

 Wiley Trading

THE COMPLETE GUIDE TO

OPTION STRATEGIES

**Advanced and Basic Strategies
on Stocks, ETFs, Indexes,
and Stock Index Futures**

Michael D. Mullaney

The Complete Guide to Option Strategies

*Advanced and Basic Strategies on Stocks,
ETFs, Indexes, and Stock Indexes*

MICHAEL D. MULLANEY



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The Complete Guide to Option Strategies

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*To my wife, Sue, for her support, encouragement,
and guidance along the way.*

*To my daughter, Melissa, who has always made me proud and
continues to do so as she pursues her dream of becoming a
physician at Florida State University's medical school.*

*To my daughter, Michele, who is attending Emory University
and who always amazes me with her passion and
determination to excel.*

Preface

Why should you read a book on options? Rapid and severe declines in the stock market demonstrate that the buy and hold method of investing has a lot of risk and that traders need a different vehicle to control risk. Individuals who recognize and embrace the shift to a trader's market have the best chance to prosper, and the best trading vehicle available is options. Options can help you in volatile and unpredictable markets by enabling you to profit in numerous ways.

Options are probably the most versatile trading tool today. No other investment vehicle seems to have such a unique set of characteristics and flexibility. Options have become a popular tool for individuals and, fortunately, you do not have to work on the floor of an exchange to understand options. Trading options can empower an individual trader to move quickly in comparison to institutions, which must stay invested at all times with large and diversified portfolios.

Your chances of success increase if you have a game plan, establish goals, and understand how options move. Focusing on becoming a better trader to make money should be the main purpose of reading a book on options. I realize that a book on options can also be read for the enjoyment of learning the theory, mathematical applications, and technical jargon. (Who would not enjoy learning about the assumptions underlying options?) There is nothing wrong with tackling the intellectual challenges associated with learning, but our time is valuable, and it is more important to stay focused on how to become a better trader.

The Complete Guide to Option Strategies is intended to describe option principles in an understandable manner by starting with the basics, then moving up the educational ladder to the intermediate level, and finally to an advanced level. This book provides the tools that will allow you to prosper in many market conditions and enable you to trade options not only on stocks but also on exchange-traded funds (ETFs), stock indexes, and stock index futures. The content of these pages describes the option buying and selling strategies that you should know and would most likely be interested in using.

This book addresses simple and complex strategies by using hundreds of examples, tables, and graphs. Some option strategies are known to be difficult, but the examples, tables, and graphs add great clarity; as they say, a picture is worth a thousand words. The presentation means you have a comprehensive and step-by-step analysis of each strategy. The consistency of the examples is designed to make it easy for you to compare one strategy with another. I even decided to include a chapter on option terminology to

provide a framework with which you can view options so you can quickly analyze any option position at a glance.

A separate chapter is devoted to every main strategy. This book avoids shortcuts when describing strategies so it gives you full and complete understanding. As much as possible, each chapter stands on its own. Occasionally, of course, you may want to flip back and forth between chapters. This approach is intended to help you gain a thorough understanding of option strategies and make the book easier to follow. As a result of this approach, you will notice some repetition; however, this is intentional because it should help reinforce your knowledge of strategies and principles. The book uses similar language to describe variations of the same strategy, again, to make it easier to follow. The overall approach is to first show how a strategy can be executed from the approach of buying calls, then buying puts, followed by selling calls, and then selling puts. The typical strategy, therefore, approaches the strategy from four different perspectives.

Each strategy chapter (Chapters 7 to 22) is organized in a similar manner to make the chapters easier to read and to ease comparisons of one strategy with another. Chapters typically include opening remarks, an overview, a description of each variation of the strategy, and a comprehensive example of each strategy. After strategy examples, each chapter includes a section called “Beyond the Basics” and concludes with a section called “Final Thoughts.”

HOW TO USE THIS BOOK

The Complete Guide to Option Strategies is intended to be a reference book, although it also can be read from cover to cover. If you are very familiar with basic concepts, you can simply skip chapters and go directly to the discussion that you are looking for.

The book begins with the basics and, in the process, describes hundreds of options terms, most accompanied by an example. It then covers more fundamentals, such as option pricing, the Greeks, buying versus selling, and terminology.

It takes the approach that basic option strategies can be broken down into buying a call, buying a put, selling a call, and selling a put. Once you understand this framework, you should be able to comprehend any option strategy at a glance. A separate chapter is devoted to each of the four basic option strategies before moving forward to more complex strategies in later chapters. Each basic strategy is analyzed from different perspectives; for example, the chapter on a call option provides a description of the strategy and comprehensive examples at strike prices of 90, 95, 100, 105, and 110. Likewise, the chapter on a put option provides a description of the strategy and comprehensive examples at the same strike prices. Spread strategies are covered in later chapters. After considering the different variations in strategies, this book covers hundreds of option strategies.

After the strategy chapters, a comparison of options on stocks, ETFs, stock indexes, and stock index futures is presented. The final part of the book covers advanced topics,

such as volatility, exercise and assignment, risk management, margin, and taxes. *The Complete Guide to Option Strategies* is divided into the following five parts:

Part One: Learning the Fundamentals

Chapters 1 to 6 describe option basics in depth. Part One includes Chapter 1, “Getting Ready to Trade”; Chapter 2, “Option Fundamentals”; Chapter 3, “What Determines an Option’s Price?”; Chapter 4, “Tools of the Trade—Greeks”; Chapter 5, “Buying versus Selling”; and Chapter 6, “Understanding Spread Terminology.”

Part Two: The Four Basic Option Strategies

Chapters 7 to 10 cover the four basic strategies. Part Two includes Chapter 7, “Long Call”; Chapter 8, “Long Put”; Chapter 9, “Short Call”; and Chapter 10, “Short Put.”

Part Three: Spread Strategies

Chapters 11 to 22 cover spread strategies. Part Three includes Chapter 11, “Vertical Spread”; Chapter 12, “Iron Condor”; Chapter 13, “Unbalanced Spreads”; Chapter 14, “Straddle and Strangle”; Chapter 15, “Butterfly Spread”; Chapter 16, “Condor Spread”; Chapter 17, “Calendar Spread”; Chapter 18, “Diagonal Spread”; Chapter 19, “Covered Call”; Chapter 20, “Combination”; Chapter 21, “Collar”; and Chapter 22, “Covered Combination.”

Part Four: Comparing Underlying Instruments

Chapters 23 to 26 examine the differences in trading options on different underlying instruments. Part Four includes Chapter 23, “Comparing Stocks, ETFs, Indexes, and Stock Index Futures”; Chapter 24, “ETF Options”; Chapter 25, “Stock Index Options”; and Chapter 26, “Stock Index Futures Options.”

Part Five: Advanced Topics

The final part of this book (Chapters 27 to 32) covers advanced topics. Part Five includes Chapter 27, “Assessing Volatility”; Chapter 28, “Exercise and Assignment”; Chapter 29, “Risk Management”; Chapter 30, “Margin”; Chapter 31, “Placing an Order”; and Chapter 32, “Taxation of Options.”

Appendixes A, B, and C

Appendix A covers ETF option strategies, Appendix B covers index option strategies, and Appendix C covers stock index futures option strategies. At a glance, the strategies included in the appendixes illustrate many of the strategies covered throughout this book.

A glossary with approximately 200 definitions is included as a reference tool that can be used before, during, and after your reading of the book. A comprehensive index is provided to assist you in finding key topics and definitions.

From what I can tell, the Greeks seem to scare new (and some experienced) traders. The Greeks are tools that tell you how option values are expected to change based on certain assumptions. The Greeks are addressed step-by-step throughout this book, in case you are interested in advanced principles. However, you do not need to be an expert

in the Greeks to trade many option strategies. You should not let specialized options terminology scare or intimidate you from becoming an outstanding option trader.

This book explains the option terms you need to know because the option industry has its own language. For simplicity, most of the discussions and examples in this book refer to options on stocks, but the principles and strategies can be applied equally to ETFs, indexes, and stock index futures. For the most part, I use the word *stock* to mean any underlying instrument, such as a stock, ETF, index, or stock index futures. Continually using the phrase *underlying instrument* can be cumbersome and confusing because most traders do not use the phrase very often. The word *stock* is simple and to the point. I contemplated using the word *security*, but it seems legalistic. So, let us just call it “stock,” among friends. I realize that there are important differences in underlying instruments (primarily relating to the size of contracts, exercise, margin), and that is why an entire part of this book is devoted to explaining how each works.

Examples Are Consistent

To make it easy to compare one strategy with another, examples are presented in a consistent format from chapter to chapter. Each example assumes that XYZ stock (a hypothetical stock) is initially trading at \$100 a share and then shows the gain or loss from each strategy, at the expiration date of the option, assuming that the stock is at \$75 to \$125, in five-point increments.

Before engaging in any option transaction, you should determine your maximum gain, maximum loss, break-even point, and probabilities of success. It is useful to back test option strategies, like you would other strategies. With options, however, you should learn how to forward test strategies by making assumptions about a range of possible outcomes in the future. In this book, the comprehensive examples show a wide range of possible outcomes. A table and chart both show the gain or loss. After you examine the table, you get a chance to graphically see the gain and loss pattern on a chart. It does not get any better than this.

Examples assume an initial XYZ stock price of \$100 a share, consistent option pricing for both puts and calls, rounded option prices, the same entry date for the trade, and the same expiration date so that you can focus on the principles that need to be understood without having to deal with the confusion associated with changing facts. The use of \$100 a share and the same entry date of the trade should make it easier to see how options move.

The prices on the profit and loss graphs are consistent from example to example and from chapter to chapter to make them easier to follow. After the graph, each example includes hypothetical Greeks, the effects of later expiration, and exercise and assignment. The consistency of the examples is designed to make things easy for you to compare one strategy with another.

Putting It All Together

You do not need to become an expert on each strategy, but learning multiple strategies will enable you to choose which strategy or strategies are best for you. You should refer

to Appendixes A, B, and C and examine the strategies at a glance because they illustrate many of the strategies covered throughout this book and are presented according to whether they are primarily bullish, bearish, profit inside a trading range, or profit outside a trading range.

There are risks associated with buying and selling options because there is no free lunch (or any other free meal, for that matter). Personally, I prefer to sell options instead of buying them. In some respects, selling options is like eating chocolates: Once you get a taste of it, you will want more. In fact, I have gained a few pounds since I began selling options.

New Option Traders

The book provides all of the definitions and fundamentals of options that you need. However, it is helpful to actually trade options to more easily understand the principles.

Some individuals to whom I have talked are afraid to try trading options because they are confused or intimidated by the complexity of strategies and option terminology, especially the Greeks. A great way to overcome such concerns is to open an account at a brokerage firm and trade in a practice account (also called paper trading or simulated trading). This way, you can practice buying and selling options without the fear of losing money. If simulated trading is not available at your broker, you can trade one option at a time, making sure that the amount of money you are paying is small and that you have limited risk. It is certainly understandable how difficult option strategies can appear without actually having the benefit and experience of executing some trades.

PREPARATION IS THE KEY

In some cases, traders do not fully understand the risks of trading and the probabilities of success and are forced to spend a great deal of time and effort (and money) cleaning up the mess. They seem to be relying on the Will Rogers risk management strategy: "If stupidity got us into this mess, then why can't it get us out?" No investment strategy is risk-free, but the risk-reward profile of options can be attractive if you understand what you are doing. Risk management strategies are described throughout this book, and an entire chapter is devoted to this important topic.

As you can tell, I am very excited about the opportunities in option trading. My intention is to provide a great tool to help you elevate your trading to the next level and, therefore, help you trade options with confidence. This book is written from the perspective of how an individual trader can make money by trading options. After reading this book, you should have an understanding of the power of options. Let us get started.

MICHAEL D. MULLANEY

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M. D. M.

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