makes it a credit if the Call is at a higher price.

Alternatives for Closing Out the Trade

Before Expiration

If for some reason you, once again, become bullish on the stock, you can close out your collar trade as simply as you put it on. Just place the combination order to buy back the Call and sell the Put as a transaction. The cost to close your trade will depend upon the price of your long stock at the time you liquidate the trade.

At Expiration

If the stock is still trading between the two strikes, you'll generally just let the options expire worthless. This is especially true if you initiated with a credit. You will still own the stock and can initiate a new collar trade if you wish.

If the stock is selling below the Put strike price, it will have intrinsic value, and you can elect to sell the Put on the last day and pocket the money from the sale. In the alternative, you could exercise the Put and sell the shares, but commission costs may be higher.

If the stock is selling above the Call strike price, your goals have been achieved, so you would probably just let the stock go. If you have changed your mind about selling, you can buy back the Call and keep the shares.

In My Experience
If done properly, the collar trade can be executed with close to zero risk. This is the perfect strategy for conservative investors happy with a 12% to 15% rate of return on their holdings.

Chapter 28
Straddles and Strangles

"Life's up and down from the time you get here to the time you leave."
Luke Bryan

Stocks, like life, are up and down, and trading stocks and options is very much about trying to decide if the next move is going to be up or down … unless you want to use straddles.

THE STRADDLE

The image above illustrates an option strategy that will deliver profits no matter which way the stock moves. This is known as a bi-directional trade. The key is that it must move one way or the other, and it must move enough to overcome your cost. In its simplest form, a straddle is betting that a stock is about to move significantly in one direction or another.

To profit from a move in either direction, you will be buying a Put and a Call, both at the same strike price and both with the same expiration dates. The normal trade uses a strike price that's ATM (At the Money) or very near it. By holding long Calls and Puts at the money, you will see one side of your trade gain in value no matter which direction the stock moves. Let's look at a simple example:

Underlying stock trading at $50/share
You buy a $50 Call for $2.50
You buy a $50 Put for $2.25 same expiration date as Call
Your cost for the trade is $4.75 x 100 = $475

Our potential losses from this trade are limited to the premiums plus commissions ($475 + commissions.). Our gains are potentially unlimited to the upside if the stock takes off, or all the way down to zero on the downside. We make money no matter which direction,

as long as the move is great enough to generate profits in excess of our premium and commission. In this case (ignoring commission) we would need for the stock to move up or down by at least $4.75 if we hold the options until expiration. We break even at approximately $45.25 down, or $54.75 up.

You can see that we really need to have a reasonable expectation of a large move in either direction. We may have this feeling because we know this stock has been volatile when earnings are announced, and it can move a lot with either good or bad earnings news. One thing we need to take into account is that this volatility also increases our cost for the options.

If the stock continues until expiration to trade between $45.25 and $54.75, we'll lose our premiums paid on the trade unless we adjust it. In that price range, we can buy our way out of the trade at any time, of course, but it will result in a loss due to time decay of the option values.

My 10 Rules for Long Straddle Trades

I have developed 10 rules that increase my odds of profitability on long straddle trades. You are buying both puts and calls. The more of these rules that you can meet when placing your trade, the better your chances for making a profit.

 # 1 – Timing of the trade: *Place the trade approximately 30 days before an earnings announcement or other expected news.*

 # 2 – Verify the earnings date: *Never rely only on past history, as things happen and earnings dates and reports can change.*

 # 3 – Securities price minimum: *Only do straddles on securities selling above $15/share.*

 # 4 – Check speculation level: *Look for high open interest in the strike prices you are considering; lots of activity means others are expecting stock price movement.*

 # 5 – Verify past price movement: *Has the underlying stock exhibited significant movement either prior to, or after major announcements or earnings reports?*

 # 6 – Buy at least three months prior to expiration: *You are allowing plenty of time for movement in the price, and you are lessening the effect of time decay prior to the earnings announcement.*

 # 7 – Balance contracts: *Buy an equal number of Put and Call contracts.*

 # 8 – Delta neutral: *Buy ATM (At-the-Money) options with deltas around 50.*

 # 9 – Cost of trade limit: *Buy right by limiting the cost of the trade to less than 25% of the price of the security.*

#10 – Quantify the expected move: *You'll want to limit your activity to trades in which you expect the stock to move in price at least three times the 30 day trade risk. Check the time decay, estimate it for 30 days out, and enter the trade only if you expect the stock to move at least three times that amount in price.*

Let's put all of these into context. You want to place a straddle trade, and you expect significant movement in a stock's price when earnings are announced. With a long straddle, you really don't care which way the stock moves, as long as it moves a lot. That's because you have purchased ATM Puts and Calls and you must overcome that cost before moving into profits.

You are familiar with XYZ Corp's stock movement over time, and it is made some significant moves due to earnings surprises in the past. Earnings are due to be reported in about 30 days from now,

and the stock is trading at $75/share today. You also notice that options with expirations out 60 to 90 days have a lot of open interest in strike prices $10 or more over and under today's share price. There's speculation that the stock is going to move.

You check the $75 strike prices for Puts and Calls, and you see that you can purchase one of each right now for a total of around $15.00 with an expiration three months out. That's only around 20% of the current price of the stock. Theta (time decay) for these ATM options is only -.04, so 30 days from now they will have lost only around $1.20 in value. You are expecting a move of at least $7.50/share in price up or down.

This could be a good straddle trade. You'll just have to monitor it over time with the idea that you may want to adjust or close it if the stock remains too stagnant in price movement and time decay is a factor.

What about short straddles?

Let's contrast the risk/reward of the long versus short straddle:

Long Straddle-Unlimited profit potential, loss limited to premiums paid. Time works against you.

Short Straddle-Profit limited to premium received, loss unlimited. Time works for you.

If you are doing short straddles, you are selling the ATM Puts and Calls and making your profit if the stock remains in a tight trading range. Your total profit is locked in at the time of the trade, and it is limited to the premiums you take in from selling the options. It is very risky, and you should be able to find enough opportunity in long straddle positions to make long trades a far better strategy.

The Long Strangle

While you are straddling an ATM position in the straddle trade, you are surrounding the current price with a strangle. Instead of buying ATM options, you are buying OTM Calls and Puts. It is going to take a bigger move of the stock to make good money, but profit potential is theoretically unlimited if the stock drops significantly or takes off to the upside.

The major advantage of a strangle trade over a straddle is the much lower premiums you'll have to pay to initiate the trade. Remember our simple straddle example above:

Underlying stock trading at $50/share
You buy a $50 Call for $2.50
You buy a $50 Put for $2.25 same expiration date as Call
Your cost for the trade is $4.75 x 100 = $475

If we were doing a strangle trade, we may be buying the $60 strike price Call and the $40 strike price Put. We would be paying a lot less in premium, but would also have a lower chance of significant profits, as the stock will need to move farther before we hit profitable territory.

The 10 Rules

The ten rules for long strangles are the same as for long straddles, except for number 8. You'll be buying options with deltas between 20 to 30 (0.2-0.3) rather than 50. Otherwise, you are still expecting a significant move in price prior to expiration, and you have checked the trade against the other rules to increase your expectation of profits.

What about short strangles?

Short strangles are similar to short straddles, in that you have unlimited potential of loss and your profit is limited to the amount of the

premiums you receive. Short strangles offer lower premiums than with a short straddle as well. It is true that you would hope to have a better chance of the stock staying between the sold Put and Call strike prices, but it is a lot of risk for a limited reward.

In My Experience
If done properly, the collar trade can be executed with close to zero risk. This is the perfect strategy for conservative investors happy with a 12% to 15% rate of return on their holdings.

Chapter 29
Debit Spreads

"The game has its ups and downs, but you can never lose focus of your individual goals and you cannot let yourself be beat because of lack of effort."
Michael Jordan

Just like in life or in sports, stock prices go through ups and downs. When you have an opinion on a near-future price movement of a stock, one popular spread strategy is the "debit spread."

A debit is when money comes out of your account. A debit spread is buying one option and selling another at a farther out strike price. Taking in less on the sale than you are paying on the buy side creates a debit to your account.

The debit spread is placed when you have a reasonable expectation of the stock moving in price and you want to take a position that will profit from the move. We use debit spreads to replace a straight Call or Put buying strategy because we want to reduce the cost of the trade. Just buying a Call can be profitable, but selling another to take in some premium reduces the overall cost of the strategy. It is the same on the Put side.

We have two possible trades based on whether we expect the stock to rise or drop in price. They may represent a better approach than just buying Puts or Calls, especially if the options are relatively expensive, or, during a time of high volatility.

The Bull Call Debit Spread

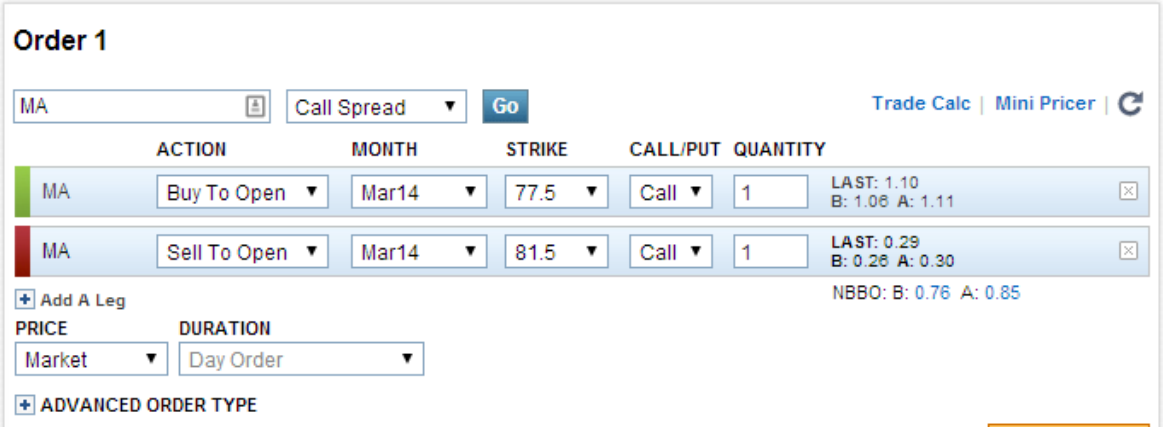
You are monitoring a certain stock and you believe that this stock will be moving higher in the coming weeks.. By placing a Bull Call Spread, you will reduce your costs, in taking a bullish trade, but you will also be limiting your upside profit potential.

Buy Call at Closer Strike Price

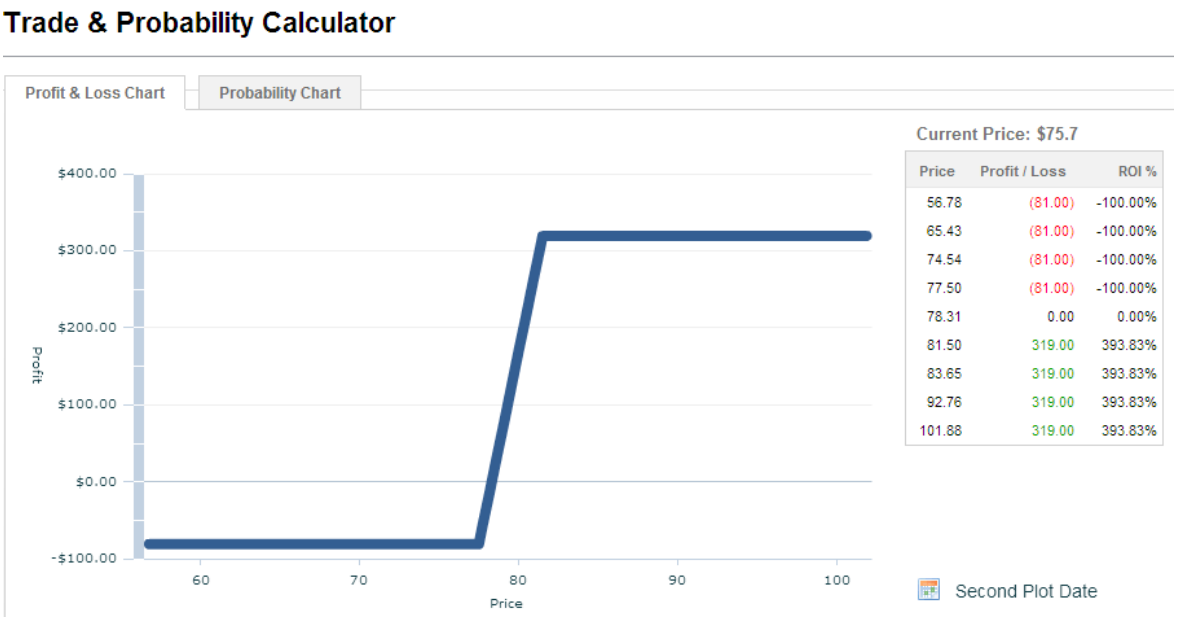
and

Sell Call at Farther Strike Price

The Call you are selling will be less expensive than the one you are buying, so there will be a debit to your account. Let's look at an example using real market data at the time. You are expecting a move upward for MA, MasterCard Incorporated. It is currently trading at $75.70/share.



The order screen at OptionsXpress shows the Call spread we are placing, buying a $77.50 strike price Call and selling the $81.50 strike. To keep it simple, we are not considering the commission and we are not placing a limit order.; Instead we'll let it execute at market price.

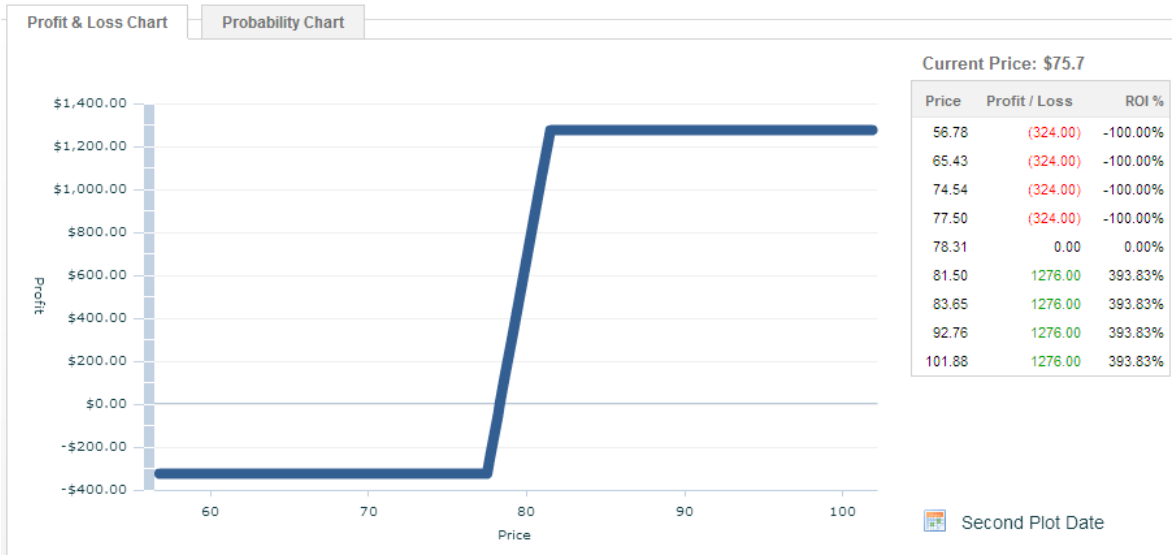


Courtesy OptionsXpress

This image is for this specific trade, but the profit/loss line pattern is the same for all bull call debit spreads. Below the zero line represents a loss, and above the zero line, is profit. As we are buying and selling only one contract each, the cost of the debit spread is $81.00 for 100 shares. This means that the difference between the purchase price of the Call and the sale of the farther strike is -$0.81.

You can see why this is an extremely popular option trading strategy. The trader limits her loss, no matter what happens, but can more than triple her investment in this example. The profit is limited to $319 for a single contract. However, if this investor is very bullish, they could have placed the trade for 4 contracts, as an example.

The upside is more than $1,276.00, with the maximum loss only around $324.00. Here's that chart:



You do not have to take a 100% loss if you find the stock does not move in your favor. You can close out the trade prior to expiration and recuperate any time value that still exists.

Once you have a price move expectation, your strategy is to try and combine your options for the lowest debit with the best return between the strike prices. In this case the $4.00 difference in the strikes reduced the debit much better than if an $82.50 strike were selected for the sell side. It would have increased possible profits, but the debit would have been significantly higher.

Cutting the Cost of High-Priced Options

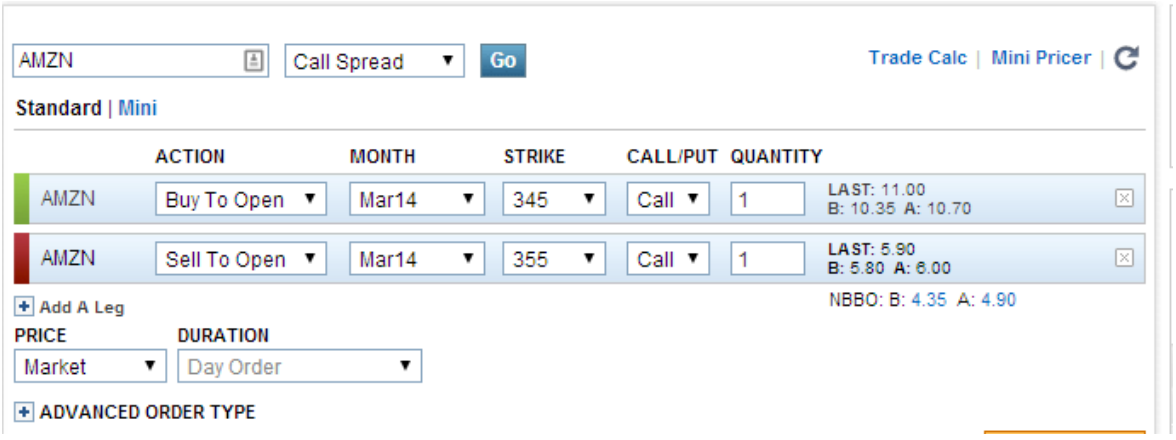
While the previous examples do a good job of illustrating how the Bull Call Debit Spread works, let's explore when could be most effectively used as a cost-saving measure.

Let's say that we want to do a Bull Call Spread on AMZN, Amazon.com. Right now it is trading at $346/share. We are bullish on the stock, as it recently had a correction downward, and has found support. Here's the chart:

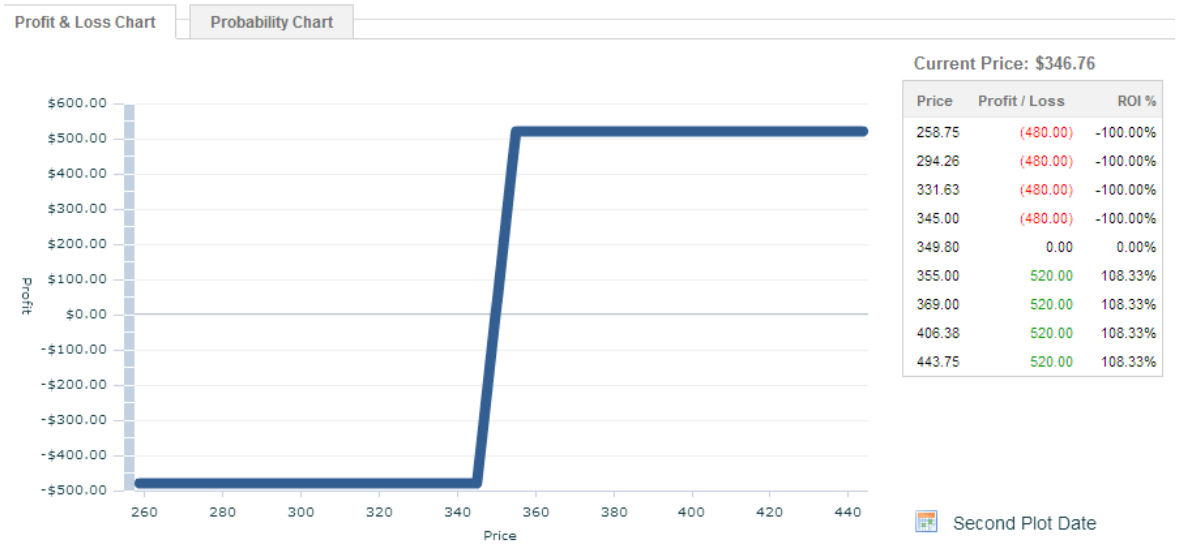


Courtesy ycharts.com

We want to do a bull call spread buying the ATM Call and selling a Call $10 OTM. So we are looking at the $345 Call to buy and the $355 Call to sell.



We see to the right under the shaded bars that this trade at the current market price should execute at around a $4.90 debit. That's $490 for one contract.



We can see that we are risking $480 maximum, and our maximum gain can only be around $520. While that's around double-the-money, in this case there is another trade we can make to bring our cost down farther.

We could sell an OTM Put to bring in an additional premium and defer our costs of this trade even more. This obligates the Put seller to purchase the stock should its price fall below the strike price of the sold Put. This is not something you want to do unless there is significant price support at or above the Put's strike price, and/or, you are willing to own the stock. Notice that there is support above the 200 day moving average line at around $326. So now we are going to sell a $325 Put to bring down the cost of this trade. Here is the options chain that includes the Put we discussed:



Puts							
Strike	Last	Chg	Bid	Ask	Vol	OpInt	
AMZN @ 346.76							Feb
305.00	0.16	0	0.09	0.16	00	175	Trade
310.00	0.18	0	0.11	0.19	00	428	Trade
315.00	0.22	0	0.21	0.24	00	203	Trade
320.00	0.32	0	0.30	0.33	00	736	Trade
325.00	0.47	0	0.45	0.50	00	1,407	Trade
330.00	0.73	0	0.71	0.78	00	548	Trade
335.00	1.23	0	1.22	1.31	00	513	Trade
340.00	2.15	0	2.17	2.28	00	884	Trade
342.50	2.93	0	2.85	2.98	00	260	Trade

We notice that the 330 Put would give us another $0.25 in premium. It is very close to where we expect price support to be. To be cautious, however, we will sell the 325 Put and receive about $0.50. Doing so will cut the cost of our trade by an additional $50 per contract.

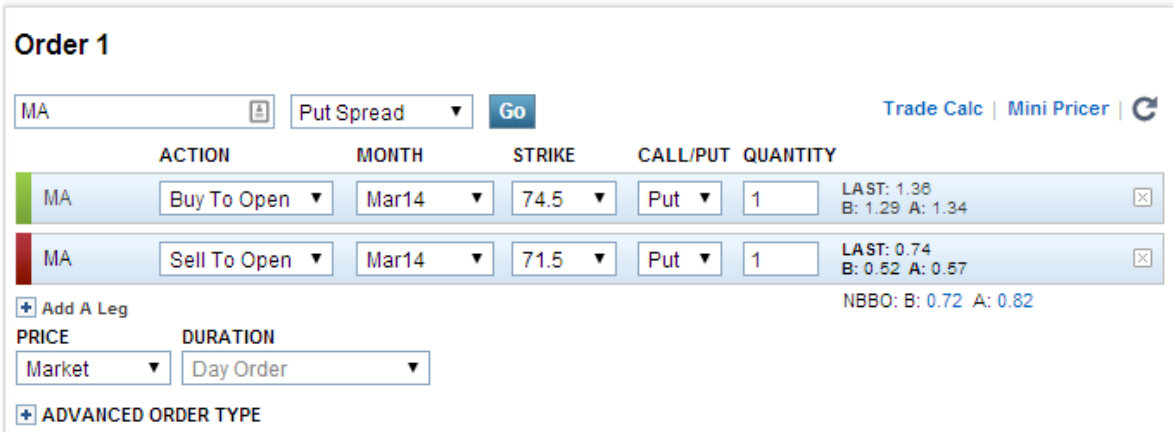
If you are really bullish on the stock, the 335 Put would cut our trade cost further and increase our potential return on investment significantly, but the support may not be there at that price. This is an example to show you how you can use the Put sale to further drop the cost of the trade. You'll run into better situations with closer price support levels that can make this a really attractive cost-cutting strategy.

This represents one of those tough decisions you will have to make. Selling the Put will reduce the cost of your trade but will bring in an additional risk factor. If the stock rises as you expected it to, the trade will work perfectly. If, on the other hand, the price of the stock begins to fall, you can close out all three contracts or just buy back

the Put. In later chapters, you will learn other corrective adjustment actions.

The Bear Put Debit Spread

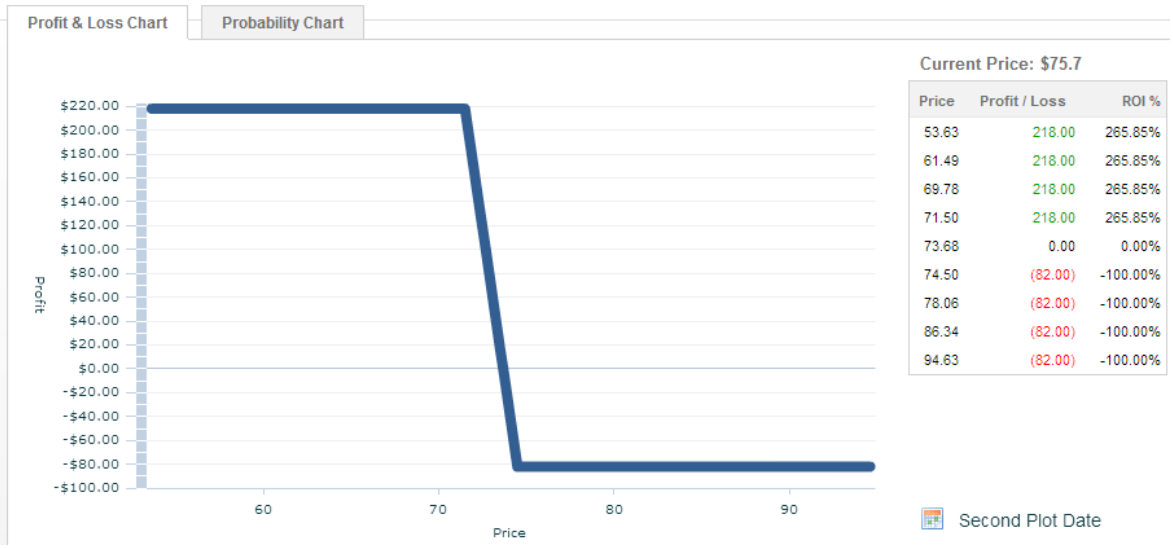
Let's use the same stock and time period, but this time, we are bearish in the near term and expect a significant drop in price.



Remember that the stock is trading at $75.70. We are placing a market order to buy one Put at the $74.50 strike price and sell one at the $71.50 strike.

Notice, to the right under the shaded bars, we see the Bid and Ask for this Bear Put Spread at market prices. The Ask is $0.82, so we hope to execute this bear put debit spread at around that price, or $82.00 (plus commissions) for the 100 share equivalent of stock.

As our two strike prices are $3.00 apart, our possible approximate maximum profit in the trade would be $300 less our cost of the debit spread. Here's how it looks:



Notice that with Puts, the chart is reversed, with the profits being realized as the stock drops in price. We see that executing the trade at the $0.82 market price, we have the opportunity to make a maximum profit of around $218, while our maximum loss would be $82 (commissions not considered, for simplicity).

Spreading out the strike price between the bought and sold options would increase the maximum profit, but would also create a greater debit cost of the trade.

In My Experience
Debit spreads are a great way to speculate in the market for pennies on the dollar. They work especially well with stocks that are technically bullish or bearish.

Chapter 30
Credit Spreads

*"The three most dreaded words in the English language are **negative cash flow**"*

David Tang

We just learned about debit spreads, which is a type of trade for which we pay money out of the account. With credit spreads, we take in cash, and benefit, due to the time decay of the options. If we profit from the credit spread trade, our profit is limited to the amount of the credit.

As the image indicates, we do the opposite of the debit spread by selling an option at a strike that's nearer to the current underlying price and buying one farther away. The long options limit our potential losses from the sold options and a potentially large move in the underlying stock's price. Though it may sound odd, we are either placing a Bull Put Spread or a Bear Call Spread order. Because the sold option strike is nearer to the current price of the stock, it will sell for more premium than it will cost us to buy the long option. This creates the cash credit to our account.

The credit spread can be used very effectively for more than just individual stocks. ETFs, Exchange Traded Funds, are good vehicles for credit spreads. Using ETFs or Index options enjoys several advantages:

- As a credit spread is a neutral strategy, ETFs are better due to their more predictive behavior than found with individual stocks.
- There are no earnings announcement surprises, nor are there negative management news announcements to create large price movements because of the large number of companies making up an ETF.

- They are traded at higher volumes and lower spreads than most individual stocks, allowing tighter control of your trades.

The smaller bid/ask spreads also help you in placing limit orders instead of market orders, giving you more control over your trade and expected profit. You'll want to use limit orders to specify the credit you want to receive.. You are doing credit spreads to create a higher probability of profit, but this requires that you tightly control the execution credit amount.

The Advantage of Credit Spreads

When you buy a stock, you have a 50/50 chance of profit, as it can go up or down in price. When you buy or sell options, you still must call the direction of the trade, and you have to be accurate as to the magnitude of the movement in price to make money.

With credit spreads, you have a major advantage. Using a Bear Call Spread you can be neutral or somewhat bearish on the underlying security's price movement in the short term. I like to do these trades with expirations out around 30 to 45 days to take advantage of Theta. When we execute credit spreads, we are a net seller of options and hopeful that what we sold expires worthless. With this spread, if the stock stands still, you make money. If it moves down in price, you still make money. Even if the stock moves up a bit, as long as it does not breach your short Call strike, you still make money.

It is the same with a Bull Put Spread, just in the opposite direction. If the stock does not move, you will profit from the time decay of the options until expiration. If the stock moves down slightly, the credit is still yours to keep. The stock can move up as high as infinity, and your profit is locked in.

I am placing credit spread trades with a 90% or greater probability of being profitable. This probability is calculated by a tool

provided by your online broker. There are three primary criteria that help to achieve this high probability of profit:

1. The trade is placed just outside of substantial price support or resistance.
2. We keep the delta of the short options to 0.10 or lower, and adjust the trade if it exceeds 0.25.
3. We are realistic about profit, shooting for a credit of at least 5% every 30 to 45 days as a Return on Risk.

The goal with credit spreads is to increase the likelihood of profit with these conservative rules, allowing a reasonable return on margin with lower trade risk. After all, if you could consistently realize 5% every 45 days on 90% of your trades, here's what your year would look like:

8 Trading Periods (45 days each) x 0.05 Return x .90 = 36%

Of course, not every trade will work like you want it to, but see if you can find any other consistently conservative investment that will yield an annual return of 25% to 40%.

The Credit Spread in Practice

Let's take a look at a Bear Call Spread and then a Bull Put Spread as they could be placed in the market in early 2014. These examples are selected to show you how you can find support and resistance levels and trade accordingly to reduce your risk and get that 80% to 90% profitable trade result.

Bear Call Spread on GLD

GLD is the SPDR Gold Shares ETF, and our research shows that GLD is trading at or near major resistance levels. This means that we would want to place a Bear Call Spread trade with the expectation that GLD will remain in a trading range below resistance or even drop in price during the life of our trade. Here's the chart:



Courtesy of ycharts.com

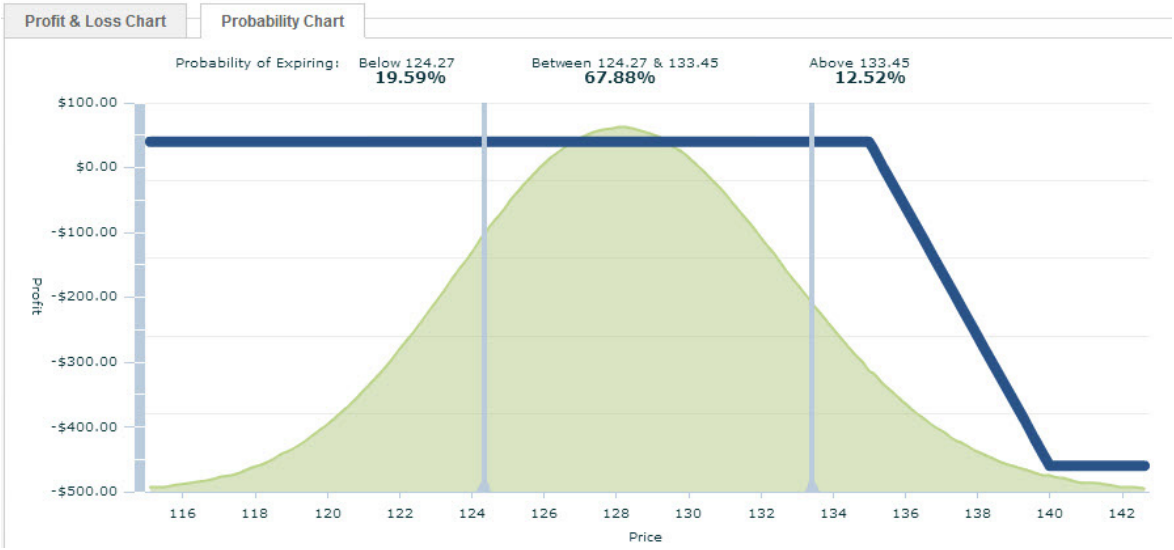
We see that there is resistance at around $130, with a bounce off of that level back in November. There is more resistance at around $135. So here's what we want to do:

- Sell the Mar 2014 135 Call to Open
- Buy the Mar 2014 140 Call to Open
- Place a limit order at a $0.40 credit



Price	Profit / Loss	ROM %
96.08	40.00	8.00%
111.23	40.00	8.00%
127.17	40.00	8.00%
135.00	40.00	8.00%
135.40	0.00	0.00%
140.00	(460.00)	-92.00%
143.11	(460.00)	-92.00%
159.06	(460.00)	-92.00%
175.00	(460.00)	-92.00%

We can see in the profitability chart that this is an 8% ROM, Return on Margin. How about probability of profit?



This trade has a greater than 80% probability of profit. By the way, the delta of the short option here was approximately 0.07 when the trade was placed. This indicates a 93% probability that the options will expire worthless and that the trader will keep 100% of the credit.

Bull Put Spread on AMZN

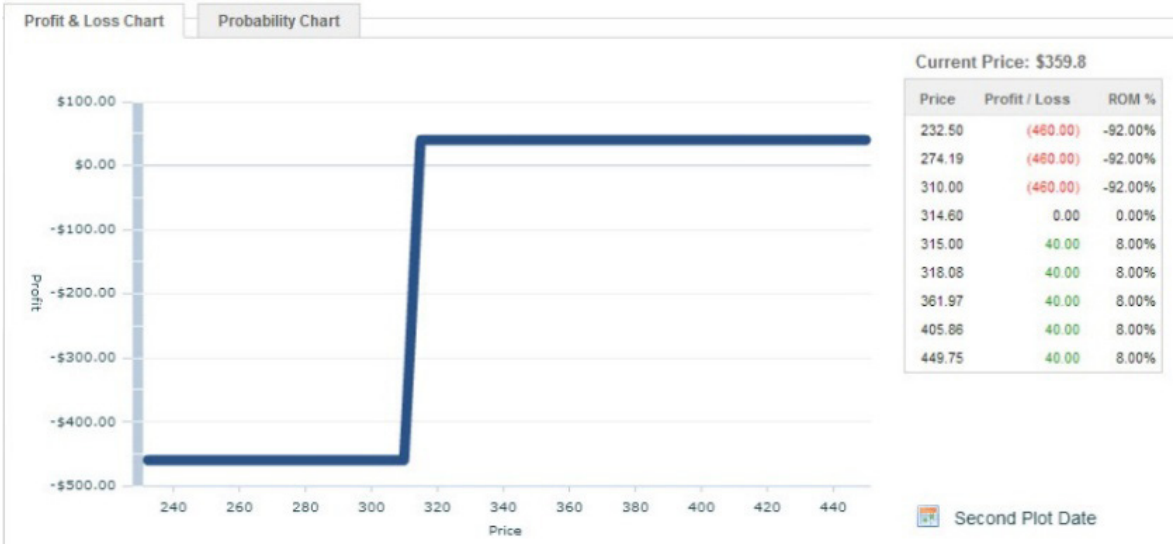
This was a better example of a Bull Put Spread opportunity than any we could find on an ETF at the time. Amazon.com is also a high volume stock and options are very liquid, so it will work for a trade if the rules are met. When doing credit spreads on individual stocks, make certain that any future earnings announcements occur after the spread trade is scheduled to expire, as earnings can cause an unexpected move in the price of the stock.

We notice on the chart that Amazon is trading down near significant support, and we are placing a trade with a neutral to slightly bullish bias. We'll make money if the stock trades in a range, rises to any level, or does not fall far below support.

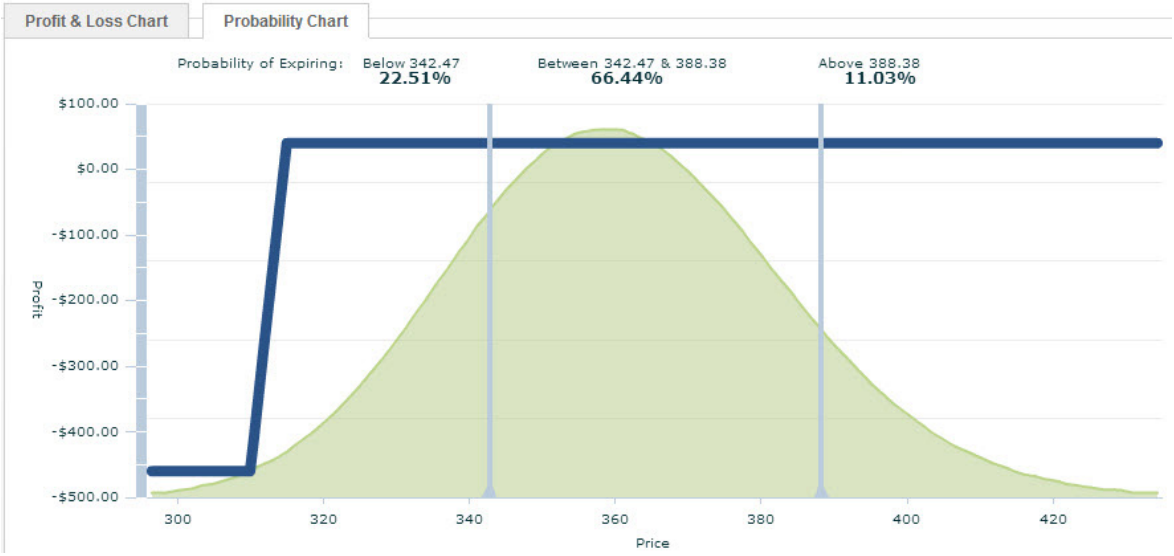


We see short-term support where the stock is trading, at around $350. This support goes back into November. There is more support at around $325 and major support at $300. Here's the trade:

- Sell to Open the Mar 2014 315 Put
- Buy to Open the Mar 2014 310 Put
- Initiate the trade with a limit order of $0.40



We can see that, again, we have an 8% return on margin, and we are profitable provided the stock stays above $315.



We are around a 90% probability of a profit on this trade, and I actually did this trade in my personal trading account.

Adjusting Credit Spreads

As I mentioned earlier, if our short option's delta approaches 0.25, we want to adjust the trade to close, protect profits, or limit losses. There are several choices depending on the situation and your new outlook on the underlying:

- **Go Up and Out –** Buy back the current spread and place a new one farther out of the money using our rules.
- **Buy Short Hold Long –** Buy back the short option and hold the long option.
- **Change the Trade –** If something dramatic happens, change from a Bear Call to a Bull Put spread or the opposite.

Closing Out to Take Profits

Take your risk off the table whenever you can close out a spread at $0.05 or less. Not only will you remove any further trade risk, you'll free up margin to place another trade.

In My Experience
Credit spreads are my go-to strategy. These trades allow the investor to make money regardless of market direction. Look for trades that yield 5% or more per month with a 90% or higher probability of success. Focus on diversified investment products for these types of trades (indexes and ETFs). Individual stocks are too unpredictable.

Chapter 31
Iron Condors

"Since I had my gastric bypass surgery in 1998, I eat like a bird. Unfortunately, that bird is a California condor."

Roseanne Barr

A condor has a gigantic wingspan, and the Iron Condor trade is simply wrapping big wings around an underlying stock or index that's trading in a price range. In other words, we expect the underlying security to continue to trade in a range with strong support and resistance levels, so that it remains inside our wingspan. If the underlying security stays within that trading range, we realize our maximum profit.

Up until now, our option strategies either have required a strong bullish or bearish outlook, or at least a bias in one direction or another. Credit spreads helped us to profit from our outlook, but the Iron Condor allows us to have a totally neutral attitude about future price movement.

How much of a wingspan we need depends on the support and resistance levels for the underlying and our trade profit requirements. The goal is to place the trade in such a way that at expiration all of the options will expire worthless, and the credit we took in, when the trade was placed, will be our profit.

This spread strategy requires four trade legs. In effect, it is a Bull Put spread coupled with a Bear Call spread. The strike of the short Call is placed slightly above the resistance level. The strike of the short Put is placed slightly below support. This trade enables us to generate credits above resistance and below support, increasing our potential profits.

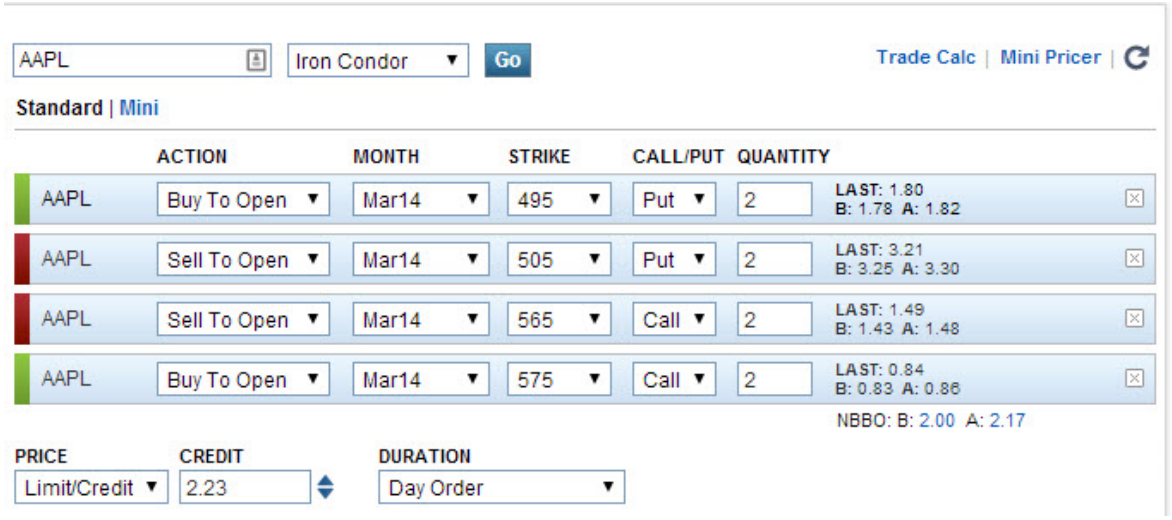
Of course, the farther away our sold Call and sold Put strike price are from the current underlying price, the safer the trade. Due to the fact that you don't begin to lose money until the price moves past one of those short leg strike prices. Also, the farther apart the short and

long option strikes on each end, the greater your potential loss on the trade. However, once the price goes past the long Call on the upside or long Put on the downside, your losses are capped by the long option.

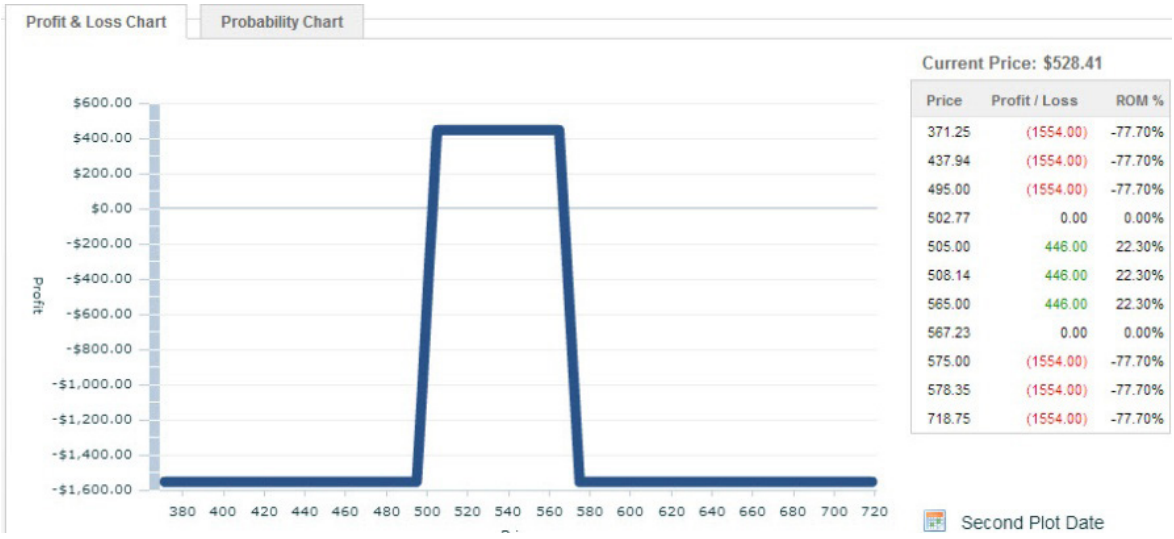
Let's use AAPL, Apple, as our example for this spread trade. On the date of the trade, Apple is trading around $527/share. We see in the chart below that there is strong resistance at $575/share and good support at around $500. We see that there should be very strong support at the 200 day moving average of around $491.



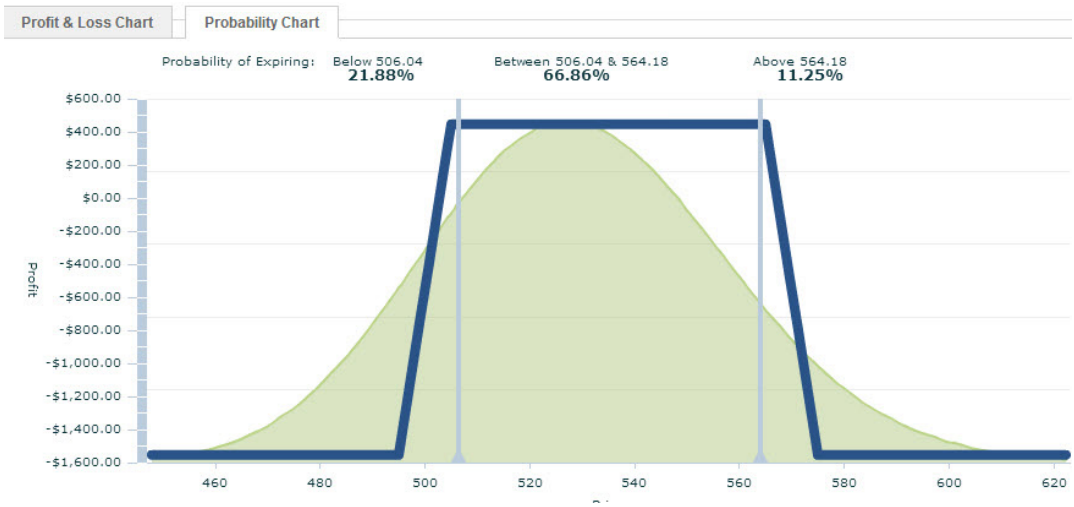
We want to place a relatively safe Iron Condor trade with the neutral position that AAPL will continue to trade in this range until options expiration in March, 25 days until expiration.



Here's the trade we are contemplating: We placed a limit order for a $2.23 credit for two contracts in each leg. Notice that the difference between strike prices is the same for both the Calls and the Puts, which is required for this spread profile.



Here is the profit and loss chart. We see that we will get to keep the entire collected premium as long as the options expire with the stock price between $505 and $565. Yes, there is a larger potential for loss, but we can make adjustments to this trade later, or leg out of it before we have to take the entire possible loss.



Our probability chart looks pretty good for this trade. Our chances are around two out of three that we'll end up with our full profit realized, and this is a roughly 22% return on the margin required for this trade.

Legging Into The Trade

The other great thing about Iron Condor trades is that you can leg into them. You do not have to place both credit spreads at the same time. In the case of Apple, it can move a couple of dollars a share either way inside a single trading day. So you could catch it on a high and do the Call side, then wait for it to drop a bit to do the Put side. This way, you are maximizing the premium you are getting for the nearer sold options.

Some very experienced traders consider the Iron Condor their favorite strategy. While the holders of stock are lamenting sideways movement, and the option buyers are betting and losing on bullish or bearish opinions, the condor traders are just banking their profits.

In My Experience
Iron condors are perfect for securities trading in a range. Use the Deltas to pick your short options. I like a Delta of .10 or less. Don't forget to adjust or close out the trade if the Delta gets above .25.

Chapter 32
Trade Adjustments

"A man must be big enough to admit his mistakes, smart enough to profit from them, and strong enough to correct them."

John C. Maxwell

"Oops!" can happen in options trading. Even when we are working with careful planning, great research, and a very high probability of success, there is a reason we say "probability of success". Things happen, and stuff goes wrong. Stocks and markets change direction unexpectedly. This chapter is about ways in which to adjust trades that are not going as planned.

There is no substitute for very careful trade placement in the first place, not even great trade adjustment strategies. If you take shortcuts or jump into marginal trades that don't totally meet your trade criteria, you are going to need to know some adjustment strategies. I am not saying you'll always call it right, because you will not. There are far too many variables in national governments, economies, and markets for any person to be able to predict the future correctly, one hundred percent of the time. So let's talk about corrective actions when trades are going wrong.

Straddle and Strangle Adjustments

Let's say you are long options in straddles and strangles. You buy a Put and you buy a Call. In a straddle, they are ATM, while in a strangle they are OTM. You are going to make money only if the stock moves in one direction or another, and it must move far enough in price to offset your investment with commissions.

When you are buying OTM options, the stock will have to move even farther to create profits. Time is your enemy with straddles and strangles, as the value of the options is decreasing with the passage of time. An adjustment, when we are talking about straddles and

strangles, would be an action we take when the stock is not moving and we want to cut our losses.

Of course, you can just wait and hope for the best, knowing that your maximum loss will be the price you paid for the options. However, if you have changed your view on whether the stock is going to move significantly in either direction in the time until expiration, then you may want to do something to mitigate your loss.

There is no easy remedy in this situation. You should consider closing out the trade before losing any more time value. Now, if the stock has moved far enough in one direction, you may want to sell the profitable leg, and continue to hold the other option, which does not have much value at this point, anyway. If the underlying security should dramatically change direction, there is a good chance you will come out of this trade whole.

Debit Spreads Adjustments

Debit spreads, Bull Call Spreads and Bear Put Spreads, are trades to cut the cost of a price-directional expectation. In other words, instead of just buying a Call, you would also sell a Call with a farther OTM strike price. The premium received is less than the cost of the long option, but it does cut the cost of the overall trade. However, it also limits your maximum profit.

You are expecting XYZ Corp to make a move to the upside within the next month because earnings are to be announced and you expect good news. It is currently trading at $65/share. You buy a $70 strike price Call for $1.10 and sell a $75 strike price Call for $0.65. Your net debit is $0.45 plus commission. You have cut the cost of your trade significantly.

The possible outcomes are:

- The stock moves up as you expected to more than $70/share, so you are working on a profit.

- The stock sits relatively still, and your trade is losing value daily due to time decay.
- The stock takes a dive and heads down due to selling pressure..

Obviously you can close out the trade at any time if you are in profit territory. If you set a profit goal, you may want to close the trade early when you reach that goal and take any more risk off the table.

If the stock is hanging around the $65 mark and not moving much, you may close the trade at a loss at any time by buying back the $75 Call and selling the $70 strike. If the $75 is now selling for $0.30, and the $70 strike is now selling for $0.80, your debit to execute the trade would be approximately $0.50, so your loss would be limited to around $0.05 plus commissions.

This works the opposite way with a Bear Put Debit Spread, and your actions would be the same. Basically, you are trying to limit losses when the stock is not moving in the expected direction. You can set a stop loss order to close out trades like these at a stated price, cutting your losses automatically at some point. Of course a limit order to take profits works when things are going right.

Credit Spreads & Iron Condors Adjustments

With credit spreads and Iron Condors, we are working more with a neutral expectation, and we really don't want to see the underlying security take off in either direction. We are selling options at strikes closer to the current underlying price than the ones we are buying. For this reason, we are taking in a positive premium amount, a credit to our account balance.

Remember that we can set up credit spreads and condors with a very high probability of profits. However, the downside is that when the trade goes the wrong way, our losses in relationship to our profits are much greater than with a debit spread. For this reason we want to

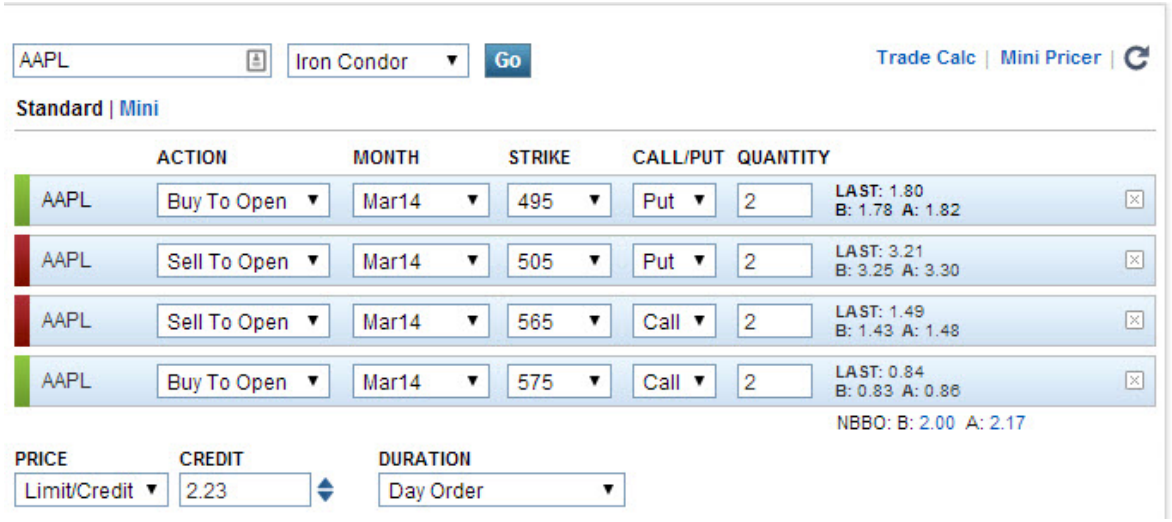
take action by adjusting trades when we see the underlying security moving too close to one of our short options.

Rolling Up or Rolling Down

Let's use our example trade from Chapter 29: the Iron Condor with AAPL. We can use the condor because it is really just a combination of two credit spreads. We have a Bear Call Spread and a Bull Put Spread, and we are expecting the stock to stay within our inside strike prices that we sold. To refresh your memory, here are the details:



We want to place a relatively safe Iron Condor trade with the neutral position that AAPL will continue to trade in this range until options expiration in March, 25 days until expiration.



This is a pretty wide wingspread condor. If we had placed that trade, at this time the stock is still trading well within our inside strikes, with a current price of $531. However, for purposes of illustrating an adjustment, let's assume some dramatic price movements.

Fast Move Up

If Apple suddenly won one of its patent lawsuits with Samsung, perhaps the stock might take a leap to the upside. Let's say that it is a pretty dramatic leap, and it is suddenly trading around $550/share. We are still inside our $565 sold option strike price, but we are thinking that we may need to take protective action. We can "roll up."

Basically, we would buy back the $565, and we would sell the 570 Call to close out that trade. Now we are going to sell the 590 Call and buy the 595, creating a new position "rolled up." Because this is just an example, and we don't have any real life contract prices, we cannot say what the net result would be. However, the net effect would be pushing our risk out farther on the upside.

Suppose you are now bullish on Apple. An alternative strategy would be to buy back the original 565 Call and hold onto the 570. If you are bullish, this would leave you with a long Call that would profit from a continued rise in the stock price.

Fast Move Down

Maybe Apple lost the lawsuit, and suddenly the stock takes a tumble. We would possibly want to "roll down" by closing the original trade, by buying back the 505 Put and selling the 500 Put. We would then sell the 480 Put and buy the 475. We have "rolled down" our position to push our downside risk out farther.

The 'rolling down' of the trade means that we are still bullish on the stock. If we are not, and we expect it to drop more in price, we could just buy back the original 505 Put and hold the 500 for an increase in price as the stock drops farther.

Rolling Out

"Rolling Out" refers to the trade rolling out to a different expiration month. Frequently, traders combine a rolling up, or a rolling down trade with rolling out. Let's use a fictional example trade to help you understand this.

You are bearish on the short term outlook for XYZ Corp. It is currently trading at $60 share. You initiate a Bear Call Credit Spread by:

- Selling a $65 strike Call at $1.15.
- Buying a $70 strike Call at $0.35.
- Net credit is $0.80 before commission.
- You made this trade on 30 day expiration options.

It is now around 15 days until expiration and the stock makes a sudden move upward to $66/share. You could just buy back the spread and exit the trade, but that spread would cost $1.50 to get out, which is a significant loss. You are still bearish on the stock, so you decide to roll up and out. Here's how you may do that:

- You buy back the 30 day expiration $65 Call
- You sell the 30 day expiration $70 Call

- That trade was at a net debit of $1.50
- You sell a 60 day expiration $70 Call
- You buy a 60 day expiration $75 Call
- This spread is at a net credit of $1.30

You have pushed the risk upward in strike prices, but because you still believe you are going to be right about this stock, you moved your trade out in time to collect additional time value. Let's look at the net results without commissions for simplicity:

Initial credit spread, credit of $0.80 (+$0.80)

$1.50 debit to close it out, so net debit of $0.70 (-$0.70)

$1.30 credit to initiate roll trade (+$1.30)

Now potential profit is $0.60 (+$0.60)

You can choose new strikes in rolling up, or rolling down and/or new expirations in rolling out to suit your new outlook and desired profits. The key here is that you take action to protect your position, even if it is just minimizing losses.

In My Experience
The difference between amateur and professional options traders is that amateurs put on a trade and hope it works out. Professionals put on a trade, and if the security moves against us, we adjust, turning a potential big loss into a small loss or, perhaps,even a winner.

Chapter 33
Asset Allocation

"I think that the first thing is you should have a strategic asset allocation mix that assumes that you don't know what the future is going to hold."

Ray Dalio

This is a tough chapter, simply because, we are all very different in our styles, in investment objectives, and in our tolerance for risk. However, if we stick to the basic premise, that you should have an asset allocation plan and stick to it, then we can get a grip on this concept.

Here's how Investopedia.com defines "asset allocation: "*an investment strategy that aims to balance risk and reward by apportioning a portfolio's assets according to an individual's goals, risk tolerance and investment horizon."* For our purposes, we are ignoring things like bonds and mutual funds, simply because we have learned enough about options trading to know that we can do better with simply trading stocks and options. You may want to own bonds for a hedge or for income, depending upon your own needs. However, when considering stocks, as there are option strategies that are based on owning the underlying security, we have a starting point for our asset allocation plan. We'll also talk about option collars in this chapter, which can replace some asset allocation strategies.

What is the ideal percentage of equities versus options that you want to hold? Again, only you can determine this ratio, but there are some basic limitations in order to keep your assets more secure. There is risk in holding stocks long; however, using options, you can hedge that risk by "buying Puts" as insurance to limit your downside exposure. There is also risk in holding long options. In fact, this is a significantly higher risk than owning stocks. Remember that around 80% of all options expire worthless.

We also looked at selling Covered Calls to increase our portfolio income, though we are limiting upside potential to do so. At this

decision point, a lot can ride on the size of your account balance. If you are sitting on $500,000 or more, you have a lot more flexibility in setting up your asset allocation plan and sticking to it.

If your account is significantly smaller, it becomes more difficult to maintain discipline and not "over-trade" your account with options. Simply saying that you want to create x% in income each month on your holdings is not going to cut it, especially if you have a smaller account balance. You'll end up taking too much risk in relation to your account balance and your margin abilities.

One thing to consider is that holding stocks long gives you the ability to use their value as margin for options trades. To increase your income safely, you can simply sell Calls and buy Puts for insurance. In this plan you would hold a significant portion of your portfolio as stocks, perhaps 65% or higher.

If you want to do more in the way of spread trading, you may still use the margin ability of your stock holdings to facilitate those trades, but you'll have a great deal more risk and also possible reward potential in the options side of the portfolio. Downside movements in your stocks could result in margin issues on your option trades, negatively impacting your profit potential or requiring corrective action sooner.

More cash in your account can help in this regard, as you don't get margin calls on cash like you do on a falling stock that's the basis of margin for your option trades. If you are doing more spread trading, you may want to cut your stock holdings to as low as 25% to 30% of your account balance to avoid margin issues related to stock fluctuations.

Overall Percentage of Account at Risk

Many successful options traders set a top limit on the percentage of their portfolio value that they are willing to risk or invest in options trading. For larger accounts, this can be as low as 2% to 10%. Of course, this would severely limit trading opportunities for smaller accounts in the $10,000 to $25,000 range. It still may be better to

protect your assets than to risk a higher percentage, hoping for a bigger reward.

Collars vs. Asset Allocation

Some analysts advise using "option collars" as an alternative to asset allocation to manage risk. In other words, instead of possibly using different stock positions, bonds, or other assets to balance risk, option collars can limit risk and even create income, in some cases.

The simplest explanation for an option collar is buying a Put to limit risk on the stock, and selling a Call to offset the cost of the Put. Let's work with some real numbers for one of our favorite examples, Apple (AAPL). We own the stock, currently trading at $530/share.

22.50	+0.35	18.90	19.65	71	557	Trade | Detail	510.00	0.04	0	0.04	0.05	410	3,813	Trade | Detail
16.84	-2.61	16.50	17.15	314	396	Trade | Detail	512.50	0.06	0	0.05	0.07	279	2,629	Trade | Detail
14.70	-3.05	14.00	14.65	58	627	Trade | Detail	515.00	0.08	0	0.07	0.09	1,281	3,583	Trade | Detail
12.28	-2.77	11.50	12.15	17	673	Trade | Detail	517.50	0.12	-0.01	0.11	0.13	[illegible]	[illegible]	Trade | Detail
9.50	-3.45	9.30	9.70	768	2,176	Trade | Detail	520.00	0.22	0	0.20	0.23	2,179	5,431	Trade | Detail
7.05	-3.65	7.00	7.40	145	1,488	Trade | Detail	522.50	0.40	+0.08	0.39	0.40	1,617	2,066	Trade | Detail
4.95	-3.05	4.95	5.20	1,657	3,834	Trade | Detail	525.00	0.79	+0.19	0.76	0.81	5,566	5,614	Trade | Detail
3.25	-2.75	3.15	3.35	1,317	2,199	Trade | Detail	527.50	1.42	+0.48	1.41	1.49	5,751	3,862	Trade | Detail
1.86	-2.19	1.83	1.92	10,271	7,635	Trade | Detail	530.00	2.58	+0.88	2.52	2.60	12,137	6,398	Trade | Detail
1.08	-1.78	0.95	1.02	10,644	3,682	Trade | Detail	532.50	4.20	+1.54	4.05	4.30	6,829	2,302	Trade | Detail
0.49	[illegible]	0.46	0.51	16,141	9,283	Trade | Detail	535.00	6.20	+2.10	6.05	6.35	5,043	2,396	Trade | Detail
0.24	-0.69	0.23	0.24	5,986	6,689	Trade | Detail	537.50	8.05	+2.35	8.30	8.65	292	790	Trade | Detail
0.14	-0.35	0.14	0.15	5,415	8,635	Trade | Detail	540.00	10.55	+2.55	10.70	11.00	1,421	917	Trade | Detail
0.08	-0.21	0.08	0.09	2,016	3,605	Trade | Detail	542.50	12.89	+2.64	12.80	13.55	80	295	Trade | Detail

In the image, Puts are on the right, and Calls on the left side of our option chain display. We see that we can buy downside protection at $520, covering us for a loss of less than 2% in value, and we can do that at an Ask price of $0.23.

We also see that we can sell a Call at a Bid Price of $0.23 for the $537.50 strike. This is a wash (except for commission) thus almost free insurance. Of course, we could lose the stock at $537.50, so we might want to move to a higher strike option, but we would be increasing the cost of our protection.

Determine Your Allocation

Once you make some asset allocation decisions, unless there is a major change in your account makeup or balance, you should try to stick with your plan and avoid the temptation to place trades that don't fit the plan.

In My Experience
Never put more at risk in a trade than you can afford to lose. Never risk more than 10% of your account in any one trade. The longer term victor in the markets is the one who lives to fight another day.

Chapter 34
Building a Trading Plan

"Plans are nothing; planning is everything."

Dwight D. Eisenhower

You have learned some really amazing options and equities trading strategies in this book. With the knowledge you have now, and a little practice in a virtual trading account, and solid planning, you should enjoy great success in your trading.

Will you be using all of the strategies we have learned, some of them, or just one or two? You have seen how some strategies require no margin, such as straight buying of options. However, this approach is also riskier, with many options expiring worthless. You learned how to use debit spreads to cut the cost of a directional option purchase strategy and still avoid margin problems.

If you already own stocks, you know how to use collars for hedging and how to increase your income by selling Calls. You also learned how to buy insurance on your holdings with Puts. We looked at placing a trade that purchases the stock and sells in the money Call options at the same time in order to earn income with the expectation of losing the stock.

Then we got into credit spreads and iron condors. These trades initiate with a credit to your account, and can be crafted for a high probability of success, but do have varying margin requirements. That is because the loss potential will be greater than the credit you receive when you place the trade.

With all of these possible strategies, it is imperative that you develop a trading plan and then stick to that plan. For example, let's assume you are relatively new to options, but you believe you have learned enough to begin trading. You don't hold stocks currently, so you are planning on option strategies only. We will not consider the size of your account balance at this time, but instead, will discuss

strategies that are not dependent upon how much equity you have in the account.

Types of Trades

Let's assume that you have decided to do some debit spreads when you have a directional bias for a stock or index. You also like the idea of high probability credit spreads and iron condors, so you want to do some of those as well. So, we are working with all spread trades.

Debit Spread Plan Example

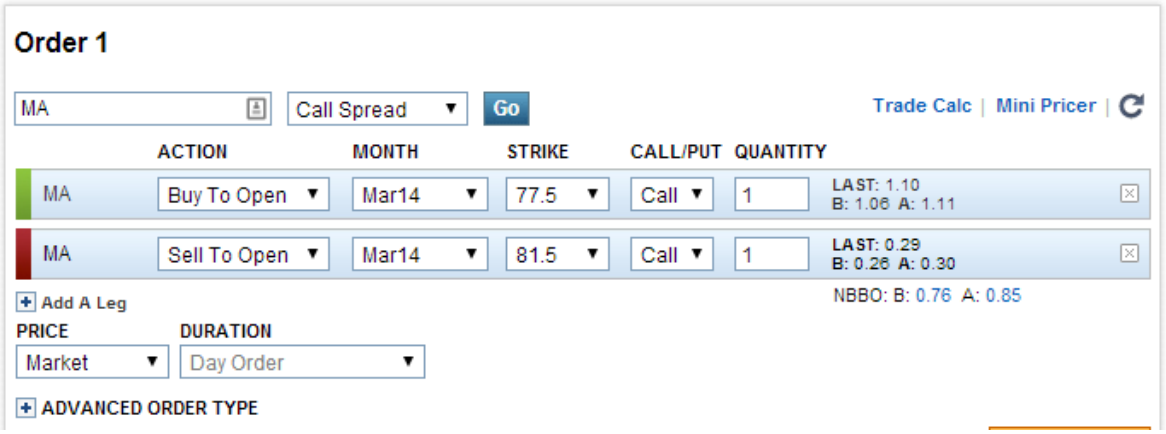
Your plan should be written down, and it should begin with how you are going to decide on which underlying stocks or ETFs you will want to use as your underlying security. If you are a technical chart enthusiast and believe that you can use chart patterns, indicators, and oscillators, to predict trend reversals or continuation patterns, this will help you to develop your strategy.

Any Underlying: You decide on the charting resources you like best, and how you'll identify patterns. If you are using some kind of alert service to deliver patterns, then determine in which ones you have the most faith. In other words, what type of bullish trend reversal pattern do you want to watch for? The same would go for bearish reversals or trend continuation patterns. Or, you may just watch for overbought/oversold indicators.

Watching Specific Underlying Stocks/ETFs: Many traders find that they do much better if they follow a small group of stocks and indexes and learn how they move over time. Rather than trying to catch a chart pattern for a stock you know nothing about, you would watch for trends in stocks and indexes you follow regularly. You keep up with the fundamentals and know when earnings announcements are due, so there is less risk of a surprise. Here again, overbought/oversold indicators can be of value, especially if you see a pattern over time for stocks/indexes you follow.

Support and Resistance for Trade Cues

We have looked at examples for using support and resistance price levels to place trades with a directional expectation. In other words, we see a stock bounce off a strong level of support, so we assume that the price will rise in the near term. This cues us to place a Bull Call Debit Spread. We buy a Call at a closer strike price and sell a Call with a strike farther out to offset some of the cost. Of course, this also limits our profit potential, but we still profit nicely if the stock moves in the direction we predict. It works just as well with Bear Put Spreads if our bias is bearish.



This was one of our example trades, a Bull Call Spread on MasterCard. By selling the 81.5 call, we cut our cost of buying the 77.5 near-the-money call. We are expecting the stock to rise in price for our profit. This is the PLAN, at least step #1.

Our first step in a Debit Spread Plan would be to identify an opportunity with a reasonable expectation of the stock moving in the direction we want. We are betting on an up or down move with a simple debit spread.

Step #2 in our plan could be a decision as to whether we are going to work with ATM, OTM or near the money strike when we are buying the close-in option. Of course, we'll then sell an option farther away in strike price. This step in the plan would probably be

based on our basic plan for how much money we want to tie up in a trade of this type.

In other words, if we don't want to have more than $1.00/share or $100/contract invested (commissions ignored) then we would consider option buy/sell combinations that would keep us under that maximum. We would check to see if we could buy/sell for a debit under $1.00 and still meet our objective and expectation of price appreciation.

Step #3 in our plan may be to check the Greeks of our desired trade to be sure that we are not taking on too much time decay risk or that we have enough Delta to reach desired profit goals. This could be a part of step #2 as well. The point is to have a written plan and follow it for each and every trade.

The all-important adjust-or-out decision is a definite plan requirement. When will you decide that you have made the wrong call and bail out of this trade? You would want to salvage some of your investment if possible, so part of your plan is the exit strategy.

The Trade Checklist

For our example debit spread trade, we would create a checklist to keep us on track. It is too easy in our busy day to forget a step which can come back to bite us later. For a debit spread, a checklist can be as simple as:

1. _____ Identify opportunity – underlying hitting significant support level.
2. _____ Select strike prices that will work for our price movement expectations and fit our maximum investment objectives.
3. _____ Check the Greeks.
4. _____ Set an exit strategy.

We used the debit spread for our example because it is simple, and it also gives us a guide for the more complex credit spreads and Iron Condor trades.

Credit Spread Example Plan

Remember that credit spreads result in a credit to our account which becomes our profit if we have called the underlying security's movement correctly. The main advantage of credit spreads (See: Chapter 28) is that we make money if we call the price direction right or if the stock does not move much at all. Let's use a Bull Put Spread example. We are also using the support/resistance chart patterns for this trade. We see a stock or index hitting major support after a downward move in price.

We sell the nearer Put option and buy the farther strike price, both under the current price of the stock. Our plan is that the stock will bounce off support and trade upward, but we also make money as long as it trades sideways and does not drop to our near Put strike price. Our plan checklist may look something like this:

1. _____ Identify opportunity – For credit spreads I strongly suggest using an ETF or Index option. One trading near support would be an ideal choice.
2. _____ Look for options that expire in 30-45 days.
3. _____Check Implied Volatility — the IV should be equal to or greater than the historical volatility.
4. _____ Pick the short option with a Delta with less than .10.
5. _____ Select a long option at the next available strike price. (Further out of the money.)
6. _____ Make sure your credit yields a minimum of a 5% Return on Margin (ROM).
7. _____ Make sure to purchase an equal number of long and short contracts.

8. _____ Select an exit strategy — Either when the options expire worthless, the value of the trade drops to .05 with more than 5 days until expiration, or close/adjust trade if the short option's Delta exceeds .25.
9. _____ Never risk more than 10% of your account in any one trade.

Checking the margin requirement leads us to have a more detailed planning step for adjusting our trade or exiting it completely, or maybe just closing out one side of the trade. The point is to have a written plan and checklist, don't leave out any steps, and stick with it. If you make trade adjustments, you'll also be making plan adjustments on the fly to adapt to the new position.

Our exit strategy could be closing the trade, or in many cases we can roll up, down, or out, in time to adjust for a move against the position.

The Iron Condor

We are simply doubling up on our planning here because we have two options on each side of the current stock price. Our plan is to profit by the amount of the credit to our account. This happens when the stock stays between our inside sold option strike prices until expiration. We are expecting sideways price movement, not much up or down until option expiration.

1. _____ Identify opportunity – For Iron Condors, I strongly suggest using an ETF or Index option. You will be looking for a security trading around the mid-point between support and resistance, and trending sideways.
2. _____ Look for options that expire in 30-45 days.
3. _____ Check Implied Volatility — the IV should be equal to or greater than the historical volatility.
4. _____ Pick the short options with a Delta with less than .10.

5. _____ Select long options at the next available strike price. (Further out of the money.)
6. _____ Make sure your credit yields a minimum of a 5% Return on Margin (ROM).
7. _____ Make sure to purchase an equal number of long and short contracts.
8. _____ Select an exit strategy — Either when the options expire worthless, the value of the trade drops to .05 with more than 5 days until expiration, or close/adjust trade if the short options' Delta exceeds .25.
9. _____ Never risk more than 10% of your account in any one trade.

In all of our plans, part of the exit strategy step should be to take profits and remove risk from the table, when appropriate. We would close out trades when we reach a planned profit objective that has little additional profit left in the trade.

The Pro Trader Institute Trade Plan Checklist

At ***www.protraderinstitute.com/learn-to-trade/trading-checklist*** there is a much more comprehensive trade planning and checklist. You are welcome to use it.

TRADING CHECKLIST

General Market Sentiment: ___Bullish, ___Bearish, ___Neutral

Underlying Equity: _____

Current Price/Share: $_____ Next Earnings Date: _____

Avg Daily Volume: _____ Support at $_____ Resistance at $_____

Fundamentals: ___Strong, ___Improving, ___Weakening, ___Weak

Technicals:

___Very Bullish, ___Bullish, ___Slightly Bullish, ___Neutral, ___Very Bearish, ___Bearish, ___Slightly Bearish

Recent News: _____

Capital for Trade: $_____

Time Horizon: ___Days, ___Weeks, ___Months, ___Years

Strategy(ies): _____

Trade Legs:

1. _____

2. _____

3. _____

4. _____

Contingency Order(s): _____

Primary Exit: _____

Secondary Exit: _____

Adjustment: _____

Max Risk: _____ Max Reward: _____

As you can see, this is a comprehensive plan for a trade, and it keeps you on track to be sure that you have thoroughly analyzed the situation. It will also be fun to look back at your checklists with a note on each as to how well you did in that trade. If you did not do as well as planned, these checklists can help you identify where your analysis may have fallen short.

Chapter 35
Managing Your Account

"Money is only a tool. It will take you wherever you wish, but it will not replace you as the driver."

Ayn Rand

Hopefully by now, you are getting excited about applying all of this new information — and you should be. What you have learned in this book is how to exponentially multiply your chances of investing success. You are no longer simply *hoping* to generate profit, instead, you are going to be placing high probability trades with the Law of Averages on your side. (Just keep in mind that each of these trades will have a certain level of risk.)

This chapter is about managing the entire account, which means trying not to over-trade or place too much of your account at risk for any one trade. We try to never place a single trade that risks more than 10% of the account value.

Let's use some example numbers to illustrate the point. You have an option trading account with a $25,000 balance. Our rule would mean that we would place trades that require no more than $2500. And, we would not place any credit spread or Iron Condor requiring more than $2500 to be held in margin. Keep in mind, though, that margin requirements can change as the underlying security's price moves around.

Don't Force Trades

Sometimes the markets are not in the mood to cooperate with your chosen investment strategies. At times the market can be a bit too turbulent due to news like unrest in foreign countries or economic problems in the U.S.

We have learned trading strategies that we can use to take advantage of movement up, down, or sideways., However, at times there

will not be an available trade to meet our guidelines. Or, you may find a few trades, but they are borderline acceptable, at best.

The key to long term success is to avoid placing borderline trades, just to have a trade in place. This is how you end up with losers, and working from a deficit is not a good approach. Perhaps you are highly focused on debit spreads but the market seems to be moving sideways. This could be the right time to consider credit spreads and condors for your account. The market should dictate the type of trades you place.

Taking Risk off the Table

We have already talked about eliminating risk while discussing several of our trading strategies. However, it is definitely worth mentioning again. When you are planning your trades, you are planning an exit strategy and adjustments, if necessary. For the exit, you might, at times, close out a profitable trade when there's still a tiny bit of profit left before expiration.

In other words, if you have placed a credit spread at an original credit of $1.00, and it is still five or ten days before expiration, you should consider closing out the trade and taking your profits, if you can do so at $0.05 or so. Giving back that nickel can be well worth it, if you can get rid of the risk and move on to another trade. You might even give back a bit more, if the underlying is moving in a way that presents a possible threat in the time left before expiration.

Larger Positions

Sometimes trading successfully in small contract quantities can lead to over-confidence and to you deciding to gradually increase the size of your trades. When a really large trade goes bad, you'll be wishing you had stuck to three to five contracts instead of jumping up to ten or more. You may have valid analysis to back up a decision to increase the size of a trade, but keep in mind the 10% rule for risk.

It is all about profiting while preserving our capital.

Your focus on placing profitable trades with a high probability of success must be balanced with concern for that small probability of a loss. Preservation of your capital is crucial, even if you must forego some trades because they require too much margin, or the return does not justify the risk.

It is far better to end a year of trading with all of your initial capital plus 15% in profits, rather than to try and swing for the fences with low probability trades, and end up losing money on enough trades to create an overall loss for the year. It is also a good idea to reinvest in your business. It is okay to take some of your profits for discretionary spending occasionally, but reinvesting the majority of your bounty is how true wealthy is created.

In My Experience
Sometimes not taking a trade is the right trade. If everything does not line up (both fundamentally and technically) then wait for another day. Forcing trades is the folly of the uninformed and impatient investor.

Chapter 36
Strategies Overview & Quick Guides

This chapter is somewhat of a review of everything you have learned so far, and it is an overview of options trading and why I find it the very best way to profit in the stock market. You need a strategy to trade options, and this chapter can help you to define that strategy.

There are generally three types of options traders:

- Income traders – attracted to various types of credit spreads.
- Growth traders – more likely to speculate with debit trades.
- Hedgers – these traders want to reduce risk in their equity portfolios.

Options offer much greater flexibility than equities and other trading tools. They allow you to structure your trading for markets whether they are in an uptrend, a downtrend, or they are trading sideways. Some of the strategies in this overview will apply for each of these market directions, and some work well in all of them.

This is an overview of each trade strategy, and you can go back to the full chapters as well, which have much more detail with which to refresh your memory and to see example charts and trades.

Option Strategies: Long Call

Purchasing calls has always been the most popular option trading strategy with investors. Thoroughly understanding the long call and how to use it will help you in understanding more complex spreads.

When to Use

The investor who is mostly interested in a small investment amount and leveraged returns will be drawn to long calls. The investor is betting on the stock price increasing before the option expires. Buying a call is a bullish strategy with the expectation of an increase

in the price of the underlying stock. The more out of the money the strike price, the more bullish the outlook.

An investor can also take a long call position as an alternative to owning shares of the stock. Purchasing at the money or in the money call options, especially with expirations many months out, is a way to control many shares with far less capital invested.

The option holder does not have any of the rights afforded an actual shareholder, such as voting rights, dividends, and so forth. However, when one can enjoy equity appreciation investing, but for far less than the cost of buying the shares, it is a tradeoff many are happy to accept.

Risk vs. Reward

The maximum profit one can enjoy from a long call position is theoretically unlimited. The stock can rise to a very high level and the call option will rise in value with it. The flipside is that the risk is limited to the price of the option. The most the investor can lose is what they have paid for the option if it expires worthless. It is important to know that around 80% of all options do expire with no value, however.

Option Strategies: Long Put

The long put investor has the opposite outlook, and is bearish on the future price of the stock. Buying a put, the investor is betting on a decline in the price of the stock prior to the option's expiration.

When to Use

If you have a bearish outlook and expect the underlying stock to drop in price in the near future, you could take a long put position. This is also a highly leveraged position, in that you can purchase puts and participate in the stock's price declines, committing far less money than the account margin required to sell the stock short.

Risk vs. Reward

The maximum profit from a long put position is realized if the stock drops all the way to zero. The risk involved is limited to the amount of the premium and the commissions paid to enter the position. As with long calls, the rewards can be significant with a limited risk profile, but the ratio of worthless expirations to profitable trades is also very high.

Option Strategies: Covered Call

The covered call is a strategy in which the investor writes (sells) a call option contract while at the same time owning an equivalent number of shares of the underlying stock. If the stock shares are purchased at the same time as the sale of the call, it is called a "buy-write" strategy. The ownership of the stock covers the obligation conveyed by the sale of the call option.

When to Use

The covered call strategy is used to accomplish two different purposes. One, is to buy limited protection against a decline in the price of the underlying stock owned. The other is to increase the income in the account through the premiums received in selling the call. This is accomplished by selling out of the money calls at strike prices the investor hopes will not be reached, as he wants to retain ownership of the stock.

Another approach is to use covered calls to sell your stock shares at a higher price and increase the return by the amount of the premium. An example would be, owning a stock currently trading at $50/share with the desire to sell it at $60. It is not moving a lot in price, but you can increase your return by selling call options over and over and pocketing the premiums until the stock is called away at your $60 price point.

Risk vs. Reward

Your maximum profit is limited, as you will not receive any more profit past the strike price of the call option. In the example above, if the stock rises quickly to $65/share, your profit is limited to the rise to $60, as after that, your short call is offsetting gains in the share price, and your stock will be called away. The buyer of your short call will exercise and take your shares.

Option Strategies: Married Put & Protective Put

The married put is a hedging strategy used when the stock is purchased and the owner wants to hedge against a drop in price while they have a bullish outlook. A put option is purchased for the same number of underlying shares.

When to Use

The investor using this strategy wants the benefits of owning the stock, including voting and other rights, as well as receiving dividends, if they are being paid. The outlook is bullish on the stock, but the investor wants insurance against near-term downside risks.

While getting all of the benefits of stock ownership, the investor is buying "insurance" to protect their investment. The premium paid for the purchase of the put option is the cost of the insurance.

Risk vs. Reward

Because the investor owns the stock, the maximum profit potential is unlimited as the stock rises in price, less the amount paid for the put option. The maximum loss possible for the investor is limited to the stock purchase price minus the strike price of the purchased Put, plus the premium paid for the option.

Example: You purchase 100 shares of the stock at $55/share and you purchase a Put with a strike price of $52.50 at a premium of $1.00/share, or $100/contract. You expect the stock to rise in price, but now you have insured yourself against loss below the $52.50

strike price. Should the stock drop to $52.50 or lower before the option expires, your loss would be:

[($55.00 - $52.50) x 100] + $100 = $350

This is your maximum loss no matter how far the stock drops in price, as the put will gain value to offset the loss in share price on the way down.

The Protective Put

All of the above applies to the protective put, except when it is purchased. The married put is acquired at the time the stock is purchased, while the protective put is purchased later. Perhaps market developments cue the stockholder to protect their position.

Option Strategies: Cash Secured Put

The sale of a cash secured put means that you have sold a put option, do not own the shares, and you have the cash in the account to purchase the shares if the stock drops to or below the strike price. Your obligation is to do so, taking ownership of the stock at the strike price.

When to Use

Some investors sell cash secured puts with a bullish outlook on the underlying. They do not expect the stock to drop to the strike price prior to expiration, and their goal is to keep the premium income once the sold option expires.

However, another very popular goal of this strategy is to purchase a stock the investor wants at a discount. Let's say that you have had a standing buy-limit order to purchase XYZ stock at $40/share. It is been trading for months in a range between $48 and $56, but you do not want to pay over $40.

You have the cash to buy 200 shares at that $40 price, so you sell two put contracts with a $40 strike price. Should the price never drop

to the $40 level, you can keep selling puts, keeping the premiums, and increasing your income on the account.

However, should the price drop to $40 or below by expiration, you'll achieve your goal of owning the stock at that price, less the premium you received.

Risk vs. Reward

If you are just selling cash secured puts for the premium income and do not want to own the stock, your maximum profit is the premium received. Your maximum loss (if you do not want to be exercised and purchase the stock) would be the amount you would have to pay to buy back your put at a higher price less the premium you initially received.

If your goal was to buy, as in our example above, it is a different story. Had you stayed with the buy-limit order, you would have purchased the stock at some price around the $40 or lower, if the drop was very fast. If you purchased at $40, the limit price, and the stock continued to drop quickly to $35, you would be in a loss position, but you would own the stock as desired.

If you used the cash secured put method with the goal of owning at $40, the situation would be the same, except you will reduce any loss by the premium you received. So, if we are comparing the risk to the buy-limit order method, we have actually reduced our risk profile by the premium we received. It is, then, less risky than buying with a limit order.

Option Strategies: Collar

A Collar trade is usually placed after a stock has risen in price while owned, and the stockholder wants to protect most of their unrealized gains. Of course, they could just buy a put and accomplish this, but the collar provides a way to reduce the cost of the insurance, and in some cases, actually make money with free insurance protection.

When to Use

You are holding XYZ stock with a current market price of $62/share. You purchased it months ago at $48. You want to protect most of your $14/share unrealized gain. Coincidentally, your outlook for higher prices is limited, so you would be willing to sell your shares at $65.

You decide to buy a $60 strike price put for $3.00, and simultaneously sell a $65 strike price call for $2.50. Had you just purchased the put for insurance, your cost would be the full $300 for the single option contract. However, by placing the collar trade and selling the call, you reduce your cost to $0.50 ($50) because the call sold for that much less than the cost of the put.

In some cases, the cost of the put we are buying can be less than the cost of the call we are selling. This would allow us to get our downside protection free, and receive a credit for the excess premium received from the sale of the call.

Risk and Reward

The discussion of risk and reward is different in this instance because we are already sitting on an unrealized gain from $48 to $62 per share. Should the stock drop in price to or below the $60 strike price of the purchased put, we are going to theoretically be losing the $2/share between the $62 price when the collar was placed and the $60 strike. However, we are not in a loss position because we are still sitting on our profit from $48 to $60.

If the stock sits still, our collar will expire worthless, as we placed the put and call trades with the same expiration date. In this case, we'll lose the $50 net cost of the trade and can place another collar trade, as we are still sitting on our unrealized gain.

If the stock rises to $65 or higher, the stock will be called, and we'll realize the gains from our original $48 to the $65 strike price, less the $50 cost of the collar.

Option Strategies: Bear Put Spread

An investor with a 'moderately bearish', to a bearish outlook for an underlying stock would consider a bear put spread strategy. It is a leveraged trade, allowing a profit if the stock price falls.

Example: A stock is trading at $42/share. You have a bearish outlook in the short term. For a bear put spread, you may want to purchase the $40 strike price put for $2.25 and sell the $35 strike price put for $1.05. Your net debit would be $1.20 or $120 for a single option contract (commissions not considered). You are betting on a drop in the stock's price below $40, the farther the better.

When to Use

When you have a moderately bearish attitude about a stock, you can, as in this example, realize up to a $500 profit for a $120 investment. A 300% +/- return on a short term investment is pretty impressive. The profit can reach $500 because that's the difference between the two strike prices of $40 and $35.

Risk vs. Reward

We have seen how the reward side works. The lower the stock price drops until it passes the lower strike price, the more money you make. The debit spread sale of the lower strike reduces the amount you have invested, and increases your potential return.

The maximum risk is the debit price of the spread. If the stock sits still or rises, both options would expire worthless and your loss would be the cost of the spread. The ratio of reward to risk is very nice in this type of trade.

Bull Call Spread

We are now on the opposite side of the expectation of price action from the bear put spread. We are 'moderately bullish', to bullish

on a stock we do not own. It is a debit spread, with the purchase of a nearer strike price call and sale of a farther out strike price.

When to Use

You expect a near term rise in the price of a stock, and you want to limit and leverage your investment. By using a bull call spread you can cut the cost of the purchased call with the sale of the farther out of the money call.

Example: The stock is trading at $53.50. You purchase a $55 strike price call and sell the $60 strike call. You'll get less for the $60 call than you paid for the $55 call, which is the debit cost of the spread.

Risk vs. Reward

The reward is structured just as it was in the bear put spread, just in the other direction. Your maximum profit (commissions not considered) is the difference between the two strike prices, or $500, less the cost of the spread. The risk is limited to the debit cost of the spread.

Option Strategies: Bull Put Spread

Bull put spreads are useful when you are 'moderately bullish', or believe the stock will move little before the expiration of the options. You are selling a nearby put and buying one farther out of the money. This results in a credit to your account.

Example: The stock is trading at $53/share. You sell one $50 put and buy one $45 put. You are expecting the stock to sit still or go up in price. The nearer strike price option will sell for more than you'll pay for the farther strike, thus a credit to your account.

When to Use

Some investors will use the bull put spread when they consider it less risky than selling the stock short or writing a naked option.

However, the majority of these trades are placed to capture the net credit as profit while limiting downside risk.

Risk vs. Reward

The maximum profit in the trade is the credit received from the buy/sell of the options with the same expiration and different strike prices. The maximum risk is the difference between the strike prices.

Example: Using our example prices above, let's assume that we execute the spread trade at a $1.05 credit. For each contract we'll potentially see a maximum profit of $105. Our potential maximum loss is the $500 difference minus the credit received. In this example the maximum loss would be $395.

Option Strategies: Bear Call Spread

This trade assumes that the investor is expecting the stock to stand still or move downward in price by expiration. It is a credit spread, as we are selling a nearby call option and buying one farther out of the money. This creates a net credit to your account, which is your profit, if you have called the stock movement right.

When to Use

You assume that XYZ is going to stand still for a while or move down in price. You want to profit if you have called it right, and the bear call spread is a way to do this with a limited risk profile.

Example: XYZ is trading at $63.50/share. You sell a $65 strike price call and buy a $70 strike call with the same expiration. You are expecting the stock to sit still or drop in price, allowing both options to expire worthless and lock in your maximum profit.

Risk vs. Reward

Your maximum profit is the net credit you receive when you execute the spread. Your maximum risk of loss is the difference between the two strike prices, or $500 less the credit received.

Option Strategies: Long Straddle

If you are anticipating coming news on a stock that would cause a dramatic price swing in either direction, it is a possible opportunity for a long straddle. It is called a long straddle because you are buying a put and a call, both with the same expiration and the same strike price. This is generally done as close to at-the-money as possible.

Example: XYZ is a bio-tech company with a drug currently in trials, and you expect news on its approval (or not) before expiration of your trade. If the stock is trading at $51/share, you may buy a $50 put and a $50 call for this straddle. This strategy works around any type of news announcement such as a quarterly earnings report.

When to Use

You expect the stock to take off in one direction or the other and to move a lot when the results of the drug trials are announced. If you are right about this, and if the news comes out before the expiration of your trade, then you could profit handsomely with a big move in either direction.

Risk vs. Reward

The maximum risk of loss is the amount you paid for the spread, and maximum loss happens if this example stock is trading precisely at $50 at expiration, when both options expire with no value.

If you don't get the big move in either direction, your loss will be mitigated somewhat, as a small move in either direction will result in one option being worth more than when you purchased it, and the other being worth less than what you paid. A move to $52 for example, would make the call worth $2 and the put worth significantly less than what you paid as you approach expiration. You could close out the trade, losing only the difference between your entry and exit spread prices. By closing out this trade at least 30 days prior to options expiration, you will also recuperate a significant portion of the time value in the options.

As for maximum possible profit, a big move upward could theoretically result in an unlimited profit. A big move downward would limit your profit, as the stock cannot go below zero. The problem with the straddle is that at-the-money options on a stock with high volatility can be quite expensive. You could be paying a lot for the two options, and if the news does not come when you expect, you can see a significant loss.

Option Strategies: Long Strangle

The long strangle is also used when the investor expects a large price movement in one direction or the other. The difference between the strangle and the straddle is that the strangle is the purchase of a Call above the current price of the stock and a Put below that price.

Example: Using our straddle example above, we may, in this case, buy a $52.50 call and a $47.50 put. The difference between this situation and the straddle, is that our investment in this trade will be quite a bit less due to the out-of-the-money call and put.

When to Use

As with the straddle, we are expecting a large move in the price of the underlying in either direction. It could be the drug company example or a pending announcement of earnings. We'll profit if the news happens and the stock takes off far enough in either direction.

Risk vs. Reward

As with the straddle, the reward to the upside is theoretically unlimited as the stock rises in price. The reward to the downside is limited to the inability of the price to go below zero. In either instance, the reward is the rise in the price minus the premium paid for the spread.

There are two risk profiles with the strangle. First, if the stock price remains between the two option strike prices, the entire premium paid will be lost unless the options are sold prior to expiration. In that case, you would recoup some of the time value. Another risk is

that the stock's move does not produce a corresponding option price increase that is enough to cover the premiums paid for the position.

There's a Strategy for Every Situation

The beauty of option trading is that options are very flexible, allowing you to profit from any market or underlying asset movement, or lack of movement. There's a strategy for every situation, and, in this book, you have learned how to trade any market.

To finish out this chapter, we will look at two quick reference charts that you can use to get you to the right strategy, and which will give you the basics for each strategy.

QUICK STRATEGY SELECTION GUIDE

Bullish Outlook

If you are very bullish:

- Long calls
- Short puts (I don't recommend unless you want to own the stock.)

If you are bullish:

- Bull call spreads
- Married put
- Call ratio backspread

When you are slightly bullish:

- Calendar call spreads
- Bull put spreads
- Covered calls
- Collar

Neutral Outlook

You are neutral about market/stock direction:

- Condor
- Iron condor
- Butterfly
- Iron butterfly

Bearish Outlook

You have a slightly bearish outlook:

- Calendar put spreads
- Bear call spreads

You are bearish on direction:

- Bear put spread
- Protective put
- Put ratio backspread

You are very bearish:

- Long puts
- Short calls (I don't recommend!)

High Volatility Situation

You are expecting a lot of volatility:

- Straddle
- Strangle

Those are the recommended strategies for each market outlook or situation.

Trading Structure

Bear Call Spread

- Sell to open, call
- Buy to open, call at a higher strike price

Bear Put Spread

- Buy to open, put
- Sell to open, put at a lower strike price

Bull Call Spread

- Buy to open, call
- Sell to open, call at a higher strike price

Bull Put Spread

- Sell to open, put
- Buy to open, put at a lower strike price

Butterfly

- Buy to open, call or put
- Sell to open, twice the number of calls or puts
- Buy to open, call or put

Cash Secured Put

- Sell to open, put
- Cash in account to cover total risk

Condor

- Buy to open, put or call
- Sell to open, put or call closer to at-the-money
- Sell to open, put or call closer to at-the-money
- Buy to open, put or call

Covered Call

- Purchase stock
- Sell to open, call

Iron Butterfly

- Buy to open, put
- Sell to open, put at a higher strike price
- Sell to open, call at same strike as the short put
- Buy to open, call

Iron Condor

- Buy to open, put
- Sell to open, put at a higher strike price
- Sell to open, call
- Buy to open, call at a higher strike price

Long Call

- Buy to open, call

Long Put

- Buy to open, put

Married Put

- Purchase stock
- Buy to open, put

Protective Put

- Buy to open, put
- Sell to open, put with shorter expiration

Short Call

- Sell to open, call

Short Put

- Sell to open, put

Straddle

- Buy to open, call
- Buy to open, put

Strangle

- Buy to open, call
- Buy to open, put at a different strike price
- Delta Neutral

Now you have your quick access charts to match strategies with the market condition or our outlook, and to select the best strategy for your needs.

Chapter 37
Make it Happen

We have covered a lot of material in this book, and it is easy to become overwhelmed. Remember to keep everything in the context of "options are versatile." We covered a number of strategies in trading stocks and options, as well as different overall investment goals. You don't have to adopt them all. In fact, it is highly unlikely that you will.

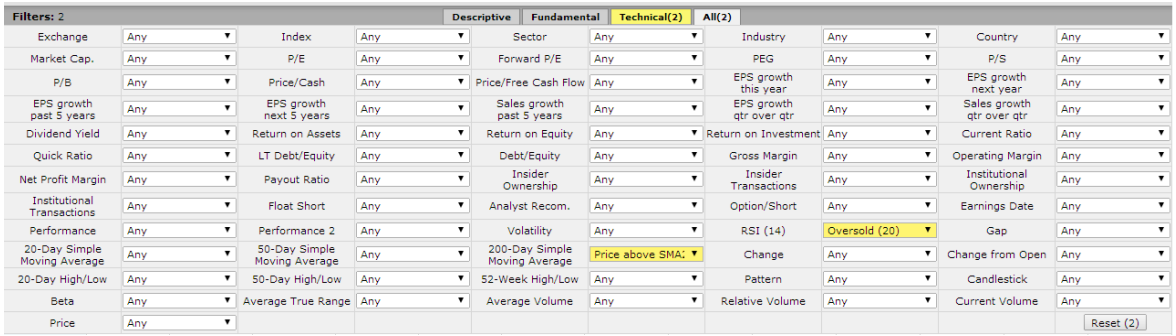
The best way to help you "make it happen" is to get you started in the most favorable and no-risk way. Information in this chapter will guide you through a step-by-step process that will have you trading for real profits in 90 days or less. The suggested 90 day period will allow you to "practice trade" without real money at risk until you are comfortable with your chosen strategies.

Open a Paper Trading Account & Pretend-fund It

This can be a paper trading feature in a regular brokerage account. OptionsXpress offers this feature in a trial account that does not require immediate funding. Their practice account funds with a pretend $25,000. If you use another brokerage, just determine what dollar amount of funding you plan to trade with for real later on, and use that amount for your practice account.

Use Finviz.com to Filter Stocks

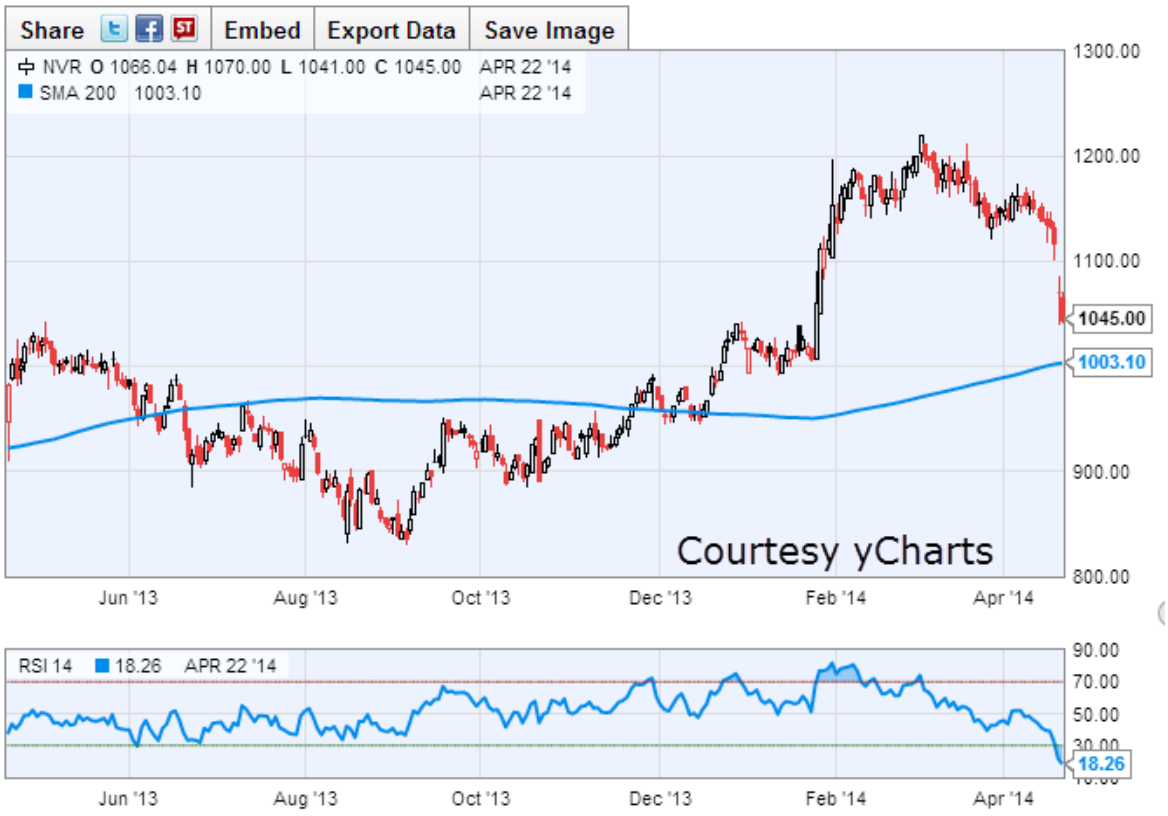
Finviz.com allows you to create and save profiles to locate bullish and bearish stocks, as well as using multiple variables to locate overbought and oversold stocks. This site will allow you to create your own desired measurements using many different fundamental and technical indicators.



Filters: 2 — Descriptive | Fundamental | Technical(2) | All(2)

Exchange	Any	Index	Any	Sector	Any	Industry	Any	Country	Any
Market Cap.	Any	P/E	Any	Forward P/E	Any	PEG	Any	P/S	Any
P/B	Any	Price/Cash	Any	Price/Free Cash Flow	Any	EPS growth this year	Any	EPS growth next year	Any
EPS growth past 5 years	Any	EPS growth next 5 years	Any	Sales growth past 5 years	Any	EPS growth qtr over qtr	Any	Sales growth qtr over qtr	Any
Dividend Yield	Any	Return on Assets	Any	Return on Equity	Any	Return on Investment	Any	Current Ratio	Any
Quick Ratio	Any	LT Debt/Equity	Any	Debt/Equity	Any	Gross Margin	Any	Operating Margin	Any
Net Profit Margin	Any	Payout Ratio	Any	Insider Ownership	Any	Insider Transactions	Any	Institutional Ownership	Any
Institutional Transactions	Any	Float Short	Any	Analyst Recom.	Any	Option/Short	Any	Earnings Date	Any
Performance	Any	Performance 2	Any	Volatility	Any	RSI (14)	Oversold (20)	Gap	Any
20-Day Simple Moving Average	Any	50-Day Simple Moving Average	Any	200-Day Simple Moving Average	Price above SMA:	Change	Any	Change from Open	Any
20-Day High/Low	Any	50-Day High/Low	Any	52-Week High/Low	Any	Pattern	Any	Candlestick	Any
Beta	Any	Average True Range	Any	Average Volume	Any	Relative Volume	Any	Current Volume	Any
Price	Any								Reset (2)

In the screenshot we see the many ways in which we can filter stocks or indexes for fundamental or technical factors that could lead us to a trading opportunity. In asking for oversold stocks with RSI (14) at or below 20 and just above their 200 day moving average, I am hoping to find a stock ready to move upward off the moving average. This is just an example, not a recommended trade.



This stock turned up in the filter for RSI and MA, and we can see that there may be reason to do more research. It is reaching recent solid support and approaching the 200 day MA. This stock does not have traded options, but does give you a good picture of how you might use filters at Finviz.com to locate possible trades. There is an "optionable" filter as well, so you would use it to make sure to discover only those stocks with traded options.

It is obvious that this type of filtering of many thousands of stocks and indexes could turn up a great many results. If you are a technical trader, you can use those filters. Fundamental filters can also be set to further refine your results. The point is to have a fast resource with which to scan the world of opportunities and to distill them down to a small group for further research.

Trends and Trading Range Technical Indicators

We saw how that looks in the Ycharts.com chart in the previous example, and you can do the same using Stockcharts.com. The point is to take your filtered results and examine them for trend and trading range indicators to further reduce your choices and refine them for the best opportunities.

Using fundamentals and technical indicators in which you have confidence, drill down to a few very promising trades. You have learned about technical indicators in this book, and can use charts to locate stocks or indexes that may be approaching strong support or resistance. You can also locate stocks locked in a trading range, which gives you another set of option trading strategies.

Start Building Practice Trades

By now, you should have determined your tolerance for risk and the options strategies you will be comfortable using in order to reach your goals. Keeping these in mind, search the option chains for your

distilled list and select trade strategies and specifics that will produce the return you want with the limited risk you are seeking.

Be selective at this point. It is far better to drill down to just one or two trades than to jump on four or five different trades when some display a higher risk-to-reward ratio.

Place Trades and Monitor

Place five high probability trades for the month with a 30 day or less anticipated holding period. Monitor those trades, and if they reach pre-determined points, make adjustments like the pros do to limit or avoid losses.

Go through three of these cycles over about a 90 day period in order to hone your skills and gain real world experience. Though you are not trading with real money right now, you are trading with real strategies and real world market and stock price movements. The goal of this stage of preparation is to build your confidence in your abilities and your trade selections.

Go Make Some Money

If you have not already done so, go ahead and fund your account. Some people have doubts about the worthiness of practice trading because they believe they will make different decisions when it is not real money at risk. Hopefully you will be every bit as conservative with your practice trades, as you will be when you trade with real money.

One thing you may have noticed when using your paper trading account was the tendency to exit a trade too quickly, taking smaller profits too soon. In your real trading account, always have an exit and/or adjustment plan and stick to it. Don't make spur of the moment decisions if they don't fit your plan unless some major new development signals coming problems.

Not every trade will be profitable, but every trade will be an educational opportunity. Success breeds confidence, but a failure now and then builds knowledge and a change for the better. What you

have learned in this book is how to *Trade Like the Pros,* something very few options traders ever learn.

Now it is time to take what you have learned in this book, and trade like a pro!

Glossary

Ask Price

The price at which a seller if offering to sell an option or stock.

Assignment

The receipt of an exercise notice from an options seller that obligates him to sell (call seller) or buy (put seller) the underlying security at a specific price. This can occur when the security goes 'in the money'.

At-the-money

An option is at-the-money if the strike price of the option is equal to the market price of the underlying security.

Automatic Exercise

A protection procedure whereby the Options Clearing Corporation attempts to protect the holder of an expiring in-the-money option by automatically exercising the option on behalf of the holder.

Bearish

An adjective describing an opinion or outlook that expects a decline in price, either by the general market or by an underlying stock, or both. During such times, options traders will use bearish strategies.

Beta

A measure of how a stock's movement correlates to the movement of the entire stock market. A Beta of 1 tracks the movement of the S & P 500. Most individual stocks will have a Beta greater than 1 meaning that they are more volatile than the overall market.

Bid Price

The price at which a buyer is willing to buy an option or stock. The seller may or may not be willing to sell at the bid price. They are hoping to receive their ask price.

Bullish

Describing an opinion or outlook in which one expects a rise in price, either by the general market or by an individual security. During such times, option's traders will use bullish strategies.

Call

An option contract that gives the holder the right to buy the underlying security at a specified price for a certain, fixed period of time. Calls are used to take advantage of an upward movement in the price of an equity.

CBOE

The Chicago Board Options Exchange; the first national exchange to trade listed stock options. The CBOE is an excellent source of options education.

Closing Purchase

A transaction in which the purchaser's intention is to reduce or eliminate a short position in a given series of options. This is also known as buying back an option.

Closing Sale

A transaction in which the seller's intention is to reduce or eliminate a long position in a given series of options.

Collateral

The loan value of marginable securities; generally used to finance the writing of uncovered options.

Combination

Any position involving both put and call options that is not a straddle (see strategies tab). Combinations are used in complex trading strategies.

Contingent Order

An order which can be executed only if another event occurs. Option traders use these orders to trigger a trade due to the price movement of an underlying security or option.

Cover

To buy back as a closing transaction an option that was initially written. This is normally done to collect a profit or minimize a loss.

Covered

A written (sold) option is considered to be covered if the writer (seller) also has an opposing market position on a share-for-share basis in the underlying security. That is, a short call is covered if the underlying stock is owned, and a short put is covered (for margin purposes) if the underlying stock is also short in the account. In addition, a short call is covered if the account is also long another call on the same security, with a striking price equal to or less than the striking price of the short call. A short put is covered if there is also a long put in the account with a striking price equal to or greater than the striking price of the short put.

Credit

Money received in an account. A credit transaction is one in which the net sale proceeds are larger than the net buy proceeds (cost), thereby bringing money into the account. Credit trades create income for the trader.

Debit

An expense, or money paid out from an account. A debit transaction is one in which the net cost is greater than the net sale proceeds. Debit trades have an up-front expense to the trader.

Deliver

To take securities from an individual or firm and transfer them to another individual or firm. A call writer who is assigned must deliver stock to the call holder who exercised. A put holder who exercises must deliver stock to the put writer who is assigned.

Delivery

The process of satisfying an equity call assignment or an equity put exercise. In either case, stock is delivered.

Delta

The amount by which an option's price will change for a one-point change in price by the underlying entity. Call options have positive deltas, while put options have negative deltas.

Early Exercise (assignment)

The exercise or assignment of an option contract before its expiration date.

European Exercise

A feature of an option that stipulates that the option may only be exercised at its expiration. Therefore, there can be no early assignment with this type of option. Most index options use this form of settlement.

Ex-Dividend

The process whereby a stock's price is reduced when a dividend is paid. The ex-dividend date (ex-date) is the date on which the price reduction takes place. Investors who own stock on the ex-date will

receive the dividend, and those who are short stock must pay out the dividend.

Equity Options

Options on shares of an individual common stock.

Exercise

To implement the right under which the holder of an option is entitled to buy (call) or sell (put) the underlying security at a specific price.

Exercise price

The price at which the option holder may buy or sell the underlying security, as defined in the terms of his option contract. It is the price at which the call holder may exercise to buy the underlying security or the put holder may exercise to sell the underlying security. For listed options, the exercise price is the same as the strike price.

Expiration cycle

An expiration cycle relates to the dates on which options on a particular underlying security expire. A given option, other than LEAPS will be assigned to one of three cycles, the January cycle, the February cycle or the March cycle.

Expiration date

The day on which an option contract becomes void. The expiration date for listed stock options is the Saturday after the third Friday of the expiration month. Holders of options should indicate their desire to exercise, if they wish to do so, by this date.

Expiration time

The time of day by which all exercise notices must be received on the expiration date. Technically, the expiration time is currently 5:00PM on the expiration date, but public holders of option contracts

must indicate their desire to exercise no later than 5:30PM on the business day preceding the expiration date. The times are Eastern Time.

Float

The number of shares outstanding of a particular common stock. Also known as the number of shares being traded in the market.

Floor Broker

A broker on the exchange floor who executes the orders of public customers or other investors who do not have physical access to the trading area.

Fundamental Analysis

A method of analyzing the prospects of a security by observing accepted accounting measures such as earnings, sales, assets, and so on. This type of analysis helps traders determine what to consider trading.

Gamma

The rate of change in an option's delta for a one-unit change in the price of the underlying security.

Good Until Canceled (GTC)

A designation applied to some types of orders, meaning the order remains in effect until it is either filled or canceled. Most contingent orders are set up this way.

Holder

The purchaser of an option.

Implied Volatility

A measure of the volatility of the underlying stock, it is determined by using option prices currently existing in the market at the

time rather than using historical data on the price changes of the underlying stock.

Index

A compilation of the prices of several common entities into a single number. Examples include the S & P 500, Wilshire 5000, and the Russell 2000.

Index Option

An option whose underlying entity is an index.

In-the-money

A term describing any option that has intrinsic value. A call option is in-the-money if the underlying security is higher than the striking price of the call. A put option is in-the-money if the security is below the striking price.

Intrinsic value

The value of an option if it were to expire immediately with the underlying stock at its current price; the amount by which an option is in-the-money. For call options, this is the difference between the stock price and the striking price, if that difference is a positive number, or zero otherwise. For put options it is the difference between the striking price and the stock price, if that difference is positive, and zero otherwise.

LEAPS

Long-term Equity Anticipation Securities, or LEAPS®, are long-term stock or index options. LEAPS®, like all options, are available in two types, calls and puts, with expiration dates up to three years in the future.

Leverage

In investments, the attainment of greater percentage profit and risk potential. A call holder has leverage with respect to a stock hold-

er - the former will have greater percentage profits and losses than the latter, for the same movement in the underlying stock.

Limit Order

An order to buy or sell securities at a specified price (the limit). This would be as opposed to a market order which would get executed at the next available price.

Listed Option

A put or call option that is traded on a national options exchange. Listed options have fixed striking prices and expiration dates.

Long Position

A position wherein an investor's interest in a particular series of options is as a net holder.

Margin

To buy a security by borrowing funds from a brokerage house. The margin requirement - the maximum percentage of the investment that can be loaned by the brokerage firm -- is set by the Federal Reserve Board.

Margin Requirement (for options)

The amount an uncovered (naked) option writer is required to deposit and maintain to cover a position. The margin requirement is calculated daily.

Market-Maker

An exchange member whose function is to aid in the making of a market, by making bids and offers for his account in the absence of public buy or sell orders. Several market-makers are normally assigned to a particular security. The market-maker system encompasses the market-makers, floor brokers, and order book officials.

Market Order

An order to buy or sell securities at the current market. The order will be filled as long as there is a market for the security.

Married Put and Stock

The simultaneous purchase of stock and the corresponding number of put options. This is a limited risk strategy during the life of the puts because the stock can be sold at the strike price of the puts.

Married Put Strategy

A put and stock are considered to be married if they are bought on the same day, and the position is designated at that time as a hedge.

Neutral

Describing an opinion that is neither bearish nor bullish. Neutral option strategies are generally designed to perform best if there is little or no net change in the price of the underlying stock or index.

Opening Purchase

A transaction in which the purchaser's intention is to create or increase a long position in a given series of options.

Opening Sale

A transaction in which the seller's intention is to create or increase a short position in a given series of options.

Opening Transaction

A trade which adds to the net position of an investor. An opening buy transaction adds more long securities to the account. An opening sell transaction adds more short securities.

Open Interest

The number of outstanding option contracts in the exchange market or in a particular class or series.

Options Clearing Corporation (OCC)

The issuer of all listed option contracts that are trading on the national option exchanges.

Out-of-the-money

A call option is out-of-the-money if the strike price is greater than the market price of the underlying security. A put option is out-of-the-money if the strike price is less than the market price of the underlying security.

Parity

Describing an in-the-money option trading for its intrinsic value; that is, an option trading at parity with the underlying stock. Also used as a point of reference - an option is sometimes said to be trading at a half-point over parity or at a quarter-point under parity. An option trading under parity is a discount option.

Position

As a noun, specific securities in an account or strategy. (A covered call writing position might be long 1,000 XYZ and short 10 XYZ January 30 calls). As a verb, to facilitate; to buy or sell - generally a block of securities - thereby establishing a position.

Position Limit

The maximum number of put or call contracts on the same side of the market that can be held in any one account or group of related accounts. Short puts and long calls are on the same side of the market. Short calls and long puts are on the same side of the market.

Premium

The price of an option contract, determined in the competitive marketplace, which the buyer of the option pays to the option writer for the rights conveyed by the option contract.

Profit Range

The range within which a particular position makes a profit. Generally used in reference to strategies that have two break-even points - an upside break-even and a downside break-even. The price range between the two break-even points would be the profit range.

Protected Strategy

A position that has limited risk. A protected short sale (short stock, long call) has limited risk, as does a protected straddle write (short straddle, long out-of-the-money combination).

Put

An option contract that gives the holder the right to sell the underlying security at a specified price for a certain fixed period of time.

Ratio Calendar Combination

A strategy consisting of a simultaneous position of a ratio calendar spread using calls and a similar position using puts, where the striking price of the calls is greater than the striking price of the puts.

Resistance

A term in technical analysis indicating a price area higher than the current stock price where an abundance of supply exists for the stock and therefore the stock may have trouble rising through the price.

Return (on investment)

The percentage profit that one makes, or might make, on his investment.

Rho

The expected change in an option's theoretical value for a 1 percent change in interest rates. (see Greeks)

Roll Down

Close out options at one strike and simultaneously open other options at a lower strike.

Roll Forward (Out)

Close-out options at a near-term expiration date and open options at a longer-term expiration date.

Rolling

A follow-up action in which the strategist closes options currently in the position and opens other options with different terms, on the same underlying stock.

Roll Up

Close out options at a lower strike and open options at a higher strike.

Secondary Market

A market that provides for the purchase or sale of previously sold or bought options through closing transactions.

Series

All option contracts of the same class that also have the same unit of trade, expiration date and strike price.

Settlement Price

The official price at the end of a trading session. This price is established by The Options Clearing Corporation and is used to determine changes in account equity, margin requirements, and for other purposes.

Short Position

A position wherein a person's interest in a particular series of options is as a net writer (i.e., the number of contracts sold exceeds the number of contracts bought).

Specialist

An exchange member whose function it is to both make markets--buy and sell for his own account in the absence of public orders--and to keep the book of public orders. Most stock exchanges and some option exchanges utilize the specialist system of trading.

Spread Order

An order to simultaneously transact two or more option trades. Typically, one option would be bought while another would simultaneously be sold.

Spread Strategy

Any option position having both long options and short options of the same type on the same underlying security.

Standard Deviation

A measure of the volatility of a stock. It is a statistical quantity measuring the magnitude of the daily price changes of that stock.

"Static" Return

The return that an investor would make on a particular position if the underlying stock were unchanged in price at the expiration of the options in the position.

Stop-Limit Order

Similar to a stop order, the stop-limit order becomes a limit order, rather than a market order, when the security trades at the price specified on the stop.

Stop Order

An order, placed away from the current market, which becomes a market order if the security trades at the price specified on the stop order. Buy stop orders are placed above the market while sell stop orders are placed below.

Strategy

With respect to option investments, a preconceived, logical plan of position selection and follow-up action.

Strike Price

The stated price per share for which the underlying security may be purchased (in the case of a call) or sold (in the case of a put) by the option holder upon exercise of the option contract.

Striking Price Interval

The distance between striking prices on a particular underlying security. Normally, the interval is 2.50 points for stocks under $25, 5 points for stocks selling over $25 per share, and 10 points (or greater) is acceptable for stocks over $200 per share. There are, however, exceptions to this general guideline.

Suitability

A requirement that any investing strategy fall within the financial means and investment objectives of an investor.

Suitable

Describing a strategy or trading philosophy in which the investor is operating in accordance with his (her) financial means and investment objectives.

Support

A term in technical analysis indicating a price area lower than the current price of the stock, where demand is thought to exist. Thus a stock would stop declining when it reached a support area.

Synthetic Put

A strategy equivalent in risk to purchasing a put option where an investor sells stock short and buys a call.

Synthetic Stock

An option strategy that is equivalent to the underlying stock. A long call and a short put is synthetic long stock. A long put and a short call is synthetic short stock.

Technical Analysis

The method of predicting future stock price movements based on observation of historical stock price movements.

Terms

The collective name denoting the expiration date, striking price, and underlying stock of an option contract.

Theoretical Value

The price of an option, or a combination of options, as computed by a mathematical model.

Theta

A measure of the rate of change in an option's theoretical value for a one-unit change in time to the option's expiration date. (see Greeks)

Time Decay

A term used to describe how the theoretical value of an option "erodes" or reduces with the passage of time.

Time Value

The portion of the option premium that is attributable to the amount of time remaining until the expiration of the option contract. Time value is whatever value the option has in addition to its intrinsic value.

Time Value Premium

The amount by which an option's total premium exceeds its intrinsic value.

Trader

An investor or professional who makes frequent purchases and sales. This is in opposition to and investor who buys and holds positions.

Type

The classification of an option contract as either a put or a call.

Uncovered Call Writing

A short call option position in which the writer does not own an equivalent position in the underlying security represented by his option contracts.

Uncovered Option

A written option is considered to be uncovered if the investor does not have an offsetting position in the underlying security. Very dangerous.

Uncovered Put Writing

A short put option position in which the writer does not have a corresponding short position in the underlying security or has not deposited, in a cash account, cash or cash equivalents equal to the exercise value of the put.

Underlying Security

The security subject to being purchased or sold upon exercise of the option contract.

Undervalued

Describing a security that is trading at a lower price than it logically should. Usually determined by the use of a mathematical model.

Unit of Trading

The minimum quantity or amount allowed when trading a security. The normal minimum for common stock is 1 round lot or 100 shares. The normal minimum for options is one contract (which normally covers 100 shares of stock).

Vega

A measure of the rate of change in an option's theoretical value for a one-unit change in the volatility assumption.

Vertical Spread

(1)Most commonly used to describe the purchase of one option and sale of another where both are of the same type and same expiration, but have different strike prices. (2) It is also used to describe a delta-neutral spread in which more options are sold than are purchased.

Volatility

A measure of the fluctuation in the market price of the underlying security. Mathematically, volatility is the annualized standard deviation of returns.

Write

To sell an option. The investor who sells is called the writer.