6 WAYS TO GENERATE INCOME USING OPTIONS

MARKET TAKER MENTORING, INC.

Dan Passarelli

MarketTaker.com
6 Ways to Generate Income Using Options

Maybe you’ve heard people say that 90% of traders lose money. Well, I have some bad news for you... It’s true! However, I have some good news too. I have trained lots of traders to generate consistent income using options. And I can train you too.

I’m Dan Passarelli, founder of Market Taker Mentoring, Inc. I spent years trading on the CBOE trading floor grinding out consistent profits day after day, week after week and month after month. In this eBook, I’m going to show you 6 ways YOU can generate income with options.

The 6 Ways to Generate Consistent Income Using Options

The term “income” means something specific in options lingo that is different than the common context of the word. “Income” option strategies are option strategies that are high-probability trades, which benefit from time passing. As time passes, options slowly lose value, all other price influences held constant. This phenomenon is called “time decay”. Taking advantage of time decay is at the heart of income strategies.

The market is always changing, so just knowing one such income trading technique is not going to work if you want to be successful in the long run. There are lots of different income strategies; but these 6 strategies are the simplest and most common...
1. Covered Call

A covered call is a simple “stock overlay” investment strategy. An investor who owns a stock—usually as part of a long-term investment strategy—sells (short) an out-of-the-money call. This call has a strike price above the current stock price and has no intrinsic value—only time value. That is important because an option’s time value is 100% subject to time decay. Again, time decay is what makes all these income strategies work and favor the trader.

Imagine you own 100 shares of Yahoo! (YHOO)*, which is trading around $33. You think the stock will remain fairly stable over the next several weeks—not rising much and not falling much. Question: How are you supposed to make money holding this stock?

A covered call could be the answer. A trader can establish a covered call by selling a call with an out-of-the-money strike price, say the May 36 call for $1.

Now, imagine the trader holds the call until the expiration date (5 weeks away in this example). In this scenario, as long as the stock doesn’t rise above $36 a share (around 9%) the call expires and the $1 remains the trader’s to keep. That means the trader makes $1 just for holding the stock. This trader might make or lose some on the stock rising or falling, but the $1 option premium is a profit. As long as the stock doesn’t fall more than $1, the trade is a winner. If it falls more than $1, the trade is a loser, but it loses $1 less than it would have without the call. If the stock rises above the $36 strike, the call gets assigned and the stock is sold at $36—also a winning trade.
2. Call Credit Spread

The call credit spread is similar to the covered call in some ways. The difference is that there is no stock involved—only options. And in addition to the short call, the trader buys a higher-strike call to create a “spread”.

For example, imagine Facebook (FB) is trading around $56. A trader thinks it won’t rise above $65 a share over the next month. So, the trader sells a May 65-70 call credit spread for $0.90. That means, the trader sells the May 65 calls and buys the May 70 calls. Like the covered call, if the trader is still holding the option position at expiration and the stock is below the short-call’s strike price the options expire and the trader keeps the entire option premium. That would be a $0.90 profit—or, $90 of actual cash for a 1-lot spread.

If FB stock falls, even significantly, the trade is a winner, as the options will still expire and the trader has no long stock to worry about. Only if the stock rises above the $65 strike price can the trade start to potentially lose. That would require a 16% rise in a 5-week period. For this reason, credit spreads are high-probability trades. Here, if the stock falls, the trade is a winner; stock stays stable, trade’s a winner; stock rises up to 16%, it’s a winner. Only if the stock makes a very large move to the upside, can the trader lose.
3. Put Credit Spread

The put credit spread is the close cousin to the call credit spread. Here, a trader sells an out-of-the-money put (with a strike price lower than the current stock price) and buys a lower-strike put in the same expiration month.

Here, imagine GM is trading around $34. But in this case, the trader thinks the stock won’t fall much. So the trader sells the May 30-32 put credit spread for $0.30. So, here the trader sells the May 32 puts and buys the 30 puts. Similar to the last two examples, as long as the options remain out-of-the-money until expiration, the option premium ends up as all profit. But, here that requires the stock to not fall below $32. It can rise. It can stay steady. It can fall as much as $2. Again, a high-probability trade, as many outcomes lead to profit. The only outcome that leads to loss is the stock making an exaggerated move to the downside.
4. Iron Condor

The iron condor may sound intimidating to the novice trader. But in fact, it is rather simple. It's simple, that is, if you understand call credit spreads and put credit spreads. An iron condor is simply a combination of those two aforementioned income strategies. Because it combines the two spreads—call credit spread and put credit spread—it combines the essence of both. First, it is noted that because the trader sells two spreads, the trader gets double option premium. That means greater profit potential. But that also means if the market rises too much OR falls too much the trade can run into trouble.

This time we'll look at U.S. Steel (X). Let's say the trader has a neutral bias. With the stock around $27 a share, the trader thinks it won't rise above $29 or fall below $24. That's a $5 range on a $27 stock (or 18.5%) in which it must remain in this 5-week period—pretty realistic expectations.

So, the trader can sell the May 29-31 call spread at 0.41 \textit{AND} sell the May 22-24 put spread at 0.26. That is a combined option premium of 0.67 for this May 22-24-29-31 iron condor.

It works like this: As long as U.S. Steel, in this example, remains between $24 and $29 through May expiration, the $0.67 premium (or $67 of cash for one spread) represents all profit. This, again, is a high-probability trade in and of itself. Only if the stock breaks out of a rather large range does the trade fail and lose money.
5. Iron Butterfly

No. Not the 70s rock band. It’s a classic income spread that is nearly as simple to use as the iron condor. This trade again is a combination of a call credit spread and a put credit spread. But the only difference between this and the iron condor is that the short put and short call share the same strike.

It’s common for iron butterflies to be shorter-term trades because of the little amount of premium left in the “wings” or the long, out-of-the-money options. So, for this example, we’ll use a 10-day trade in General Electric (GE).

With GE at $25.90, the trader will trade the serial weekly options that expire in 12 days. The trader sells the 25-26-27 iron butterfly by selling the weekly 25-26 put spread AND the 26-27 call spread, collecting a total of $0.44.

This trade needs just a bit more analysis than the iron condor. In this case, the trader wants to focus on the “break evens” of the spread. Here, the $0.44 option premium provides a buffer. As long as GE, in this example, stays within $0.44 of the middle (short) strike, the trade is a winner. So, it can’t fall below $25.56 or rise above $26.44. This $0.88 range is much tighter than the previous example, but there is much less time until expiration and GE is a much more stable stock.
6. Time Spread

The time spread is more complex than the previous 5 strategies. But it is the most powerful in that clever traders can use volatility analysis to get “edge” on this trade to really stack the odds in their favor:

In its most basic form, the time spread is when a trader buys a call and sells another call with the same strike price but with less time until expiration. Instead of both calls, the trader can also execute this strategy using both puts to the same effect.

Time spreads are also often crafted to be neutral-market strategies, like the iron condor or iron butterfly. Time spreads can be constructed with longer-term months, or even weeklys.

Here’s an example in Target Corp. (TGT). The stock is at $60.50. In the weeklys, the trader buys the May 2nd 61 calls for $0.83 and sells the April 25th 61 calls for $0.64, paying a net debit of $0.19. One great advantage of time spreads is that the trader only risks the initial premium paid, in this case $0.19, or $19, but the trader can potentially have a leveraged profit.
Good luck in your trading,

Dan Passarelli
President, Market Taker Mentoring

**Dan Passarelli** is an author, trader and former member of the Chicago Board Options Exchange (CBOE) and CME Group. Dan has written two books on options trading — “Trading Option Greeks” and “The Market Taker’s Edge.” He is also the founder and CEO of Market Taker Mentoring, Inc., a leading options education firm that provides online options education, options newsletters and personalized, one-on-one coaching for option traders.

Dan began his trading career on the floor of the CBOE as an equity options market maker. He also traded agricultural options and futures on the floor of the Chicago Board of Trade (now part of CME Group).

In 2005 Dan joined CBOE’s Options Institute and began teaching both basic and advanced trading concepts to retail traders, brokers, institutional traders, financial planners and advisors, money managers, and market makers. In addition to his work with the CBOE, he has taught options strategies at the Options Industry Council (OIC), the International Securities Exchange (ISE), CME Group, the Philadelphia Stock Exchange and many leading options-based brokerage firms. Dan also contributes to financial media such as TheStreet.com, FOX Business News, Bloomberg Television, BNN, Public Radio (NPR), and the CBOE blog. And he has a weekly featured video on CBOETV.

* All examples used in this eBook are hypothetical and for educational purposes only. Prices are not current.

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