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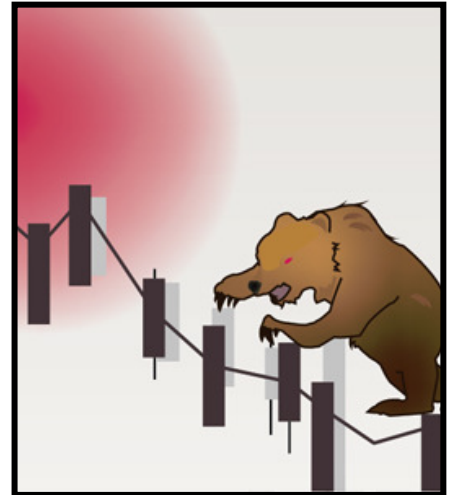
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Sample 1

What does Bearish mean?

Being bearish is when you are expecting the price for a particular market or stock to fall and a bull market is a market where prices are falling.



When you are trading options, you would want to adopt option strategies that are suitable for a bear market. There are several bearish option positions that you can trade to take advantage of a bear market and that will yield higher return and carry lower risks in that type of market.

When you foresee a downward move in the market and you want to take advantage of that move, you take a bearish option position while taking into consideration the expiration date of the option contracts position as you will need the downward movement in the underlying stock to occur before expiry.

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When to take Bearish positions

To trade in any market, you either buy when you are bullish or sell when you are bearish and to make a profit, the trade will have to move in the direction that you have chosen which is down if you are bearish.

So deciding when to take a bearish position will depend of your fundamental and technical analysis of the market in general and stock and its options in particular.

Taking a bearish position means you are expecting the market to go down. Ideally, you would want to take such position when you are expecting large future downward movements. Generally, markets can go down in big movements when there is a stream of bad major economic news, earnings, litigation settlements and major company news, an expectation of such bad news, when the market technical analysis is bearish, like for example markets are heavily overbought, there is a bearish trend and so on.

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Sample 2

In The Money & Out Of The Money Strategies

What is In the Money & Out Of The Money

An option contract is In The Money when it is already making a profit if the option if exercised. This occurs when the underlying stock price is higher than the option strike price for a call option and lower than



the option strike price for a put option. At The Money is when the underlying stock price equals the option contract strike price.

For example if you are long on the following option contracts and the strike price of the option is \$30, the following applies:

Option strike price	Option type	Underlying stock price	
\$30	Call	\$35	In The Money
\$30	Call	\$28	Out Of The Money
\$30	Put	\$35	Out Of The Money

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\$30	Put	\$28	In The Money
\$30	Call	\$30	At The Money
\$30	Put	\$30	At The Money

In The Money Strategies

Covered Calls

A Covered Call Strategy involves Buying the stock and selling an In The Money Call Option.

Example:

Buy 100 shares of the underlying stock

Sell 1 an In The Money Option contract

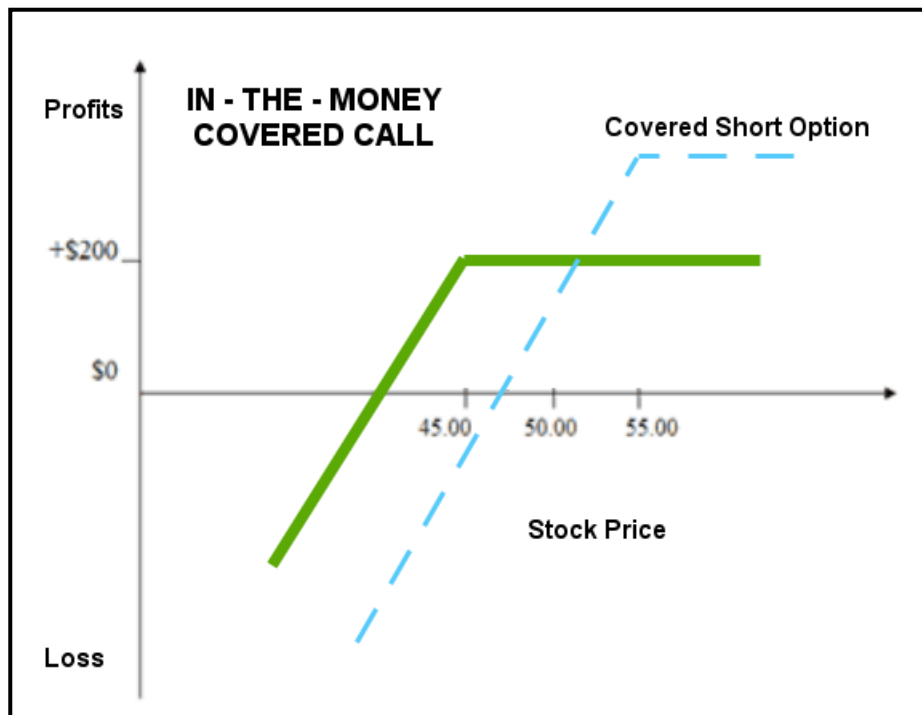
The maximum profit is the profit earned from the premium of the short option as you cannot benefit from any rise in the stock price because of the option you have sold.

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On the other hand, this trade offers some downside protection as should the stock price falls, the fall in the premium of the then In the Money option that you have written offsets part of the loss incurred due to the fall in the share price. At expiry you still make a profit if the fall in the stock price is less than the collected premium.



Profit=

Premium - Purchase price of the stock + Strike Price of the Short Option which is the maximum profit. This maximum profit is achieved when the price of the underlying stock is greater than or equal to the strike price of the short option.

Loss is unlimited and starts to occur when the price of the underlying stock is less than the purchase price of the underlying stock less the premium.

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Example:

The underlying stock is trading at \$40, and you entered a covered call trade by selling a next month's \$35 call option contract (100 shares) for say \$750 and bought the 100 shares for \$4,000. The net cost of this trade is \$3,250.

If at expiration the stock price is \$35, the option expires worthless so you cash in on the premium of \$750 but the long stock has lost \$500, so your net profit is \$250.

If at expiration the stock price is \$40, the value of the short option is \$500 and the long stock has neither lost nor made a profit, you collected a premium of \$750, so your net profit is \$250.

If at expiration the stock price is \$45, the short option value is \$1,000 and the long stock has made a profit of \$500 and you collected a premium of \$750 so your net profit is: $\$500 + \$750 = \$1,250$ less \$1,000 the value of the short option which is still \$250.

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If at expiration the stock price is \$30, the option expires worthless so you cash in on the premium of \$750 but the long stock has lost \$1,000, so your net loss is \$250.

Your breakeven point at expiration is when the underlying stock has lost an amount that is equal to the premium. In this case, if the price of the underlying stock at expiration is \$32.50, the option expires worthless so you cash in on the premium of \$750 but the long stock has lost \$750, so you break even (not taking into account commission).

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Sample 3

Why should I use options?

There are two main reasons why you should use options—firstly, to speculate and secondly, to hedge risk. It's safe to assume that we're all pretty familiar with the "speculation" part of investment, as every time you buy a stock you're basically speculating the direction that stock will move in. We are speculating as we are uncertain about which direction any equity investment is going to go. We may imagine being 100% positive that IBM is heading higher as we buy the stock, and you may even be right most of the time. Still, if you were *truly* 100% positive that IBM stock prices were going to go up, you'd have invested everything you had into buying the stock, right?

Every rational investor realizes that there is no "100% positive" or "sure thing" when investing, as every investment no matter how big or small incurs at least some risk.

This is the same risk that the options investor is going to be compensated for when he or she purchases an asset, but with options you can use strategies to manage and limit risk which is a big advantage. You can purchase options to

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“speculate” on future stock price movements where you have actually limited downside risk while, at the same time, unlimited the potential for your upside earnings. You can use options to hedge your investments and control and limit risk, like an insurance policy against adverse movements.

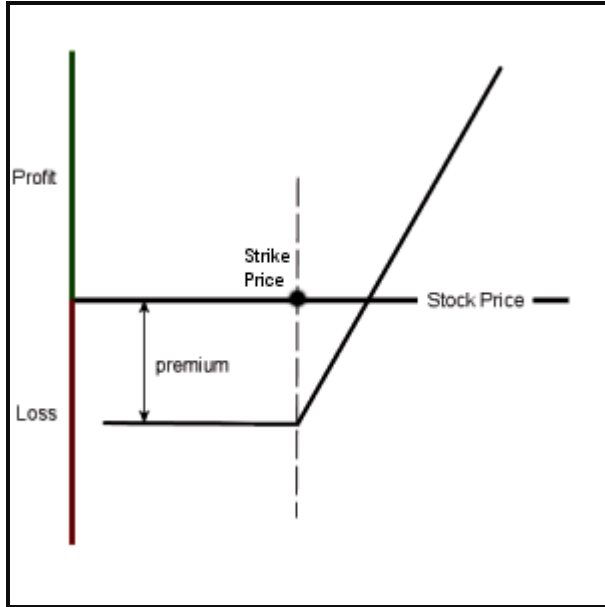


Because of their nature, options offer a lot of strategies that enable us to increase return and limit risks. We will cover some of these strategies in this book and other books in this series.

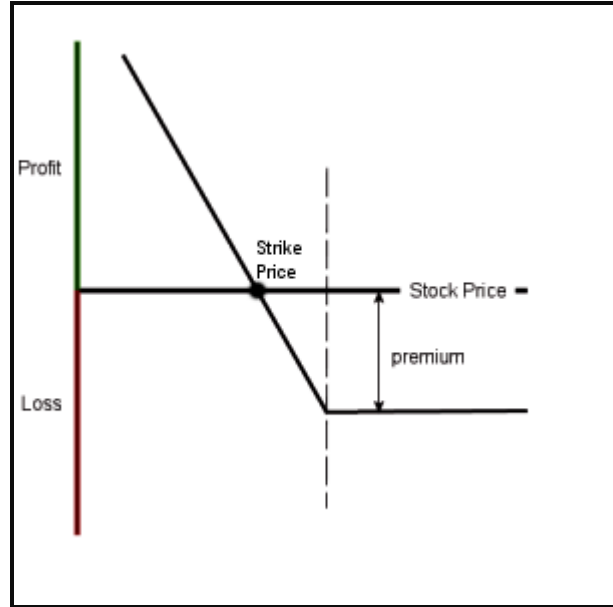
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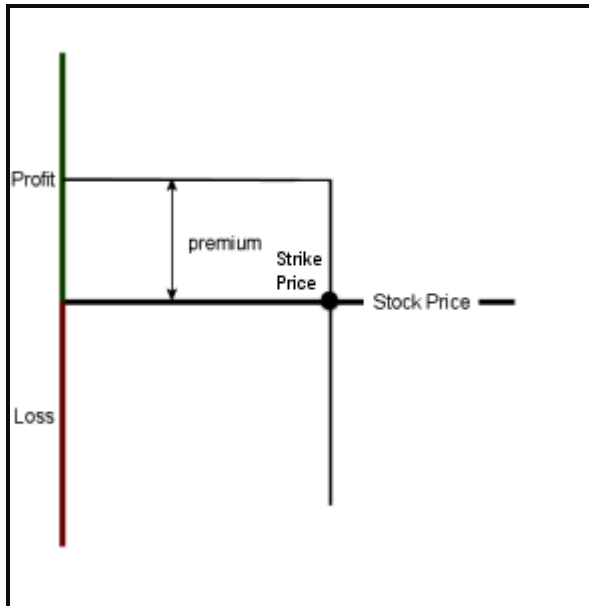
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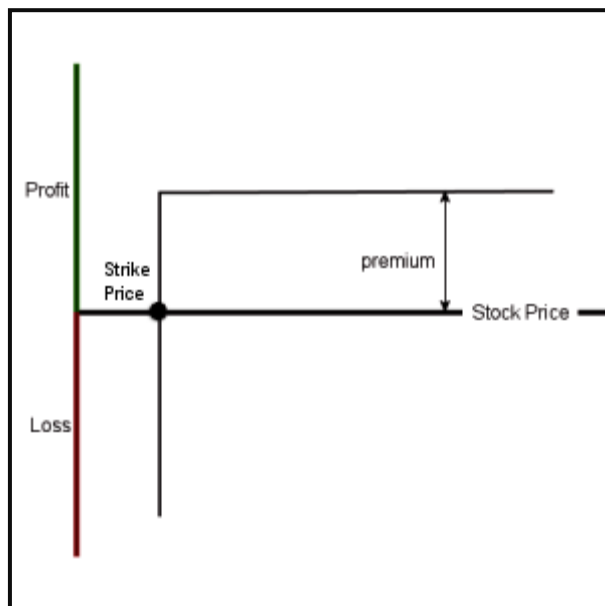
Long call option



Long put option



Short call option



Short put option

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Spreads

If you have already traded options, you must have already heard the term option spread being mentioned at some stage. It may sound complicated at first but once you understand how it works it is really straight forward.

Spreads involve taking on positions with more than one option. They offer very useful strategies as they enable you to limit risk and leverage profits. They also allow you to benefit from a wide range of events or from the change in relationship between various prices.

When you do basic option trading, you simply buy or sell a call or put option and you are dealing with one expiry date, one strike price and one underlying stock. In that case, there is only one set of *Greeks* that apply to that particular option.

Conversely, option spreads could involve different expiry dates, strike prices and even underlying stocks and as you are trading with more than one option, the

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various option contracts of the spread or legs, as we call them, have different

Greeks that make the value of the various options change in different ways.

Spreads help reduce risk, limit exposure to time value decay and the effect of adverse price movements.

The effect of the “Greeks” on option spreads

The option risk measures which are called *Greeks* play an important role in spreads and the main Greeks that affect option spreads are:

→ *Delta*

Delta is a measure of the effect of price change in the underlying stock on the price of the option. In a spread, we may have two options with two different Deltas. So when the underlying price moves the spread is affected by the differential movement on the option prices due to the difference in the value of the Deltas of the spread legs.

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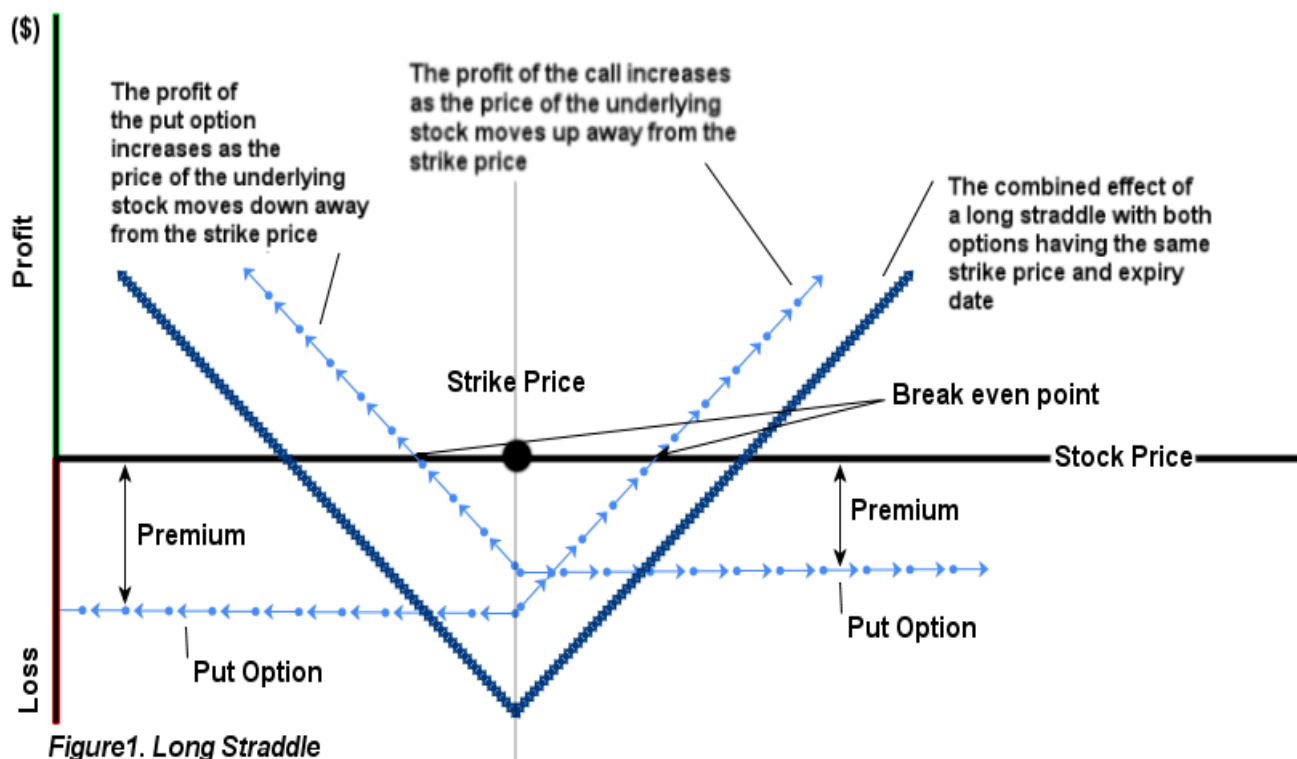
Volatile Market Strategies

Volatile markets option strategies are option positions that you take to benefit

from volatile markets where the underlying stock is expected to move strongly up or down. There are several types of strategies which include:

Long Straddle Strategy

A Long Straddle is when you buy a call and a put on the same stock with the same strike price and expiration.



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By going long on both options, you are neither bullish nor bearish but you are not expecting the market to remain stagnant either. Should the market price of the underlying stock drops, you will be just as happy as if it rose. So long Straddles are all about taking advantage of volatility, the movement and instability of the market.

So where's the risk if you benefit whichever way the market moves?

The main issue here is that for this trade to be profitable you need the movement in the underlying stock price, whether up or down, to be enough to cover the total of the premiums spent on the strategy. Basically, you need the underlying stock to move enough in either direction before the options expire to cover the premiums spent on this strategy to make a profit. Long Straddles lose money when the market fails to move enough to cover the premium of a straddle to be considered profitable.

Now if the price of the underlying moves either way but not enough to cover the premium, then this trade will lose a lower amount depending on how far the price is from the option strike price.

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Beyond the strike prices, the gain is unlimited and can occur in either scenario, whether the stock goes up or down.

The larger the movement in the underlying stock the more successful the straddle trade. So straddles need high volatility as you want the stock to move, in whatever direction, as long as it makes large moves. With long straddles, if the price of the stock doesn't move enough to cover the premiums, you will lose on the trade but if they make large movements, you will make good profits.

The *Greeks* play an important role in long straddles. When the price of the underlying stock moves in one direction, the option which is now deep In The Money has a high Delta while the other option which is Out of The Money has a low Delta. This is one of the main advantages of long straddles where the *Greeks* of the various legs of the option combine to reduce the overall risk of the position and enhance its return.

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For example, as the underlying stock goes deeper in the money, the Delta of the deep In The Money option is close to 1.0 where as the Delta of the Out of the Money option is low, perhaps close to 0.3, so as the price moves deeper in the money, the In The Money option is reflecting almost all the gain with a Delta close to 1 where as the Out of The Money option is not losing as much with a Delta of say 0.3.

So when you have no idea which way the market will move and you have volatility and are expecting a major rise and fall in the market of a particular stock, long straddles are particularly attractive.

Good times to engage in long straddle strategies is when you're looking for large movements in one direction after events and during times of high volatility, insecurity and unexpected news.

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Long Straddle tips:

i. Selecting the Stock:

- Study the trend of the stock you are buying and make sure there are no clear areas of resistance or support that are going to hinder the movement of the stock.

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