

>: Why You Must Start Trading Options Now

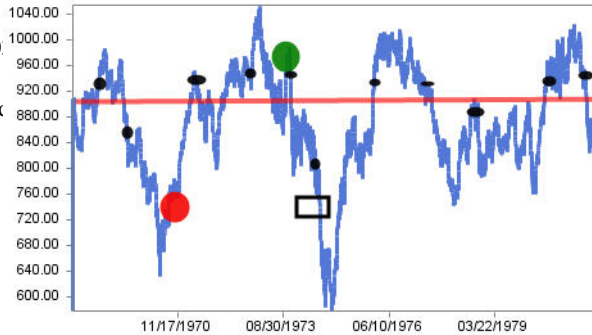
Tuesday, December 23, 2008 / Chris Rowe

Options are the greatest way possible to invest in the stock market. There are a number of reasons why. (My favorite happens to be the fact that you can dramatically decrease risk without decreasing potential reward). Today I'll go over a couple of big ones...

If you know anyone who knows, for sure, what's going to happen to this market next, please shoot me an e-mail and I'll bankroll the rest of your life. But one thing that's very possible is, while the economy is working out some very serious long-term problems, the stock market will reflect that process. That means while the market might have sharp spikes higher, and sharp spikes lower, the market just might end up in the same long-term range for a decade.

Does that sound unrealistic? Perhaps 200

Check out this chart of the Dow Jones Inc



imes.

Now, I'm not making that call today, but I'm saying it's definitely possible, especially given the current economic circumstances, and I'm sure many of you agree with me. The next question becomes: Does that matter to me? The answer is simply NO. Trading stock option contracts, it's possible to make money by trading "direction", "fear" ("implied volatility"), or both.

For example: In the chart above, you can imagine (and many of you can remember) how fearful investors were in 1970 after the Dow declined by about 35% and bounced up to the red dot. Using options in a situation like this, you can profit in two ways:

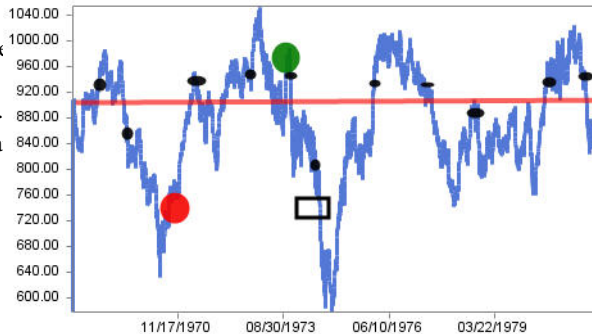
1. By betting on the market trading higher.
2. By betting the amount of fear in the market will decline.

The strategy you would use in this case would either be [selling naked puts](#), or selling a [vertical put spread](#).

Typically, the two things will happen at the same time (a reduction in fear when the market moves higher). But what if the market traded sideways for a period of time instead of moving higher? What would likely happen in that case is the fear in the market would still decline, which means you would have generated a profit even when

You would do the opposite in 1973 wher

1. By betting on the market trading lower.
2. By betting the amount of fear in the ma



:an profit in two ways:

Typically, the two things will happen at the same time (the market moves lower while fear increases). You can see on the chart that the market

dropped by 40% relatively fast. That would cause a double whammy for people who owned put options. They would become more expensive as the market traded lower, but since it happened so fast, the fear level in the market absolutely exploded!

What if the fear level didn't explode? If the market just gradually lost value, you would profit because you were right about the direction.

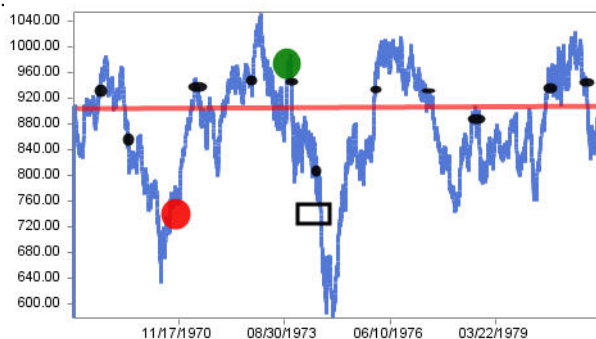
What's amazing about options is it doesn't have to be a 50% bet on direction and a 50% bet on fear. Depending on the option you choose to trade (in this case, the put option you decide to buy) you can bet more on the direction and less on fear or vice-versa. If you want to bet more on the "directional play" you would do what I like to do: [buy deep in-the-money puts](#).

On the flip side, what if you were betting the market would move *higher* by buying call options. Well the smartest way to make that bet is to buy deep in-the-money call options. But if you made that bet at the green dot on the chart, you would probably have lost money. However, since fear increases when the market declines, your "ITM call option" would decline, but by a lesser amount than the underlying stock would.

If a stock declined by 5 points and you owned 1,000 shares, then you would lose \$5,000.00. But if, instead of buying 1,000 shares, you bought 10 call options (representing 1,000 shares) you would probably only lose 3.5 or possibly 4 points. Why did the option trade down by so much less? Because options become more expensive when the level of fear increases.

I'll give you another reason why options are the greatest tool for investing. You can use them in conjunction with your current stock holdings. If the market trades sideways, causing most of

take a fortune [by selling covered calls on the stock](#)



See the little black dots? Your timing doesn't have to be absolutely perfect. But if you [sell covered calls](#) on the positions when you think the market is a bit too high, you will continue to collect income on your positions. This way, even if the market trades about 13 years without making even 1% (like it did from 1968 - 1981), you can still profit from your stock positions. In fact, by selling covered calls each month or even every other month, you can make a killing!

One last reason I think options are the greatest tool on earth and then I have to go. What if you have cash on the sidelines and you think it's the greatest time to buy the stock market because it has sold off enormously? You've always heard about how dangerous it is to try to "catch a falling dagger". On the other hand, you know the best times to buy, historically, is when everyone was fearful and nobody thought it would trade up. What do you do?

Do you see the black rectangle on the chart? That's about where you would be thinking about this.

Remember, using options you can trade both direction and fear. When fear is at its highest, options on the stock market are at the most expensive prices. That means it would be a great time to [sell naked puts](#) as I mentioned before. That just means, instead of you just going out there and buying the stock, someone out there is paying you for the right to sell you the stock.

For example, if you bought stock in "Chris' doughnut shop Inc." at \$40.00 and the market declined by 20%, knocking the stock down to about \$32.00, you would be pretty upset. But if, instead, you sold naked puts, you might have had someone pay you \$5.00 for the right to sell you stock in Chris' doughnut shop at \$40.00.

Do the math:

Sold naked puts and received \$5.00
Stock declined and you bought it at \$40.00
Your cost basis is now \$35.00.

Even if the stock was down at \$32.00, you would feel pretty smart, and if you want to, you could sell covered calls on the stock and start collecting more money immediately, or after the stock traded up a bit more.

With this strategy, even if the stock traded flat you would be profitable by \$5.00/share. (Each option represents 100 shares.) Heck, if the stock

traded up by \$2.00, you would be up by \$5.00! My point is, even when the market is incredibly boring, you can make it incredibly exciting without increasing your risk levels, but reducing them.

I guess I'm making a case for options, and I'm also making the case for trading. The "buy and hold" approach isn't always the right way to play, as we can see in the 1968 - 1981 chart of the Dow. You'll be pretty upset if you just hunker down for 5 or 10 years, watching the market trade up and down 50%, only to end up right back to where it started from. (Ask anyone who bought and held from 68 - 81, or from 2003 - NOW!)

?Profit from the Trend?



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