Beginner's Guide To Turning Options Trades Into Automatic Paychecks -- For a LIFETIME

How to Win 80% of Your Trades or Better for Over ~~50~~ 60 Years and Counting

By Don Fishback

It is a well-known fact of the markets that prices tend to trade within ranges most of the time. They tend to move in powerful trends infrequently. The stock market during a recent month period is a perfect example. From August expiration 2009 to July expiration 2011, the S&P 500 was up more than 28%. But big moves were few and far between. There were only two months where the market moved more 5%: May and August 2010. During the 21 other months, the gains and losses were relatively modest. That is to say, 91.3% of the time, the market was treading water. It was volatile only 8.7% of the time. This is not uncommon. In fact it is very common for markets to move sideways. Markets spend little time in pronounced uptrends or downtrends.

What this means to the option trader is crucial. If we can construct an option strategy that makes money in a trendless market, we can make money a vast majority of the time. Is there such a strategy? Of course there is. That's the beauty of options: their flexibility.

The easiest solution is to sell an out-of-the-money call and simultaneously sell an out-of-the-money put. Out-of-the-money means that the option has no exercise value. Therefore, an out-of-the-money call is an option whose strike price is above the current market price. An out-of-the-money put is an option whose strike price is below the current market price. If the market were to remain range-bound and trendless, as it does most of the time, you'd keep the entire proceeds you received from the sale of the options.

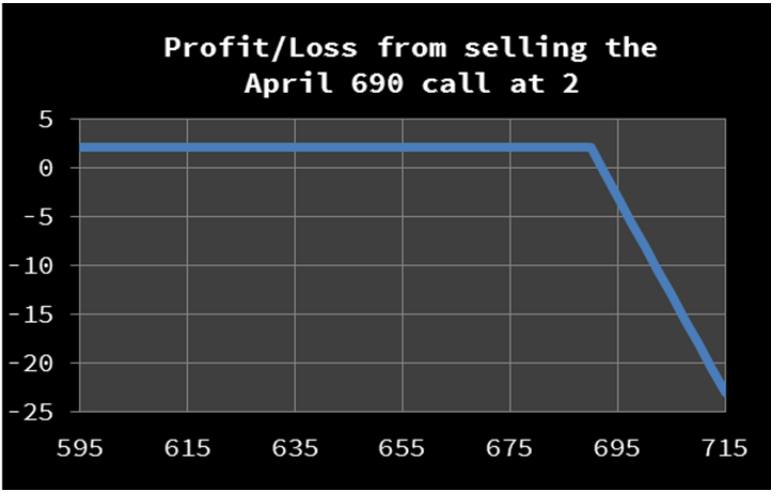
The key questions we have to answer are: how do we define range-bound and how frequently are the markets bound with the defined range? **Over the past ~~50~~ 60 years, the market has had a tendency to trade between +5% and -5% of the current market price about 80% of the time.**

As noted, one way to take advantage of that is to sell an out-of-the-money call. The call we want to sell is one that would expire worthless as long as the market did *not* go up by more than the +5%. We also want to sell an out-of- the-money put that would expire worthless as long as the market did *not* go down by more than the -5%. Let's look at the S&P 100 Index, the OEX, as an example. The S&P 100 is an index that very closely correlates the behavior of the S&P 500. The options are worth $100 per point. [*It's important to note that you can use this methodology on any broad-based equity index that is highly correlated to the S&P 500. While this example uses the OEX, individuals are likely to find that trading options on index-based ETFs are preferable. We tend to use the SPY more than any other index ETF option.*]

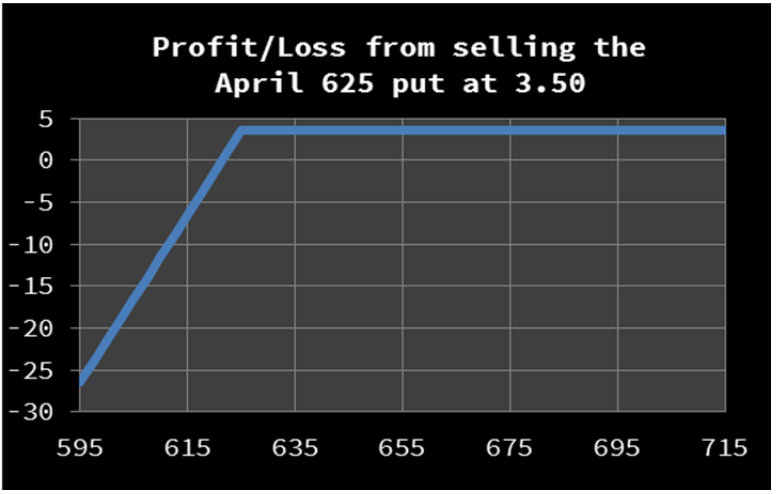
Let's say that the S&P 100 is at 655.48 on March 15 (one month prior to April option

expiration), 5% above is 688.25, 5% below is 622.71. Therefore, if we simply sell the April 690 call (690 is the closest strike price to 688.25), we will have an option trade that makes money if the market stays in the + or - 5% range. If we sell the April 625 put (625 is the closest strike price to 622.71), we will have another option trade that makes money if the market stays in the +5% or -5% range. If we do both, then we automatically will have an option strategy designed to make money 80% of the time. Let's say that the price of the April 690 call was 2 ($200.00); the price of the April 625 put was 3.50 ($350).

The following is a profit/loss graph (at expiration) from selling the April 690 call for 2.



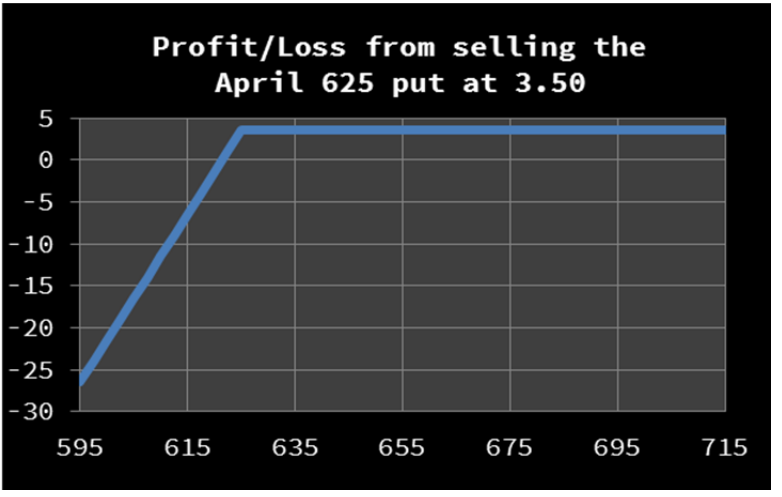
Below is a profit/loss graph from selling the April 625 put for 3.50.



When you simultaneously *sell to open* an out-of-the-money call and put on the same asset, with the same expiration date, you are said to be *short* a strangle. Conversely, when you simultaneously *buy to open* an out-of-the-money call and put on the same asset, with the same expiration date, you are said to be *long* a strangle.

Based on our assumed option prices, if we just sold one call and one put, we would have a strategy that has a profit potential of $550 (Remember, when we sell an option, the proceeds are paid to us) and a probability of profit of about 80%. That is, if the pattern over the past ~~50~~ 60 years holds true, there is about an 80% chance that the market will stay between 690 and 625 and that the options will expire worthless (i.e., our short strangle will hit its target profit).

Here is the profit/loss graph for the option combination: the short April 625 put, short April 690 call short strangle with a total credit of 5.50



Notice that what you've done is change the way you make money. You make money by something *not* happening. What you've essentially done when you've written a strangle is enter the insurance business; you've just written an insurance policy. Insurance companies make money when something does not happen. For instance, auto insurance companies make money when you do *not* have a wreck. In the insurance business, the possibility of having to pay a claim is remote. But if you *do* have to pay a claim, it *could* be a whopper.

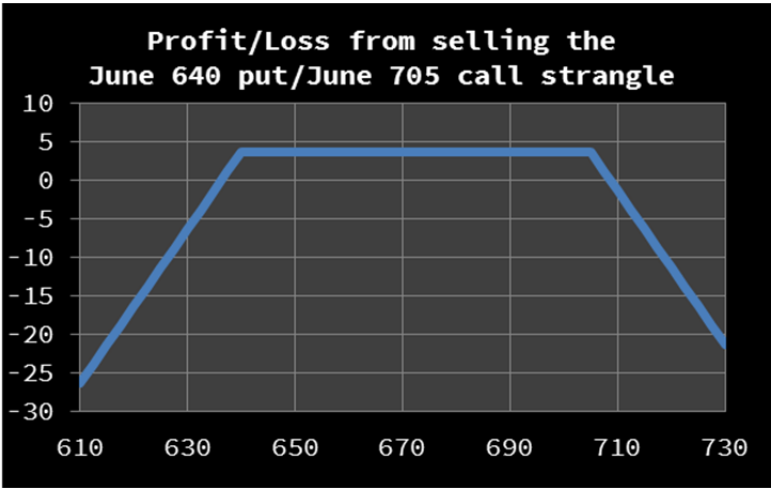
The same could be said of this strangle sale. The probability of profit is 80%. The probability of loss is 20%. So the odds are in the trader's favor. But the loss is potentially unlimited!

In the instance of this particular short strangle, you can see that if the market were to suddenly make a large move in one direction or the other, the losses could be devastating, as they were in September and October 2008, when the S&P 500 dropped -25.06% and -14.94% respectively!

This unlimited risk is why many insurance companies, in order to control risk, utilize what's called reinsurance. They take some of the premium they collect and use those proceeds to buy insurance of their own. That is, they forego some profits in order to put a cap on the size of the losses that could occur if the improbable happens.

We're going to do the same thing that the prudent insurance company would do. And it's going to shock you how easy it is to do it. The strategy even has a name. The tool we're going to use that duplicates this insurance/reinsurance business model is called a *credit sprea*d. We're going to collect a premium, and then use a portion of the premium we've collected to cap our risk.

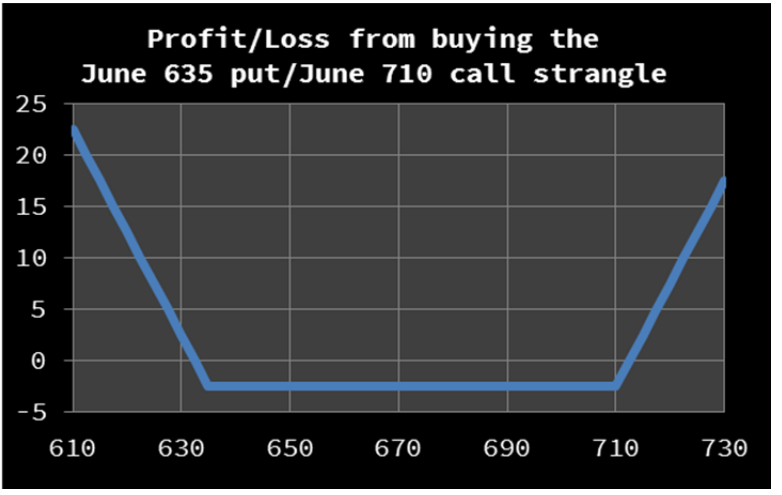
Let's look at two examples. In the first example, let's assume that it is May option expiration. We want to sell a strangle that has an 80% probability of profit. The OEX is at 671.76. We want to sell a call that is 5% above the current market price (705.35) and a put that is 5% below the current price (638.17). The call we want to sell is the 705 call, priced at 1.75 ($175). The put we want to sell is the 640, priced at 2, ($200). Our total credit is 3.75 ($375 per spread). Below is a graph of the short strangle.



Now let's look at the trade using credit spreads. It is May option expiration; we are looking for a trade with an 80% probability of profit. We want to sell a call that is 5% above the current market price (with the OEX at 671.76, 5% above is 705.35) and simultaneously buy a call one strike price further out-of-the-money. Also, at the same time that we want to sell a put that is 5% below the current price (638.17), we want to buy one put one strike price further out-of-the-money. The call we want to sell is the 705 call priced at 1.75 ($175). The call we want to buy is the 710, priced at 1.25 ($125). The put we want to sell is the 640 priced at 2 ($200). The put we want to buy is the 635 priced at 1.25 ($125).

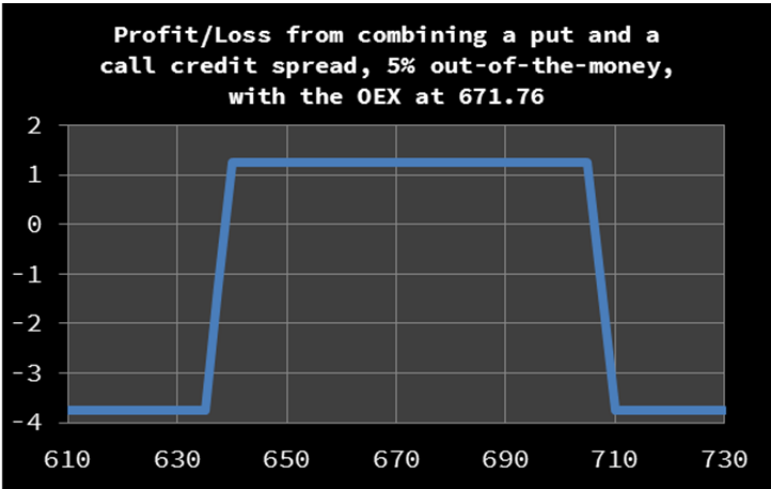
We've already looked at the options we'd be selling as part of the credit spread combination. Now let's look at the options we'd be purchasing as part of the total transaction. As noted, we're buying the 710 call and buying the 635 put for a total of

2.50 ($250). Remember, when you buy an out-of-the-money call and put at the same time, you are long a strangle.



In the credit spread strategy, we are going to combine the long strangle with the short strangle. We are collecting 3.75 ($375) when we sell the strangle. Next, we're going to turn this position into two credit spreads. We're going to take a portion of those funds we've collected and buy a strangle, the 710 call and the 635 put. Both options are one strike price further out-of-the-money than their put and call counterparts in the short strangle. We will be paying out 2.50 ($250) for the long strangle. The *net* credit, for the entire strategy is 1.25 ($125)—definitely smaller than $375. The key, however, is that our risk is limited to only $375. That's because the maximum risk is equal to the difference between the strike prices, minus the net credit received.

Here is a graph of the combined credit spreads:



Here's why credit spreads are preferable for the risk-averse investor. Note from the graph on page 5, if the OEX were to go down to 632.5, the loss from selling the strangle would be $375. On the other hand, the loss from selling the credit spread would be only $375. If the market kept dropping, and the OEX fell to 610, the loss from selling the strangle would have been $2,625.00, but the loss from the credit spread would have been only $375—a dramatic improvement. If you've implemented five strangles, your losses exceed $13,000.00. If you've implemented five credit spreads, your maximum losses are $1,875.

That is one thing you have to be aware of when evaluating credit spreads is they tend to look good only when you are comparing it to the catastrophically improbable.

In other words, if the probable happens, taking on potentially unlimited risk via a short strangle looks great... in hindsight. But if the *improbable* occurs, you're out of business.

With credit spreads, the profits are not as great. But if the improbable does happen, you're *not* out of business. You won't win! But the loss won't be so devastating that it does to your account what Hurricane Andrew did to some insurance companies—wipe them out. You'll be around to trade another day.

By the way, if anyone needs evidence of exactly what we're talking about in this report, strangle selling was the type of trading that one fellow did down in Singapore. He was extremely successful at it for a couple of years. He made his company so much

money that they promoted him repeatedly until he was in charge of trading and balancing the books. Then, all of a sudden, the strategy didn't work so well. In just a few short weeks, the tens of millions of dollars that he had accumulated in profits disappeared.

Unfortunately for the firm, the losses didn't stop there. Because the positions had unlimited risk, and the trader did nothing to stop the losses once they mounted up, it turned into a catastrophe. The trader's losses caused the collapse of the firm he worked for—centuries-old Barings Bank. It happened again in October and December 1997 during the Asian financial crisis, in August and September 1998, and October and November 2008..

In each of the credit spread examples shown earlier, we talked about finding trades based on probability of profit. We simply counted how many times the market made a move greater than 5% in a month. But what if you want to implement a trade that lasts a week, 21 days, or even two months? Also, what if you wanted a different probability number, say 90%, instead of 80%.

Fortunately, there is an answer—a more scientific approach. One that uses statistics and probability to spot high-probability winners without guessing market direction. Some of you may have heard of it. I invented it, and revealed it to the trading public in 1994. It is called ODDS, which stands for Options and Derivatives Decision Support.

Using the ODDS methodology, you simply need to input four easy-to-derive numbers into a formula, and you'll be given the boundaries of the upper and lower range. Then you'll be able to set up your own option trades that can achieve a winning percentage that is as high or as low as you want.

This is precisely the method taught in our course, *The Casino Secret to Profitable Options Trading*, and the kind of trade that is provided each week in the *ODDS High Accuracy Options - Weeklys*.

I encourage you to give either of these products a try. Just go to our web site:

www.donfishback.com

Or call 800-834-6488.