



>: Want to Increase Your Odds of Success - Enormously?

Tuesday, February 19, 2008 / Chris Rowe

I recently wrote an article for you about [selling naked puts](#). It was a big hit because it's perfect for this kind of market.

This strategy holds a bit less risk than just buying a stock as it reduces the cost basis of the stock (on a short-term trade). We accept that there is a cap on the upside potential in exchange for a strategy that is more likely to end up profitable than the outright stock ownership.

I was talking about the article with a friend of mine Bob Jones (that's really his name), who read it and asked me if there is a way to increase the potential profit vs. loss ratio.

Bob: "Chris, on one hand, I like having better odds of success because I know I can profit from naked puts if the stock trades up, sideways or even slightly lower."

(This is true because since we're essentially selling short the naked put option, we profit when the put option loses its value as a result of time passing.)

"But on the other hand, if the stock doubles in price, I will only make the amount that someone has paid me when I sell that put option so the profit is limited. It seems like selling naked puts is actually risky when you consider the reward."

Me: "First of all, the risk versus the reward makes sense when you consider the fact that odds of success increase. And it's not a risky strategy, but maybe it's just not exactly what you're looking for. Consider the fact that I just heard from a very reliable source that the world's largest options trader is a guy by the name of Warren Buffett. In case you've never heard of him, he's been jumping in and out of first place on the Forbes 400 richest people list for decades. But he certainly isn't a speculator. He's a value investor, and not a guy who I'd consider a "risky" player.?"

Bob: "I know the margin requirement for a put spread is only about 20% (1/5) of the underlying stock position, so I can sell 5 times as many put options so at least I can profit a lot more that way if the stock trades flat or up. But that opens me up to 5 times the downside risk! What do you suggest?"

Me: "I suggest that you read the Tycoon Report on Tuesday and I'll write an article about the "vertical put spread" since I can't legally give you individualized investment advice.

Bob: "No, seriously."

Me: "No... Seriously."

Quick review on selling NAKED puts:

Stock Trader buys 100 shares of OIH (an oil service ETF) at \$170.00:

- Requirement: \$17,000.00 cash or \$8,500.00 on margin
- Maximum upside potential: Infinite
- Downside risk: \$17,000.00
- Break-even price: \$170

Seller of 1 naked put option (which obligates the trader to buy 100 shares of OIH at the strike price):

OIH is currently at \$170.

In this example, we will use the March 170 put option trading at \$7.00. By selling 1, we are saying we are willing to buy 100 shares of OIH at \$170.00 upon request before March 22, 2008 when the option expires. In exchange for the put option contract that we are selling, we get \$700.00.

- Requirement: Strike price X 100 shares - premium received (\$17,000.00 - \$700.00 = \$16,300.00) in a non-margin account. However this is typically done in a margin account with a 20% requirement. (0.20 X 16,300 = \$3,260 cash outlay.)

NOTE: Be sure to check with your brokers about their specific margin requirements before doing this or any strategy for the first time.

- Maximum Upside Potential: There are two possibilities. The upside if the person *whpurchased* the March 170 put does NOT exercise the put option (because OIH moved much higher making it pointless to exercise) is the 7 point (\$700.00) premium received for the put option that we sold. The upside if the *purchased* the March 170 put DOES exercise the put option is infinite (because you'd then actually own 100 shares of OIH).

- Downside risk: Strike Price X 100 shares - premium received (\$17,000.00 - \$700.00 = \$16,300.)
- Break-even point: \$163.

BACK TO BOB

Remember, Bob said that he could increase his reward tremendously, but he also brought up the excellent point that he would then be increasing his risk.

What he is saying, using our OIH example, is the margin requirement is \$3,260.00 with a \$700.00 upside. And he's acknowledging that instead of buying 100 shares of OIH which requires \$17,000.00 (or \$8,500 on margin), and instead of selling the naked puts which requires \$3,260.00, he can take about \$16,300.00 and sell 5 times as many put options which will bring in \$3,500.00 in premium (\$700.00 X 5). At the same time, he realizes even though his break-even point is still \$163.00, he would be losing \$500.00 (instead of \$100.00) for every point that the stock trades below \$163.00.

His concern here is if the stock or ETF that he sold naked puts on trades down by a large amount (e.g.: if it lost 50% in a day), he would lose 5 times more than he would have lost past his break-even point. But he likes the concept of the high probability bet so he's tempted to use the high leverage.

Here's my answer to you Bob...

I know you like the concept of profiting from time decay (deterioration of the price of an option due to time passing) of the option that you sold. If your focus is to profit from a security by staying above your break-even point with either little or no downside movement (as opposed to your focus being on trying to actually buying the stock), then you should try selling vertical put spreads.

With a vertical put spread, you are basically doing the same thing that you would do in a naked put, except you are ALSO buying insurance on the position by purchasing another put with a lower strike price. The margin requirement is the difference between the two strike prices.

So let's go back to our OIH example using March 170 put options.

When we enter a spread, we enter two "legs" of the trade at the same time (which is technically entering two trades simultaneously).

Here are three examples, because there are a few different ways to profit: