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WINNING STOCK & OPTION STRATEGIES

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APPENDIX A – STOCK MARKET ESSENTIALS

CHAPTER 1 – INTRODUCTION

The *dot.com* phenomenon in the late nineties demonstrated the ease with which money can be made in a rising market. But as the aftermath of that phenomenon demonstrated there is a flip side to that coin. Paper profits can be wiped out and major losses incurred in the seeming blink of an eye.

Many people have concluded from their experiences during the market downturn that stock market investing is very fickle, that there is a large element of luck in trading, that one must buy and sell at the right times, and that making the necessary decisions is often fraught with angst. These uncertainties have made them fearful of the stock market and at the same time they have a desire to play the market with a view to enhancing their own financial positions.

This mix of emotions, the desire to participate allied with the fear of incurring losses, is frequently compounded by misconceptions about stock markets. Many people, for example, would take it as given that money can only be made if stock prices rise. But believe it or not, that would be incorrect! What would you say if you were told that there was a way to protect what you had invested? What if you were told that you could protect the stocks that you had invested your life savings in? Would you be interested in learning how to protect your money no matter how the stock performed, even if the stock price *fell*?

What if you were told that you could generate money every month on stocks you already own? You would not have to wait passively for stock prices to rise but you could proactively generate cash each and every month. Would you be interested in learning how to do that?

The overall objective of this book is to explain how one can profit in the market regardless of the direction in which it moves, and how to do so with equanimity and a high sense of personal control. This book provides you with the necessary tools to be able to achieve this goal through the strategies of spread trading. This knowledge, combined with an understanding of techniques and strategies for analyzing stocks with a view to determining their likely direction of future movement, should enable you to trade profitably and consistently in any market. These matters and all related matters are covered in detail in this book, as are suggestions as to precisely how one should move from a mastery of the skills involved to profitable market place trading.

The strategies proposed have been thoroughly tested and disciplined adherence to them should provide you with ***Winning Stock & Option Strategies***. They should yield handsome and consistent profits over time coupled with tremendous personal satisfaction.

CHAPTER 1 – INTRODUCTION

1.1 Objectives

When you have completed this book you should have an excellent understanding of the following topics:

- **How to answer the *million dollar* question – how can I buy high, sell low and profit?**
- **What stocks to buy and *when* to buy them**
- **When to trade with the crowd and when to trade against the crowd**
- ***Eliminate greed* in your trading**
- **How to own a stock for zero cost basis**
- **Proactively generate cash flow with stocks you own**
- ***Eliminate fear* in your trading**
- **How to insure your stocks when the market goes down**
- **How to profit in a down trending market**
- **How to profit using advanced strategies**
- **What exit strategies to use**
- **How to correctly apply strategies**
- **What brokerage should you use**
- **Money management**

1.2 *What is the profit potential and how can I achieve it?*

In order to gain maximum benefit from this book you should plan on putting in the effort to get a good understanding of the principles involved and you should paper trade for a further period. It is also recommended that you refrain from real-life trading until such time as your command of the subject is producing 7 or 8 successful trades out of every 10.

Application of the strategies taught in this book could yield annual returns of 40% for low-medium risk strategies and much more if higher risk strategies are employed! Thus an initial investment of \$5,000 is capable of being turned into \$27,000 over five years, and into \$144,000 over ten years. Indeed if the annual rate of return could be lifted to 50% and the term extended to fifteen years, the original \$5,000 would appreciate to well in excess of \$2,000,000! So the potential is fantastic!

In this book you will learn that, in many cases, you do not have to accept losses. In fact when you learn to adjust your trade to the current trend you can often turn a losing trade into a profitable trade. You will learn that you can protect your money such that even if the stock you purchased goes to zero, you can still sell the stock at a fixed price and hence limit your risk. You will also learn strategies that will allow you execute a trade and be confident that even if you don't look at the stock market for the next year you will not have to worry about the outcome of the trade.

CHAPTER 1 – INTRODUCTION

1.3 *Trading Psychology*

It is further the intention of this book to eliminate *limiting beliefs* such as:

- **You have to accept losses**
- **You can lose all your money**
- **Trading is risky and complicated**
- **You have to dedicate a huge amount of time to be successful**
- **The trade must go your way**
- **You have to be very intelligent to trade**

And to replace them with *empowering beliefs*:

- **Trading can be low risk**
- **Trading with pre-defined exit points will reduce fear**
- **Trading can be simple**
- **Trading does not have to demand a huge amount of time**
- **You can be consistently profitable when trading**

CHAPTER 2 – OPTIONS BASICS

2.1 *Introduction to options*

In spite of increased access and awareness of the workings of the options market, many diametrically opposed myths exist regarding options. Options were in fact created as a means for hedging risk or protecting *long* and *short* (Appendix A) positions in the market place.

They are not as some contend a much riskier investment than stocks. This is not to say there are no risks involved in options trading or the risks cannot be substantial if they are mis-used. This can also be argued of stock investments. Those who invested in Enron during the “bubble” period of 2000 without protecting their investment through purchase of put options stood to lose their entire investment. The protection afforded by the option purchase would have afforded them the right to sell their stock for a particular price even if the stock was worth zero. This will be explained later but the concept is worth understanding now.

Another viewpoint on options is that they are a license to print money. Although options can generate substantial gains exceeding 100% and sometimes even 1000% in a small time frame, they can also expire worthless after a set time frame at which point their entire value is worthless. Correct application of when to hold options, when to allow them expire or when to exercise them will be covered in detail later.

2.2 *What is an option?*

An option is a legally binding contract between a buyer and a seller.

The contract gives the buyer the *right* to buy or sell the stock at a specific price called the strike price on or before a specific date called the expiration date.

The seller is *obligated* to sell or buy the stock at a specific price (strike price) once the option buyer exercises his/her option.

The option buyer can choose to exercise his/her option anytime prior to expiration date. The option seller must fulfill the terms of the contract if the option buyer chooses to exercise.

2.3 *What types of options exist?*

Two options trading tools exist

1. **Call Option**
2. **Put Option**

CHAPTER 2 – OPTIONS BASICS

→The *call* option gives the options *buyer* the *right to buy* the stock at a fixed price within a set time frame.

→The *call* option *seller* or writer is *obligated to sell* the stock at a fixed price within a set time frame. This is covered in more detail in the next chapter.

→The *put* option gives the options *buyer* the *right to sell* the stock at a fixed price within a set time frame.

→The *put* option *seller* is *obligated to buy* the stock at a fixed price within a set time frame. This will also be examined further in the next chapter.

How are options purchased?

Unlike stock that can be purchased on a per share basis, options are purchased in contracts.

1 contract = 100 shares of a stock

2.4 Why would I use options?

A number of powerful reasons exist to use options as a trading instrument. When using options you can:

- **Leverage capital**
- **Reduce risk**
- **Control stock without owning it**
- **Generate increased return on investment**

Options can earn significant percentage returns with reduced capital risk and reduced movement in the underlying stock.

In order to show how large amounts of stock can be controlled for a lot less capital using options let's consider the following example using call options versus stock purchasing.

Example:

If Microsoft was trading at \$30/share and I wanted to buy 1000 shares, the cost basis would be $1000 \times \$30 = \$30,000$. In order to double my money Microsoft must now reach \$60/share.

But what would happen if Microsoft instead fell in value to \$20/share? My \$30,000 investment would now be worth \$20,000 so I would have lost \$10,000.

As mentioned above 1 option contract equates to 100 shares of stock. So now let's consider what would happen if 10 contracts equating to 1000 shares of Microsoft were purchased at a strike price of \$30. The per share cost of the option was \$5. So this

CHAPTER 2 – OPTIONS BASICS

means I have paid \$5 per share or \$500 per contract and since I have 10 contracts I have paid \$5000 which gives me the right to buy Microsoft stock at \$30. Now if Microsoft trades up to \$40 per share my call options will be worth \$10/share ($\$40 - \30) or \$1000/contract or \$10,000 for 10 contracts. So as the stock moved from \$30 to \$40 within the set time frame my options investment has increased 100% even though the stock only increased 33%. And if the stock dropped to \$20 I would have lost only \$5,000 rather than \$10,000 in the case where I only bought the stock.

So using proper money management the probability of making money can greatly increase using options.

This example has shown all the advantages of options.

Leverage Capital: A \$5,000 options purchase was shown to control as many shares as a \$30,000 stock purchase

Reduce Risk: For the same decrease in stock price from \$30/share to \$20/share the purchaser of stocks lost \$10,000 while the purchaser of options lost \$5,000

Control Stock Without Owning It: In this example the buyer of the call option could sell the option when the stock rose from \$30/share to \$40/share without ever owning the stock.

Increased Return on Investment: For the same increase in stock price from \$30/share to \$40/share the percentage investment increase for the stock buyer was 33% while the options buyer had a 100% increase in investment

2.5 Summary

Options leverage capital, reduce risk, allow stock control without ownership and facilitate increased return on investment.

In order to learn how to adjust your trades to the current trend to maintain profits you will need a good understanding of options trading instruments and terminology.

CHAPTER 3 – SPREAD TRADING OVERVIEW

3.1 Introduction to Spread Trading

This chapter provides an insight into the benefits of spread trading versus directional trading.

3.2 Spread Trading Overview

Many individual investors in the market are directional traders. In general this means they buy a stock or mutual fund with the expectation that the value of the stock or mutual fund will rise over time. Directional trading is risky because the balance of forces which determine the value of a stock at any point in time is arguably as likely to push it in one direction as the other. If you buy a stock at \$10 and it loses 10% of its value you now own the stock for \$9. The stock must now increase by \$1 or 11% for you to break even. Now what if the stock dropped \$2, you have lost 20% of your investment. The stock must now rise from \$8 to \$10 or 25% before you break even. And if you lost \$5 or 50% of your investment the stock would now need to double from \$5 to \$10 before you are at breakeven, so you need a 100% gain!

This course shows you how to profit through spread trading.

Spread trading is the practice of purchasing one option contract and the simultaneous sale of a related option, such as two options of the same class (calls/puts) but different strike prices and/or expiration dates.

Spread trading is used by futures and options traders to reduce the risk of losing large sums from a sudden movement in the market.

Spread trading can yield annual returns of 20% or 30% with minimal risk and sometimes no risk. Annual returns exceeding 100% or much more are possible by increasing your risk tolerance but still exposing yourself to significantly less risk than is incurred through directional trading. So why doesn't everyone spread trade? And why don't they use options? A pervasive belief exists that options are risky. Firstly, it should be noted that options were introduced as a means of effectively managing risk. Correct application of options in the form of various strategies that comprise spread trading enables individuals' trade in a systematic manner with reduced risk. Provided an individual understands options trading instruments (and completion of this book will provide that understanding) there is no reason to consider options risky because at all times the risks and rewards of any given trade are known.

In summary, knowledge of options trading instruments reduces risk in options trading. This course will provide you with that knowledge.

So let us compare the risks associated with options trading and stock trading in a simple example.

CHAPTER 3 – SPREAD TRADING OVERVIEW

Stock Example:

So let us say stock ABC is trading at \$10 per share and I want to buy 100 shares of the stock. The price I will have to pay is my cost basis.

$$\text{Stock Cost Basis} = 100 \times \$10 = \$1000$$

Options Example:

Options are typically bought in contracts where a contract consists of 100 shares of stock. Now if I were to buy one option contract consisting of 100 shares at a strike price (this term will be explained later) of \$10, the purchase price may typically be \$1.50 per share.

$$\text{Option Cost Basis} = 100 \text{ shares} \times \$1.50 / \text{share} = \$150$$

So, in order to control 100 shares of the stock through a stock purchase I need to spend \$1000 whereas I can control the same number of shares with an option for a fraction of the capital, only \$150. So, with stocks I must risk \$1000 but with options I only risk a fraction of that capital and still maintain the same control.

Buying stock is considered directional trading because you only make money on your investment if the stock goes in one direction – up! As will be made clear on the following pages, spread trading enables you to make money when the market moves in any direction whether up, down or even stagnant.

Options terminology will be explained later. It is not necessary to understand the nuances at this point, just the overall concept.

3.3 *Directional Trading Vs. Spread Trading*

Directional Trading	
Advantages	Disadvantages
Higher profit potential	Higher loss potential
Gain from short-term movements	Must guess direction correctly to profit
	Higher risk since profit is only one direction
	Requires larger capital investment
	Price fluctuation will impact investment to larger extent

CHAPTER 3 – SPREAD TRADING OVERVIEW

Spread Trading	
Advantages	Disadvantages
Can profit when market trending up, down or even stagnant	Longer time to realize profits
Smaller capital investment required	Reduced profit potential
Ability to adjust trades	
Less susceptible to price fluctuations	

3.4 Greed and Fear

Supply and demand will affect changes in stock prices. As stock prices rise, greed will dominate the market place buyers and, when prices fall, fear dominates the mindset of sellers.

One critical key to success is the ability to trade objectively by eliminating both greed and fear and the method for achieving this will be outlined later. It is important to realize at this stage that this is one of our primary objectives.