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Top 10 Fixed Return Option Trading Stratergies


TOP 10
FIXED RETURN
OPTION TRADING
STRATERGIES
BY AN INSTITUTIONAL TRADER

Top 10 Fixed Return Option Trading Strategies

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Stratergy 1 : Selling Naked Options

Avoiding Losses

I don't usually sell naked options anymore. I used to do it long back, when I used to think I am very smart. A beginners luck may have done it. I did made a decent profit in the first two trades, but then next four were big losses and I have almost stopped selling naked options.

Yes I still sell naked Nifty options – but on principals and strict stop loss and only when markets give me an opportunity. This is mostly done when the expiry is very near and there is a decent chance for that option to expire worthless. Frankly even then I do not wait till expiry. I close the position early and am happy taking a small profit or loss as the case may be. Waiting to eat the last few nickels and dime of a soon to be worthless option may give a great kick when that actually happens – but I am better off taking the risk. If something goes wrong even in that last few hours – an option that was profitable a few hours ago may become very costly to buy back.

Update on 16-Oct-2014: I don't do this anymore as I feel the risk is not worth the reward.

When does one becomes option seller?

Well most of the option traders start by buying options. Well when they learn that buying options is not making money for them they start selling. 🙂

Unfortunately whether buy or sell, 95% of traders lose money.

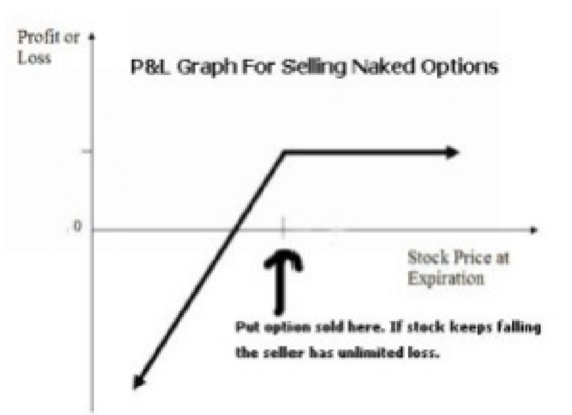
For those who don't know, selling naked options means you take unlimited losses for limited profits. (Though frankly I hate the words "unlimited loss". Unlimited loss is only on paper. Do you think an option seller is a fool to take unlimited loss? Then why would they sell options in the first place? There are ways to limit losses when a position goes against a seller. Unlimited losses only unnecessarily glorifies the cons of selling options. Furthermore I would say that option buyers face more losses than option sellers. Frankly selling or buying does not matter as long as you are you are hedging your position.)

Ok enough of talking, lets take an example of naked selling. If you think Nifty will close above 5500 this month you can sell the 5500 put options for the current month or even the next month to collect more premium. If nifty actually closes above 5500 you keep the premium else you pay for the losses.

Can you predict the markets? No one can. So why do people sell naked options? They sell when they are absolutely sure that the option they sell will expire worthless. But it ain't easy, if it were everybody would have sold options and be rich!!!

Moreover its true that you cannot predict where the markets will go, but you can to some extend predict where the markets will NOT go!!! Sell your naked options there.

Here is the profit and loss graph of naked option selling:



Note: Technically naked put option selling in NOT unlimited loss. Why? Because the stock can fall upto zero. It cannot fall further. You can easily calculate your maximum loss when selling naked puts. However selling uncovered or naked call options involves real unlimited loss. Because the stock can rise to an unlimited level which you can never figure out. Therefore in the US most retail traders sell put options more than the call option. That does not mean you should start selling uncovered or naked puts because you can still face huge loses.

Here are some things you should

keep in mind when you sell naked options:

Disclaimer: Naked option selling is very risky. These are some ideas I have developed while actually trading naked options or by doing some research. If you want to sell it naked please keep the following in mind and do virtual trading for at least 3 months before putting your money on the line.

So lets go:

1. When selling naked sell only deep out of the money (OTM) options possibly with options that have deltas =< .1. For example if Nifty is around 5700 – sell 6200 call option or 5200 put option, or both. This will give you a good chance of winning. After all what are the chances that Nifty will go 500+/- (almost 10% up or down) in the same series. Yes you make less profit but the chances of making a profit are more. **2.** If in doubt take more time. That is sell the next-month options not the near month as if anything goes wrong – Nifty opens gap up or gap down heavily, you will have enough time to give Nifty come back to a comfortable level to buy back your options at a profit.

3. Or if there is very less time and you are getting good premium (this happens when the volatility is very high), you can sell the options to make a quick buck in very less time. Say 2-3% in a few trading sessions.

4. You must have a strategy whenever you are trading options. Whether you are buying or selling. You must have calculated your profit and loss. That is if a position is going against you, what exactly you need to do. There are two things you can do then, either buy insurance or just exit the position. The choice is yours, but you have to limit your losses. If you are able to limit losses you will survive in your trading business. The problem is when an underlying opens gap up or down with a huge percentage. If your prediction was right you can buy back your options at a profit, however you can lose a lot when it is against your view. Therefore hedging is important.

IMP NOTE: Buying insurance when needed may be very costly, but at least it will limit your losses from that point. However if the movement continues in the same direction for sometime, the losses will be severely restricted. Unfortunately a whipsaw or market reversal will become costly as the insurance options you bought may start to lose money. It could be that out of frustration you close both your original trade and the insurance trade for a loss. Worst situation to be in.

Therefore even if you are 100% sure the option will expire worthless – do buy some protection using the cash you got when you sold it. Maybe 25% of it.

Spend it on buying cheaper calls or puts. At least you will be wearing your underwear. 🙂

5. Also you must be having strict stop loss in your system. If your target was to make 100 points you should exit when you are making a loss of 50 or less points. Losses can escalate very fast, so you should be ready to quit if the market goes against you badly.

6. During the life of the options you sold, you should watch them like an owl. Never let go your OTM option in-the-money. Take action quick.

7. Don’t get emotional when the market makes a move against you. Emotion is your biggest enemy. I have done it several times and almost always have lost. If you are emotional, you will keep delaying taking a stop-loss and markets will not work in your favor. You will only suffer more losses. You should make sure you don’t lose too much capital, else just 2 big losses will take you out of the game forever. **Hoping that the markets will reverse in your favor is not a good strategy.**

Important Note: Even though you may think you are smart and can make huge returns with selling naked options, I highly recommend you don’t do it. Think about this – your profits are limited and losses unlimited. If you make profits 10 times, one huge loss can take away all that profits plus some more and you don’t want to be in that situation, do you?

Let me take an example of myself. In 30-days time markets tanked 10%. I sold two lots of puts thinking markets usually change trends after a 10% move and my puts will expire worthless. As you can easily guess I got good premium for the puts as the markets were down. Well I was not wrong. However the next day Nifty went down another 2.5%. My stop-loss got violated. Exactly almost from that point Nifty reversed – and that too 10%. 🙁 My puts expired worthless but not before making losses for me. What do you learn from this? That even if you are right in your judgment, sometimes we don’t have that patience to wait and watch while accumulating losses. **Stop-loss can sometimes be your friend or be your enemy – the problem is you don’t know**.

Therefore if there is something you don’t know, then its better to hedge that position. In my trading course you will know how to hedge your positions and trade peacefully. Most of the times you win, but when you lose you will see that the great hedge will save you.

Had I bought some OTM puts of lower strikes with half of the money I received as premium, I would have had the courage to let it go few points down and eventually made a profit or at least made less loss. Had I left because of the hedge, though small – I would have made a profit.

This tells you – no matter what you must not sell naked options. You must always [hedge your position] by buying calls/puts of different strikes.

I know a lot of you sell naked options on Nifty and Stocks. What you do when the stock starts moving against the option sold? Do you take a stop-loss? Do you panic and leave everything to the almighty?

Praying to Gods for help when the markets are going against your sold option is entirely different topic which cannot be discussed here. What if God comes from heavens and asks why you did not take stop loss when the position was manageable? You know what your answer will be – **GREED!!!** 🙂 Why should Gods help you if you are greedy – almost all traders are. How can he help everyone?

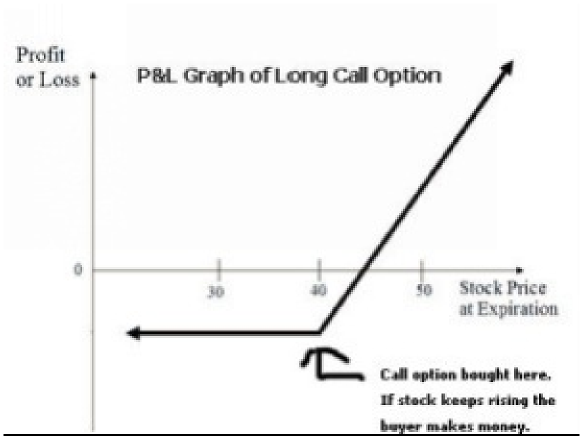
What exactly do you do when your naked shorted options goes in the money? If someone is facing this situation right now please ask in the comments section. I will try to help.

Please stop selling naked options. [Learn conservative trading today].

Chapter 2: The Long Call Option Bullish Strategy

Long call is a bullish strategy. This is a very simple and straight forward strategy. This strategy is followed by most option traders all over the world even in India.

Long call (or long put) are both highly favored by traders because it can produce jackpot profits. Limited loss is involved – that is limited to money paid to buy the option, but the trader if right can make unlimited profits. Here is the graph of the long call:



Note: This does not mean a trader always make unlimited profits buying options. In fact most option buyers lose money. The reason is the lure of hitting the jackpot one day. Unfortunately that unlimited profits never comes and in the dream of getting those profits traders keeps losing money for years but they still believe that one day one option will recover all there losses. This NEVER happens. Here is an example of a trader losing 40 lakhs buying options.

Ok, coming back to the topic. Let me discuss in a simple way. Suppose you feel a stock ABC Ltd will go up in next 2-3 months, what do you do? You simply advice your broker to buy that stock. If it goes up as you guessed, you sell it and make money. However if the stock doesn’t go up, you wait until it goes up to sell.

If your view in Nifty is the same – that it will go up, what can you do? There are no shares of Nifty floating in the stock markets. So you have two options. Either buy futures of Nifty or buy calls. Well both have their pros and cons.

If you buy futures you are taking unlimited risk. For example if you buy nifty futures when nifty is at 5500 and if your view is wrong and nifty starts going down, you will panic and sell the future at a loss only to see that your view was right and nifty started climbing up again.

What I want to say is this, buying futures will not give you the confidence to stay in the game for long. With futures you need extra-ordinary timing. Nifty should go up from the point you bought the future else you may panic. How many times can you time the markets? You will lose 8 times out of 10 for sure.

However what if you buy a 5500 call? Lets suppose the current month 5500 call is at 100, which means you only pay 100*50 = Rs. 5000 to buy a call. So your maximum risk is Rs. 5000. Does that give you some confidence? Of course it does. Now even if nifty is going down, you can wait as you know the maximum you will lose is Rs. 5000. In fact if you have decided that you will take a max loss of 2000 in this strategy – this will give you even more confidence. For you to lose Rs. 2000, the 5500 call should reach 60 – a 40% decline. For that Nifty may have to go 80 points down for you to take a stop loss. If your view was right, it actually may not go down till there, from some point it will start the upwards journey.

In the above example had you taken a future you would have taken a loss of Rs. 4000 (80*50) – double compared to call option. But still many traders prefer futures. You must be thinking why? Its just because if the risk is less in options, even the rewards are less.

Lets take the above example. Lets suppose you bought one lot of futures and one lot of call option at Rs. 100 when nifty was at 5500. Lets also suppose you were right and within 2-3 trading sessions nifty went up 100 points. In futures you profit stands at: 5600-5500 = 100*50 = Rs. 5000.00. And you profit in the call option? The call would have grown by only 50 points or slightly more/less. Why? This is due to delta. Delta is value that decides how much an option will gain in value if nifty gains 1 point. Delta works differently with different strike prices. Lets not get into further details of delta except that it effects the way option prices increases or decreases with the underlying.

So your gain would have been 50*50 = 2500.00. Not fair? No it is, if your risk is less, why should you gain more than your risk?

I would advise, buy options if you feel markets will go up. Be ready to take a stop loss at a point where you are comfortable. Most traders keep a 20-10 strict rule. That is a **20% profit and 10% stop loss**. However you can have your own rules. With this rule if you are right even 50% of the times, you will be in profit.

Another important thing that I want to mention is that **do not take your options to the expiry.** Its very risky. **If your are taking a profit, just sell the option and be happy.** You will not go broke booking profits. You can take the option to expiry only if you have already lost most of your premium and you are certain that markets will eventually take a turn that too before expiry. But you should never let yourself be in that situation in any case, you should take a stop loss. Markets behaves in their own ways, we need to respect that behavior and take our loss or profits whenever we are comfortable.

Now the next question is which option to buy. As I have mentioned before there is something called delta that effects the option prices. ITM (in the money) options have higher delta, which means they move smartly with the markets. Deep in the money options will almost move 1-1 with every increase in nifty prices. But the only problem is that they are costly.

In that above example when nifty is at 5500, a 5400 near month call will be priced at approx 140-160 depending on the time to expiry. To buy this call you may need anywhere from 7000-8000 rupees. But the benefit is that if nifty moves even 20-25 points you can realize a good profit.

However deep OTM (out of the money) calls will be cheaper. For example when nifty is at 5500, a near month 5700 call will be around 35-42. You can buy more lots with the same amount of money, but a small move in nifty will have no effect on a OTM call, and if nifty does not move beyond 5700 until expiry, you may lose your entire investment.

Therefore if there is no apparent reason and you want to buy naked calls, just buy at least at the money calls, but never out of the money calls. You should always look for percentage when trading, buying more options with less money will not be of any help. Buy ITM calls and work on percentage.

If you have less cash, then buy less lots of ATM or ITM calls or puts. At least if the markets moves in the direction you predicted you will make some profit and get out. As far as OTM calls are concerned, sometimes even if your view was correct you may start to see your options lose value with time and you may sell at a loss – this even if your view was right. **Therefore I highly recommend buy ATM or ITM calls and sell OTM calls.**

Stratergy3 : Nifty Credit Spread and Adjustments

I had done a nifty credit spread a few days back so I will be discussing a live example with you. BTW credit spreads is my favorite strategy. I mostly do them every month and occasionally naked selling only if the markets gives me a great opportunity. If you do not know what a credit spread is here is an explanation.

An option credit spared is a position when the **nearer strike option is sold and the further out of the money (OTM) option is bought** for protection. Ideally they both should be of the same stock or index and of the same lot size and of the same months (some people create credit spreads with different months but that is entirely different subject. This article deals with same month credit spreads). Since the nearer option is sold – the difference of the amount between the sold and the bought option is "credited" to your account. Therefore the name – Credit Spreads.
Confusing? Ok let me give an example to help you understand.

Lets suppose nifty is at 5800. It has already fallen 200 points recently and you think a re-bounce may happen anytime soon. Even if it falls a bit further you do not think that it will go below 5600 this month. What do you do? You sell (short) one lot (or more) of the PUT at 5600. Now as you know shorting options can be very risky, to protect yourself from a great downfall you buy the same number of lots you sold at the strike price of 5500 or 5400 as per your risk. Now if nifty goes for a free fall you will realize some profit from the options you bought limiting your losses to a certain extend in the short options.

But then, how do you profit?
If both the options expire worthless you keep the premium. That is your

maximum profit. Do not worry about losing the premium you paid for buying the options – you will profit anyway because the sold options will also expire worthless. Remember they were costlier than the ones you bought so the premium you received should be more than what you paid to buy the options.

Lets take a real example – a trade I did. As on June 12, 2013 Nifty closed at 5760. In the last 30 days Nifty made a high of almost 6200 and since May 30, 2013 Nifty is continuously falling from a high of 6133.75. This is a fall of almost 6% in 12 days. Yes Nifty can fall a bit further – but certainly from some point it will rebound. I don't know from where, but eventually it should. (Even if it doesn't I don't have much to lose – I will explain why).

The VIX (volatility index) was also on the higher end. Note that option prices are directly proportional to volatility. If VIX is high option prices will also be priced higher. Tomorrow if volatility drops the same options will lose their value. (In that case I can actually profit tomorrow itself and close my positions. However I am not in a hurry.) For those who want some more info on volatility here is a para taken fromhttp://www.moneycontrol.com/indian-indices/india-vix-36.html:

Volatility Index is a measure of market's expectation of volatility over the near term. Volatility is often described as the "rate and magnitude of changes in prices" and in finance often referred to as risk. Volatility Index is a measure, of the amount by which an underlying Index is expected to fluctuate, in the near term, (calculated as annualized volatility, denoted in percentage e.g. 20%) based on the order book of the underlying index options.

India VIX is a volatility index based on the NIFTY Index Option prices. From the best bid-ask prices of NIFTY Options contracts, a volatility figure (%) is calculated which indicates the expected market volatility over the next 30 calendar days.

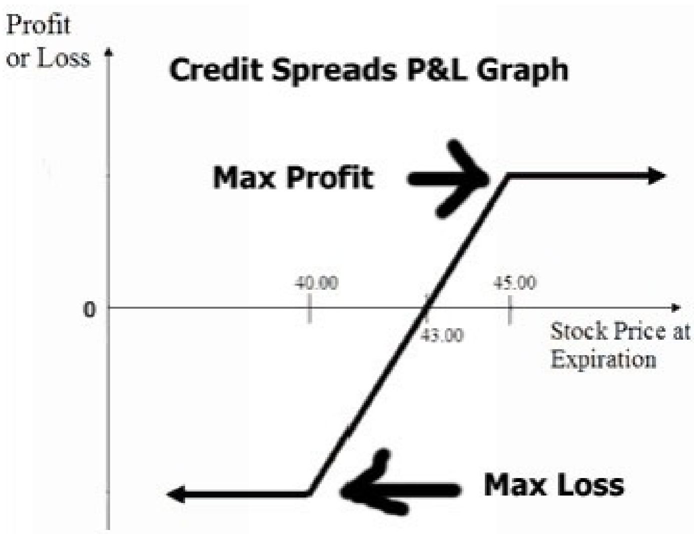
Since the volatility was high I was getting a good price on July 5500 PE (put option). I got it at 45. Now you tell me what are the chances that after falling 6% in 12 days Nifty will fall another 5% and more? Slim. But one can't predict markets, so protection is important – very very important. Here is what I did:

1. Short (sold) to open Nifty July 5500 PE at 45*400 (8 lots) = Rs. 18000.00 (credit in my account)
2. Long (bought) to open Nifty July 5300 PE at 20*400 (8 lots) = Rs. 8000.00 (debit from my account)

Total credit = 18000 – 8000 = Rs. 10,000.00.

ROI: 45 days are left for expiry. Total money invested is 1,30,000.00. Absolute return is 7.69%. it comes to almost 5% return in a month. Of course, I need to get out in a profit.

Here is the profit and loss graph of Credit Spreads:



By seeing the image I hope you can understand that profit and loss in a credit spread is always limited.

Now coming to my trade. As you can see I got a credit, the trade is called "Credit Spread". This can be done either in calls or in puts. You just have to sell the option with the higher value and buy the option with the lower value to get a credit in your account.

Credit spread usually have a success rate of 80%. But here is a cliche – **one losing trade can eat profits of many months.** Therefore its important to **adjust your credit spreads if your short leg is in trouble** – and it does happens believe me – more often than you can think of.
Why I did a trade in July month and not June month. Only 15 days are left for expiry of this month so I would have not got a good credit at 5500 puts. (June 5500 PE is at 13.05) plus if Nifty starts moving down fast I will have no time to adjust my credit spread. It made sense to play the next month options.

Profits are limited, what about the losses?
Good question. You see losses are limited too since I have bought 5300 puts for protection. The difference between the prices of the options will be my

maximum loss. Lets take an example. What happens if Nifty closed at 5200 in July expiry:

1. 5500 PE = 300 (5500-5200 = 300) I had received 45 so ((45-300)*400) = -102000.00

2. 5300 PE = 100 (5300-5200 = 100) I had paid 20 so ((100-20)*400) = 32000

32,000 -1,02,000.00 = -70,000.00 this is my maximum loss. However my profits are only 10,000.00. As you can see even if I make profit for 7 months – just one month loss will offset my profits. Therefore I should adjust my spread if Nifty gets closer to my shorted puts i.e… 5500. and I have to do it much before I enter a huge loss.

Lets see how we adjust our credit spread if it really comes to that. Luckily I did not have to adjust my spreads as Nifty never came close to my short puts. (BTW if I had to, I would have taken a small loss in my credit spread and rolled it down 200 points if Nifty had fallen sharply near 5500 very fast as soon as I opened my spreads. If nifty closed above my new position I will have no profit or no loss or some profit / loss depending on the trade. But I would have certainly avoided a huge loss as explained earlier. And further I keep a record of my trades so if anytime I adjust my spreads I will update this post with a real adjustment of credit spreads.)

Here is a update: On July 04, 2013 I closed my credit spread.

I bought July 5500 PE (remember I had sold it earlier) at 16.00, and
I sold July 5500 PE (remember I had bought it earlier for protection) at 4.50.
Lets calculate my profit or loss:

Sold July 5500 PE (8 lots): (45 -16) * 400 = 11,600.00 (profit)
Bought July 5300 PE (8 lots): (4.50 – 20) * 400 = -6200.00 (loss)
Total Profit: 11,600.00 – 6200.00 = 5,400.00
Some people might be thinking why I bought the protection. My profit would have been great. Yes you are right, but falls are steeper, even before you know you can incur huge losses. With this small price for insurance at least I can sleep better in night. You don't want to make money without sleeping, do you?

Lets calculate return on investment.

Total cost of opening the spread: 1,30,000.00

Absolute returns: (5400/130000.00) * 100 = 4.15% in 20 days.

Note that I could have close my spread a few days back when Nifty went near 5900 and got even better profits in less days – but these things keep happening in trading. You never get the best price. Ultimately its the profits that matters. 🙂

Also I did not wait for the expiry. Why? Because I am already getting a good profit and a full month is left for expiry. A winning trade can become a losing trade some day, who knows. So its better to close the spread when you have realised a good profit from it and release your locked for margin cash for opening another spread or doing any other trade.

Hope this article has helped you to understand credit spreads. If you want to know anything please ask in the comments section below.

Stratergy4 : Iron Condors Strategy

Iron condors is my favorite strategy to trade nifty options month after month. Well if you want to know the winning percentage – its close to 70%. But what's more important is how to handle the 30% losses. If you are willing to take less profits you can also trade iron condors with 90% winning probability – and that's the best strategy for beginners.

First thing first – What is an Iron Condor?

An iron condor is a trade of two credit spreads – one on a call option and one on the put option – sold on any underlying for the same month. Since I always trade on nifty, henceforth all my examples will be restricted to nifty only.

If you don't know what credit spreads are, this article will help you to know about credit spreads. Read that first and then come back here.

In short in credit spreads, one near option is sold and the further OTM option is bought for insurance. Since the sold option has more points, a credit is done to your account. You actually buy the OTM option from the money you get by selling the near option. That is why the number of sold options should be equal to the bought options.

Now what if you think in this month nifty will not close beyond 6000 and not fall below 5500? you can sell an iron condor for that month. You can sell a credit spread on 6000 call by selling 6000 call and buying either 6100 call or 6200 call according to your risk capacity. Similarly you can sell a 5500 put and buy 5400 or 5300 put as per your risk. Remember the more gap you give between the sold and the bought options – the more money you make but more risky your iron condor becomes. Justified, isn’t it?

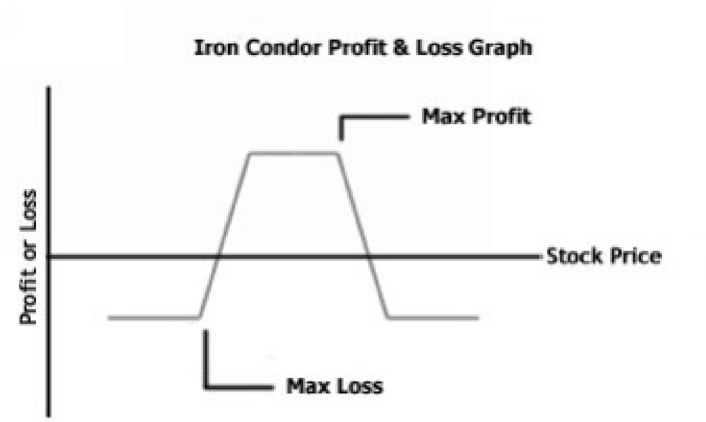
How to do it? Ok let me take a live example from one of my trades:

This trade was done in the month of May 2013. My view was that nifty will not go beyond 6000 and not go below 5700 in the May 2013 series. So I sold an iron condor for lets suppose four lots (I trade more lots but this is to simplify). Here are the details:

1. Buy 6100 Call Option: 31.70 * 100 (2 lots) = -3170 (debit)
2. Sell 6000 Call Option: 65.90 * 100 (2 lots) = 6590 (credit)

3. Buy 5600 Put Option: 12.75 * 100 (2 lots) = -1275 (debit)
4. Sell 5700 Put Option: 23.45 * 100 (2 lots) = 2345 (credit)

Here the profit and loss graph of an Iron Condor:



You can see in the graph that profit and loss is limited in Iron Condor. But the risk in the Iron condor is more than the reward you get. However Iron Condors are profitable most of the times. The rest of the times the risk needs to be managed aggressively. If you take my course I will tell you exactly how I manage the risk much better than how most traders manage it. I actually take a trade that is successful 95% of the times after my Iron condor hits a stop loss. This ensures I get back losses made in the Iron Condor trade plus I end up making a small profit because I double the lot in the second strategy.

Ok, lets get back to the strategy I was discussing in this article.

Net Credit in my account: 6590+2345-3170-1275 = Rs.

4490.00

Now lets calculate the ROI if I win.

For 6000 call and 5700 put option sold investment required: 15000*4 (lots) = 60000.00

For options bought= 3170+1275 = 4445.00

So 60000.00 + 4445.00 = 64,445.00 – this is approx cash locked in my account for this trade for margin money.

If all of the options expire worthless I keep 4490.

ROI: (4490/64450) * 100 = 6.96% in 30 days – not bad!

Now lets calculate the losses:

If Nifty expires at 6100: -3170-3410-1275+2345 = -5510

If Nifty expires at 6200: 6830-13410-1275+2345 = -5510

If Nifty expired at 6300: 16830-23410-1275+2345= -5510

If Nifty expires at 5600: -3170+6590-1275-7655 = -5510

If Nifty expires at 5500: -3170+6590+8725-17655 = -5510

Loss ROI = (5510/64450) * 100 = 8.54%

It means my maximum loss in this trade is 5510 wherever nifty closes and maximum profit is 4490 if it closes between 6000 and 5700. Does that makes sense? Yes it does if I risk 8.54% of my capital to make 6.96% in 30 days.

Now this discussion will get even interesting. **What happens if my view goes for a toss and nifty starts to**

move in one direction and my real fears come true? Well it did and that is the reason I took this month's example. A loosing one and not an easy win.

As soon as put the trade on 26-Apr-2013 – nifty started to rise – a worst case scenario. Nifty was already in a bull run since 9-Apr-2013 from touching of a low of 5487. It had reached almost 5900 when I put on the trade. I thought it wont raise any further or start to fall soon. As you can see I got more premiums from my calls than my puts. When nifty or any stock is rising the system makes the calls costlier and vice verse. This I done to make an even field for buyers and sellers. If the sellers are not getting a good premium for selling options why would they sell in the first place?

Long story short – my short call was in trouble and I had to adjust or get out or hedge my position to make sure I at least do not lose a lot on my trade.

How to adjust an iron condor?

We will come later to what I did, but lets first discuss what you can do when your iron condor is in danger:

1. The most common option done by traders – **rollover the condor one step up if the underlying is going up – or roll down if its going down**. In my case I should close the 6000/6100 leg and sell/buy the 6100/6200 calls.

Depending on profits I should also close my puts and bring them up one position to make more money. However please note that this should be done early as otherwise it will get costly to close the condor. Idea is to lose less and make more.

2. Close the losing leg in small loss (in my case the sold call) and let the other leg expire worthless. Note that the bought calls will bring in some money and offset the losses. So I don't lose 5510 – my max loss. I lose much less. In reality if your losses are less than you can make from the leg that expires worthless you make money and not lose it. Though your ROI will be less. However the problem with this strategy is that what if nifty nose dives back in the opposite direction after you close the losing leg?

3. Take a small loss before it escalates. **Close the condor before you smell trouble.** You can put on the condor again and get your money back.

4. Buy more OTM calls or puts depending on which leg is in trouble. However the same problem exists here – what if nifty starts heading south?

As you can see all the above three adjustments to iron condors come with their own risk. However one thing is clear – **you should take action before you start losing a lot of money.** Even though you know your maximum risk but why wait if you can recover the same money in that month and lose nothing?

If you actually lose nothing in that 30% of the times when an iron condor is in trouble – you will see that in a year your investments have bought in around 30-50%. And that is very good.

Now you would like to know what I did? I closed my call leg for a small loss of around 1000 and sold 6300/6400 JUNE call option. Technically this is not a iron condor as I shifted to next month, but its all fair in the game as I have to do what will make me money. The put ones expired worthless in may and I waited for nifty to go down. It did and I closed the June credit spread at a good profit. Nifty started to go down after reaching 6146. My profits actually exceeded my max profit but it took a little more time and patience. Yes **patience is important in any trade. Nothing happens in a day or even two. You have to have patience while trading. Eventually the win will come.**

As you can see iron condors can be profitable even if your view is wrong. And since **one leg is guaranteed to make money**, will expire worthless – you can use some strategy to make sure you come out winner of the other leg. However its easier said than done. What if nifty would have kept creeping up? My losses would have been much more than my max loss.

Another thing you should keep in mind when trading iron condors is that **you should go as far deep OTM as possible** if that makes sense. **The further you go, the probability of wining be more.** It depends on how experienced you are. A 700 points wide iron condor will have a 80-90% probability.

One more point: Sometime volatility will drop after you have traded an iron condor – and you will be in good profit in few days. In that case don’t wait till expiry – just book your profits. Whats wrong in making 2% in 10 days? You can make the rest in the remaining days. These small profits will add up to big profits in a year

Stratergy 5 : Out Of The Money Option Buying

If you do some research online or even ask an expert, you will find that a lot of people and experts advise against buying out-of-money (OTM) options. The reason is plain and simple. They say it has more chances of expiring worthless so you may also lose your money. They should be sold not bought. Well they are right. More often than not out of the money options expire worthless. Is that the only reason you should not buy them?

I do not agree – to some extend. If you have a well thought out strategy you can make a good profit out of them. Also out of money options have other importance too – else why are they traded? Let me put some points outright to explain:

1) OTM options are great for protection: If you have read about credit spreads, you will understand the value of buying OTM options for protection. If a spread is going against you, it is the OTM option that will bring profits and minimize your unlimited losses. In fact it is due to out of the money options that you may sleep well in the night knowing very well your max loss. Buying OTM options will limit your losses. OTM options have the same job on the iron condors as well. Buying out of the money options can be a lifesaver if you have sold in the money options.

2) OTMs double money very fast: Agreed, its easier said than done. But in my three years of experience in trading, **I have seen hundreds of out of the money options doubling in value in days.** (You feel bad thinking why you did not invest, isn't it? But that's a different topic.) I am sure you must have experienced too.

I have seen an option going from 1.00 to 3.75 in one day. **Yes an increase of 375% in one day.** No in-the-money option can ever match that even if there is a huge move in the underlying. But please never buy so deep out-of-money option. This is just an example that happens very rarely.

You see percentage wise, **it is the out-of-money options that increase in value fast – by the way, they don't decrease that fast.** Why? Because the max they can decrease is to 0.05. If 30 days are left for expiry, an OTM with the value 2 – how fast do you think its going to decrease? Because they have nothing but time value left, the deep out-of-money options cannot decrease very fast **if enough time is left**. Yes enough time should be left – and that is a very important factor. I will explain later why.

3) Who is waiting till expiry anyway? Did you make any meaning out of that? If you didn't I will explain.

Read this is important. When experts say you shouldn't buy out-of-money options they are referring to the expiry. Yes its true that OTM options mostly expire worthless, so **if you plan to wait till expiry then you are doing a huge mistake. Do not buy out-of-money options to hold till expiry.** You will lose all your premium paid. Experts are right – out-of-money options expire worthless 80% of the time. But my point is who is waiting till expiry?

Let me give you a live example. Today 26-July-2013, I bought NIFTY AUG13 6400 CE (call option) for 3.5. My max loss capacity I have determined is Rs. 3500. (Note that I am not putting a lot of money at risk as this option will 90% expire worthless, I cannot be greedy.) I have bought 20 lots. Here is the math: 3.5*20*50 = Rs. 3500.00.

Nifty today closed at around 5886. There is a lot of time for the August 2013 series to expire. I need not worry. And moreover I have made up my mind not to lose more than 2500 in this trade. If this option reaches 1.00, I will close this trade. However what are the chances that this option will only decrease in value for the next few trading sessions? For that 1) Nifty has to keep going down and 2) volatility has to also keep going down. Even if Nifty goes slightly down, but volatility rises – I can make a profit.

My target is 5.5. if Nifty goes up by even 50-60 points or volatility rises I can achieve that. The profit I make is Rs. 2000.00. I am risking Rs. 2500.00 to make 2000. Isn't that fair?

I will not update with what happened to this particular trade as it is not important. But what is important is that when you buy out of money options you should keep the following strategy in mind:

1. Never buy very deep out-of-money option. As explained earlier please do not be greedy and buy too deep out-of-money options. Yes they may also increase in value but for that the underlying has to move very fast.
2. Give your option enough time and room to increase in value. Do not buy a out of the money option in its last week of expiry. You will rarely make a profit. If you keep your stop-loss very small you are most likely to lose money every time.
3. Sometimes be prepared to lose 100% of your option premium – as you may not get time to close the trade (a huge jump against your trade) and you may not get back a comfortable amount. In that case leave the option till expiry, who knows the trend will change and you may get your money back, or you may even be in profit. Remember the first point, you should have enough time for it.
4. Do not buy options too often. Usually option buyers lose money. Yes if 80% of options expire worthless, it means option sellers are making money. Do proper research before even thinking of buying an option. Lots of people have lost lot of money buying options. This point goes for at the money (ATM), in the money (ITM) or out of the money (OTM) options. If you want to buy anyway – you should have a clear stop loss or profit booking price in your mind. You should place it in your system if you think the option price may reach there on that day.
Now you must be thinking why I bought this option? Because right now Nifty is in a bull run and it fell 200 points in three days. I am sure it will try to climb some points up in the next few days and I should get my target. No technical analysis here – just pure speculation – with risking only Rs. 2500.00. Hope you

get the idea.

4. Do not spend a lot of money on buying out of the money options. As you can see I put in less that half percentage of my trading capital into buying these OTM options. Even if they expire worthless – I will not lose much. My next trade can make me money.
Remember these points and just don’t ignore out of the money options – sometimes they carry gold with them. Spot them.

Stratergy 6 : Making Profit in Trending Market

If you have a bullish or a bearish view in Nifty, here are some tips to help you make most money in a Nifty trend. Before reading please understand that this article is written for people with some knowledge about futures and options. As Nifty does not have any stock, it is only apparent that we use futures and options to give some tips on making the most money. If you have no knowledge of futures and options – please get some knowledge before reading this article.
Here we go.

1. **You can buy Nifty futures if you are bullish or sell futures if bearish.** A future will go up or down 1:1 in the same ratio as Nifty. Yes it does have a premium. But in any case it increases 1 point with every 1 point raise in Nifty and decreases 1 point in every 1 point decrease in Nifty. So even if it has a premium, you need not worry. You should realize a profit of almost 100 points if nifty actually raises or falls 100 points from the point you bought/sold the future. If your view was wrong, your losses will also be the same.
Well whenever you are trading you must keep in mind that you will not be right 100% of the time. In fact it is nearly impossible to be right more than 60% of the time. Here is where it is important that you hedge your position even if you are absolutely sure of the move. Since the derivatives gives you a

huge leverage, doesn’t it make sense to use some of it to protect your losses to some extend?

These financial instruments are dangerous if not used wisely. You should be willing to sacrifice a percentage of your profits for the sake of protection. If you are wrong, which you will be many times during the course of your trades in one year, your protections will keep you in the game. Moreover with futures your timing has to be excellent. If your view was right but you timed it wrong, you will still end up putting a stop loss to your contract. For example if you were looking at 20 points profit or 20 points loss. You could hit a stop-loss only to see that Nifty actually moved in the direction you predicted. There will be heart burn, but then you have already lost it and there is nothing you can do to reverse it.So how to take on the ride?

There are two ways to do it.

ONE – **If you have bought futures, simultaneously buy a slightly OTM (out of the money) put, and if you have sold a future, buy a slightly OTM call.** Now you are protected at least to some extend. Remember this – this strategy WONT work if you wait till expiry. In fact in real world of trading you should not wait till expiry at all. If you have made a profit, move on to next trade. Why wait till expiry?
A wining trade may become a losing one in few hours of trading, let alone days. Today you are winner, tomorrow the same trade may be losing – so why keep yourself on the tenterhooks till the expiry day? You also save time and unlock trading cash once you book a small profit. Waiting till expiry is a foolish move. You will rarely win in the stock market if you trade derivatives and take it to expiry. Expiry day is also too volatile, and you wont have anytime left to do anything. You will be left praying if a wining trade suddenly goes against you. And praying to win in the stock market is another topic.

When you achieve your target, just close the trade. Agreed you will have to take a loss in your protection. But it will give you enough strength to stay in the trade if its going against you. Depending on how far OTM you have bought, at least you will keep getting back some of you losses from these options. Yes you will lose money if you were right in these options – but this is a limited loss and your profits from the futures will surpass this loss.

Buy the same number of lots as that of the futures. Yes if you are too far OTM or you are getting options at a very low cost (low volatility), you can buy a few extra. You wont believe if you were absolutely wrong (a strong move against your trade) – the extra options will actually bring in more profits than your losses in futures. But you got to do some math before buying protection. 20% of your profit target should be good enough. Do not spend too much on buying protection. Remember if you are right you should be rewarded for it. The protections will eat away your profits. So use your brain, do some math before buying protection.

TWO – This one is more popular. If you have bought a future, you can sell at OTM call. Now if your view was right, you will make money in your future buy, but you will lose some in your sold call option. But if you were wrong, you will recover some from the profits you will make in selling your call option. However if you are right, your profits are limited. Why? Because the losses in sold call, will offset the profits you make in the future. Lets take an example.

Suppose Nifty is at 5700 and the trend is bullish. So you buy a future and sell a 5800 Call. Lets suppose 5800 call is at 50. Now if Nifty expires at 5800, you will make 100 points from future and since 5800 call will also expire worthless, you will make 100+50 = 150 points. Now lets suppose Nifty expires at 5900. You make 200 points from future, but you make a 50 point loss in the short call. Your total profit stands at 200-50 = 150 points. That's your max profit. However since you have bought futures, you losses are unlimited. If nifty keeps going down, your max profit from sold calls is 50 only, but you will keep losing money in futures. Your breakeven is at 5650 – after that losses are unlimited. (Nifty expiry just used as explanation. You shouldn't bother going till expiry.)

Here is a tip: **What about combining ONE and TWO? If you are bullish, buy a future, sell a call and buy a OTM put from the money you got from selling the call.**You must be thinking wow what a great idea. Well everything comes at a cost. Here your max profit will be even less than the option TWO as if you are right, you will make money from the future, but lose on the short call and the bought put. Since you cannot buy deep OTM puts as they wont make sense, you may have to put money from your pocket to buy that put. What will be your payoff? Exact calculation is not possible but lets suppose you got 50 from selling call and you had to pay 50 to buy puts. If Nifty expires at 5800, you make 100 points from future, 50 from sold calls but you lost 50 form buying puts. Your total profit is 100 points. However if put was costlier than call, you need to subtract the difference from the profits. And that is you

max profit. However in this strategy your losses are not unlimited.
If your view was wrong and Nifty closed at 5600, and supposing you had bought 5600 puts for 70. You will lose 100 points in the future, your put will also expire worthless but you make 50 points from the short call. Your loss -100-70+50 = -120. This is also your maximum loss. Your max loss is greater that your max profits. Well as you can see everything in trading comes at a cost.

Similarly the above strategy can be inverted if the trend is bearish. You will then sell a future and buy a call or sell a put or both. The rest is self explanatory.

Important Note: If you have not hedged your position in futures than it is important you play with a strict stop loss. Buying or selling future is a unlimited profit and unlimited loss strategy. Also you should make sure you take maximum profit. So do not put a target. If your target is reached go for a trailing stop-loss as much as possible. This way if market goes up even after hitting your target you will not miss out on future profits. However if there is a gap down opening you may rue your decision of not exiting and booking profits. It depends on the market conditions. If you think market may go even further you may go with a trailing stop-loss. There can be a gap up opening as well. But if you are in doubt, its better to take the profit and exit.
2. **You can buy calls if the trend is bullish or buy puts if its bearish.** This one the is most sought after trade done by retail traders in India. Why? Because its easy to do and its cheap. But is it really cheap? We will discuss. But of course it is simple. If the trend is bullish you buy nifty calls and buy puts if the trend is bearish. You buy low sell high. Isn’t it the simplest way of making money from stocks? This is one single reason that attracts traders. Everybody wants to buy low and sell high. Therefore this trading strategy is very popular. Search for nifty trading tips in Google and you will see ads full of nifty option tips. They will be much more than ads of futures. Why? Because someone with even Rs. 5,000 in their trading account can buy options. And they know they can get money from you. However for futures trading you need more money in your account – at least Rs. 20,000.00.
Buying options is also a limited risk, unlimited profit strategy. This again appeal to traders. It can actually be sold by tips providers. Cheap, limited risk, unlimited profits – wow sounds so good. But is it really? No its not. The

problem with this strategy is the theta time decay. When you buy options you are running against time and volatility. Your view has to be correct from the time you bought the options. Even if nifty stays in the same place, you will lose money. Even if your view was right but the pace is slow and volatility drops, the value of your options will drop. So in reality the limited risk and unlimited profits is only on paper. As soon as you buy options your premium is at risk of melting down to zero (0.05 actually :))

How to hedge this? If you have bought calls then you should sell calls. So even if your bought options melts away, you will realize some profit from sold options. Unfortunately not many traders do this. If you make money from the bought options, the sold OTM options will not lose much. But if your bought options expire worthless, your sold options will expire worthless too and you will recover some money from them. However your profits will be limited, as the sold options will start losing money, if your bought options are making money and vice versa. Your losses are also capped at the money used to buy options. You cannot lose more than money used to buy options minus money got from sold options.

3. **You can sell puts if the trend is bullish and sell calls if the trend is bearish.** This strategy is mostly done by institutional investors and hedge fund managers. As you all know selling options is a limited profit and unlimited risk strategy. Therefore most retail investors stay away from it. However it is not as bad as it looks on the paper. You can always buy back your options if you get into losses. Where is the unlimited loss? In that sense even futures buying or selling is unlimited loss on paper. But retailers do trade in futures. However just like futures, selling naked options is very risky.
How to hedge it? Best way to hedge is to sell a credit spread. You sell a OTM option and buy the same number of even further OTM options. If you do so, there will be credit in your account. **This is a limited profit and limited loss strategy.** Credit spreads andiron condors are very popular in the west as they are easy to mange. Most of the times a credit spread will expire worthless and you make money by doing nothing for a whole month. Great? Read this – trouble starts if the trend goes against you. Moreover the risk-reward ratio is very bad in credit spreads. Two bad spreads can eat away many months of profits. Therefore here too you should put a stop loss if the spread reaches a level you are not comfortable with. As you can see every strategy comes with their own pros and cons.
However when nifty is in a clear trend you should go with the trend. Do not go

against it, or else you will lose money. And if you have good strategy in place with hedging making money in nifty in a trend is not that difficult.

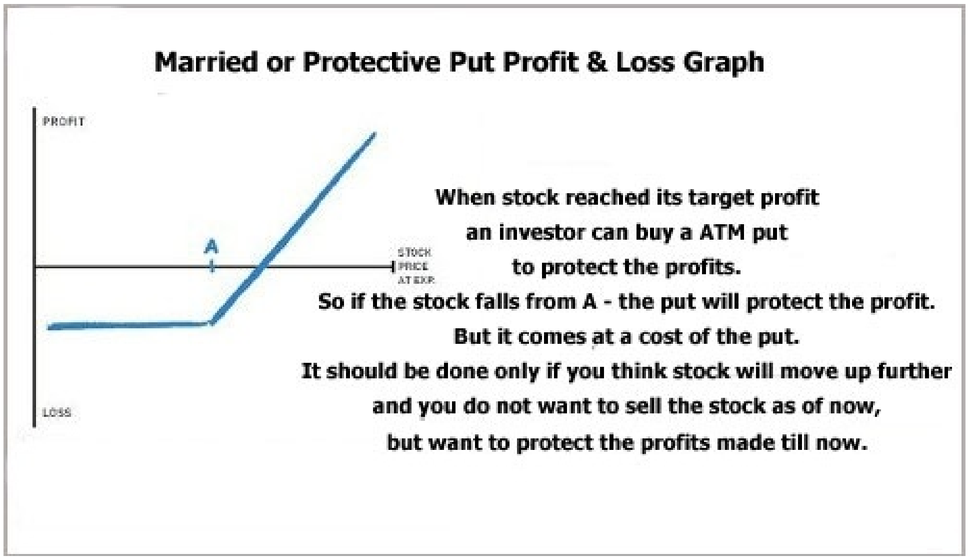
Hedging any trade is very important. If you love to take Nifty Future trade in a trend I highly recommend my course where in the directional strategy you will learn how you can hedge Futures with options. If you are right you will make money – but you make money taking a Future trade anyway if you are right. So whats so great about the strategy in my course? It is that you can make money even if you were WRONG in your Nifty Future trade. Yes if you were wrong the options' delta increases more than the Future delta and you can make money.

Stratergy 7 : Married Put

Married or Protective puts are helpful when you want to protect the profits made from a stock, but do not want to sell it as of now to lock in the profits.

Married or Protective puts are also helpful when you bought shares and fear that the stock value may fall – but for some reason you do not want to sell the stock. Married puts will help in case the stock actually falls.

Here is a graph of married puts. If stock falls below "A" the protective puts will save the investor from losses in the stock.



Let me now explain in details.

You hold quite a lot of shares of a company and some bad news comes in about the company or about equities in general and you fear that your shares' value may now tank. What do you do? You have two options:

1. Sell the shares at a loss, or
2. Buy ATM/OTM put of the same company.

Option 1 is pretty easy, but mostly you will lose money. Remember markets get the news before retail investors like us get. So even before you can trade, the markets will price the shares of the company you own at appropriate levels which almost always means you will be at a loss or may be breaking even (if you bought the shares at a great price.)

Even if you are not in a loss, one thing is pretty sure you lost a great amount of profits that you could have made had you sold the shares when they were at a higher level. Unfortunately greed came in and you kept it on hold. 
Well don't worry, it happens with everyone. Nothing to feel guilty about it. If you are still in profit, my advice is that you should get out, and re-enter at a lower levels. The problem is how on earth you know if it will ever go more

down and where to re-enter?

Timing the market is extremely difficult if not impossible. (Actually impossible – but they say nothing is impossible so 🙂

You can however protect further downside of the stock by a simple strategy called married puts. Which takes us to the second option. **Buy ATM/OTM put of the same company.**
Note: Married puts are useful if you have a lot at stake in that particular stock, at least 2-3 lakhs or equivalent to its leverage in futures and options. For example right at the time of writing this article HDFC Bank is trading at Rs. 588.00 and let us suppose you bought 500 shares of HDFC Bank at 590.00. So your total investment is 500*590 = Rs. 295,000.00. The markets are falling – especially the banking sector. You fear that HDFC Bank may also fall and so you may suffer a loss, but you want to hold the stock and don’t want to sell right now and not lose money too.

You can then buy a put option of HDFC Bank to protect your losses from the downfall. Now if HDFC Bank falls, you need not worry as the put you bought will also increase in value and you can sell it at an appropriate level to realize a profit. Now your buying cost of HDFC Bank will come down due to this profit.

Three things can happen when in a married put strategy:

1. Prices moves down: You profit from the put bought. Your cost of buying the stock comes down.
2. Prices remain at the same level: Put expires worthless. You lose the premium paid to buy it. (Worst situation.)
3. Prices move up: You profit on the stocks bought. However you lose money on the puts bought. If prices move beyond the breakeven point you will make money. The premium paid to buy the puts should be added to the cost of buying stock. This is your breakeven point. Anything beyond that is your profit.

Great. But what is the risk?

The risk is if HDFC Bank shares stays at the same level or move up. The worst situation is when they stay at the same level. Your puts will expire worthless and you will lose whatever you paid as premium to buy them. If the shares move up, you will gain some from the up move but your puts will get lower in value as the stock price moves upwards. But after your breakeven points you should be in profits.

When is a married put helpful?

You should go for married put when you are certain that the stock price of the company you hold shares in will fall in value. And you should also know the maximum risk you are wiling to take. To make married puts work its best, it is best to buy ATM or just OTM puts. If you buy too far OTM puts they may be cheap but will not increase in value fast and may actually expire worthless even if the share price drops. This will be a double whammy. You lose money in shares and you will also lose money you invested in puts as well. As in joke they will become divorced puts.  Rather your expression will be 

Yes taking a married put decision can bring rewards, but the risk is definitely there. You may ask why not sell futures of the same company when the stock price is going down.

Yes you may be right. Yes there are no premiums to pay and the cash also comes from the collateral from the same shares. You can use your collateral to buy options as well but at least you know your max loss when buying options. In futures you have no idea as it can be unlimited loss, so using collateral money in not a good idea.

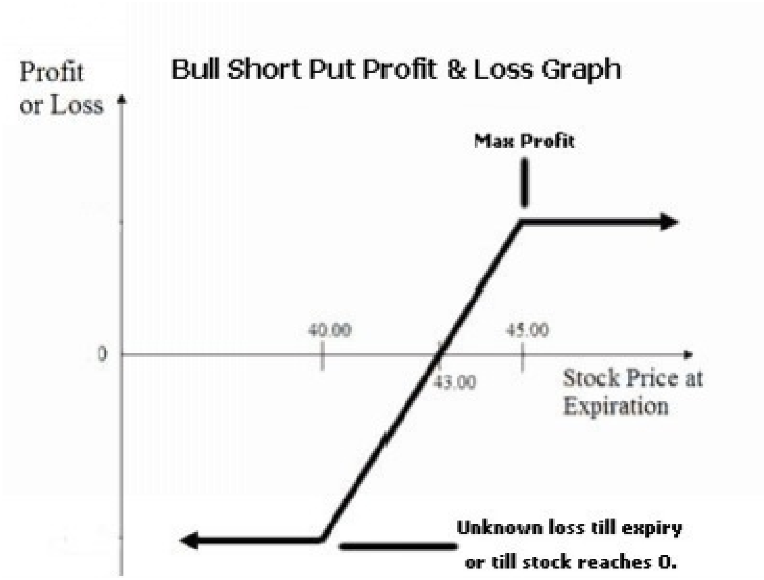
Selling future is a better option if the stock price stays there or goes down. However what happens if there is some good news and the stock opens gap up the next day morning? You will make money in stocks you hold, but lose the same amount of money in the future. Your buying cost of the stock will go up. Unfortunately you will have to pay this as MTM (mark to margin) and if you don’t have cash your broker may sell some of your shares to pay for the losses you incurred in the future. Not a good situation to be in.

With married puts you know exactly how much you are going to lose. And if your view was wrong you may actually sell the put and restrict your losses.

Stratergy 8 : Exclusive Puts Shorting

Short put is a strategy which can be played when you are bullish about nifty or any stock. If you think that Nifty will be go up you can either buy calls (long call) or short puts (sell puts). Most retailers almost always buy option and never sell. Its quite strange as option buyers mostly lose money. **Your strategy should depend on market conditions and not just one single strategy.** Anyways coming back to the topic. If you think Nifty will move up you can short puts. If your view was right, your put will expire worthless and you can keep the premium. Of course if your view was wrong – you are at unknown risk till expiry or till the stock or index reaches zero.  Put cannot lose any further.

Have a look at the graph:



Its clear from the graph above that a put loss can be max when the stock reaches 0. A short put cannot lose more than that. However a short call can lose unlimited amount of money because the stock can rise to any level on the upside. In my course I teach how you can use this feature to your advantage. Don't be afraid of shorting puts, but have a plan like buying another put for protection. Yes you can buy calls as well if your view is bullish and it does have a limited risk. But the problem is buying options also comes at a risk. We will first discuss the short put and the difference between buying calls and shorting puts later.

Let suppose Nifty is at 5300 and you think that it may go up in the near future (you are bullish), you can short OTM puts. For example if you think Nifty may not go below 5200 this series as it has already come down a lot recently, then you can sell 5200 put. The lower you go, the safer you are, but the lesser premium you get. Low risk low returns, high risk high returns.

If Nifty does not go below 5200 as you had expected, you keep the premium. However if it keeps going down, your risk starts from 5200 minus the premium you got. For example if you got 100 as premium then your risk will start from 5200-100 = 5100.

Therefore it is always recommended that you should do a credit spread. Short 5200 put and buy 5100 or 5000 put. That way you will be not be on unlimited risk and you can breath easy even if Nifty is going against your view. Selling naked options is very risky. With credit spreads you know your max risk, and the best part is you are not on max risk from day one. If indeed nifty moves against your spread you can buy it back and sell another spread much lower –

say for example 5000/4800. Chances are this time you will be successful. After all what are the chances that Nifty will close below 5000 within a month? You will get back your loss plus you may make some profit as well.
Of course you must make sure you are not taking a big loss, so before Nifty reaches an uncomfortable level you should buy back to close the spread. And if you think nifty will go even further down, you can wait for a couple of days to sell another spread. This will give you double benefits of going much lower and getting good premium. And don't forget the losses you restricted because you acted sooner. If you keep waiting for things to reverse, that's the worst decision you can ever take. Because in trading, hope never works. Period.

Yes nifty may revert back, but **most of the times waiting for too long will make your losses bigger** and impact your over all return in a year.
And one more thing – **you should not wait till expiry.** If you got 70-80% of return of a sold put or call you should close it as eventually you will find that a profitable position going back to a losing one. You do not want that. Don't be cheap. Just close your profitable position, and be happy. Look for other opportunities.
Now coming to the difference between buying calls and selling puts. Both do the same job – giving you profits if Nifty goes up. On paper though buying calls is limited risk and unlimited profits, and shorting puts is limited profit and unlimited risk. However in reality both of them have some risk and some profit.

Example time. Lets suppose Nifty is at 5500 and you decided to short put and you got 100 as premium. Your friend decides to buy calls. Lets suppose 5500 call is also at 100. As a buyer probably he is looking for 10 points or 20 points profit. That is what most option buyers look for isn't it? However you have decided that you will close your short put if Nifty reaches 5400 – that is your stop loss. Your friend will make his 20 point profit and exit. If nifty does not come back to 5500 in that series – your put will expire worthless and you keep all 100 points. Who made more?

Yes, if your view was wrong you are at unlimited risk so you can't wait beyond 5400 and close your trade at a loss, however an option buyer may wait till the end of series to try his luck as he is at limited risk. If nifty turns and starts moving up, he can close at a profit. As you can see there is a trade off in both.

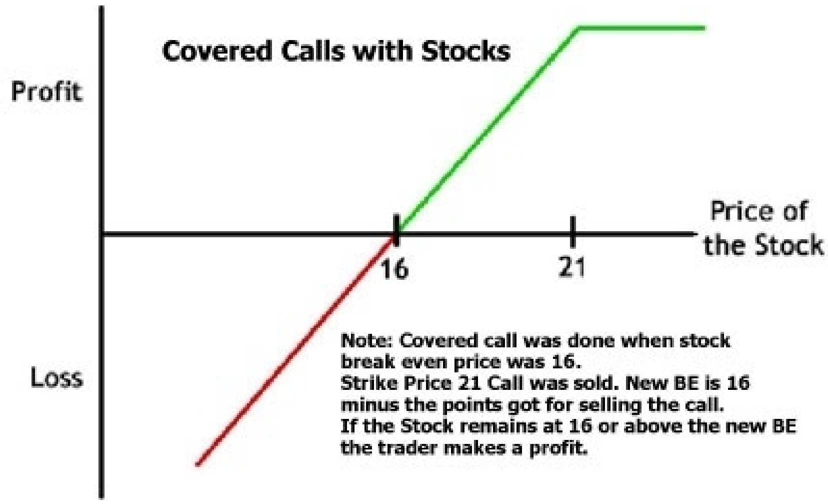
Some people like me, like to sell, but some like to buy. That is not important. **What is important is what nifty does after you put on the trade.**

Stratergy 9 : Covered Call Option with Stocks

Recently we discussed married put where you can buy puts if you feared that the stock you own may drop in the price in near future. If it does, you recover some of the losses from the profits gained from the puts.
What happens if your feelings are exactly the opposite? What if you feel if the stock you own may stay at the same level, be range bound, or may rise just a few percentage? Lets take an example. You hold 500 HDFC bank shares and your view is that for sometime (say a month) the stock is going to stay more or less where it is, or may be go up a little bit but not too much, or may head south but not too much. What do you do in such a situation? How do you make money?

Covered call is the answer. What is a covered call?

Covered call can be done when you feel the stock will not move much anywhere in the next 30 days. You should own the stock in cash equivalent to its F&O lot size. Yes a no movement in stock can also bring some money into your pockets. Supposing you bought a stock at 16 and you feel it may be around the same place next few days – you can then just go and sell the 21 out of the money (OTM) call. If stock stays at the same place, or moves up, or goes a bit down you still make money. Please note that when you sell a call you receive cash. This means your cost of buying the stock goes down. So now you have a new break even which is below 16. After selling the call if the stock is anywhere above this new break-even on the expiry day you are in profit, else loss. Note that your loss is less than those traders who had the stock but did not sell the call.
Look at the image below to understand covered calls better:



Side Note: This happens in most months. If you study stock markets you will see that most stocks trade in a range for months. Huge movements like 10-20% come only in a couple of months in a year. Most of the times your stock will be 5%+/- in a 30 day range. So this strategy is great to make money in those 8-10 months when the stocks does nothing. In fact even if it moves up or goes down a bit, you will make money with covered calls.

Covered Call in Details

Selling covered calls is not selling naked options, they are covered by your stocks – so the chances of loss is very less. Interesting? Lets discuss more.
Lets take another example.
Lets assume you bought 500 HDFC Bank shares at Rs. 650 a share (today's closing rate). Today is 18th of September, 2013. Your view is that for the next one month or so, its going to remain almost at the same place, or go slightly up or down. You think that it may not cross 700. Using your shares as collateral you can sell October HDFC Bank 700 calls. Today at closing it was selling at 15.00.

If HDFC bank stays below 700 on the expiry day of October 2013, you pocket a cool Rs. 7,500.00 (15*500 = 7500) without actually investing

anything. You still hold the same 500 shares of HDFC bank.
Even if you did not invest a single rupee while selling the call option (remember you sold using your stocks as collateral), you were still risking 3,25,000 that is the cost of buying the 500 shares of HDFC Bank. 500*650 =

3,25,000.

Lets calculate the ROI (return on investment).

Once you sell one HDFC Bank 700 Oct 2013 call at 15, you will immediately receive 15*500 = Rs. 7,500.00 in your trading account. You bought 500 HDFC Bank shares at 650 = 500*650 = 3,25,000. ((7500/325000)) * 100 = 2.30%. So your return on investment is almost 2% per month (since one and half months are left for Oct expiry – we assume its less than 2.30%). If you do this month after month you can make 25% or more on your investment of 3,25,000, which is approx Rs. 81,000.00 in one year. Yes there may be a couple of months where you may not make anything. Still even something slightly less that 81,000.00 in no small amount. Do you think HDFC bank will go up 10% every month? No, so the chances are making money are very high every month.

Isn't it great? You keep the shares and still make a good 25% of it. If you are willing to take more risk, you can sell ATM calls and you may make more than 10% per month. But the winning months will reduce.

Well there is more to it. If HDFC Bank actually moves up but not beyond 700 on the expiry day, you keep entire premium you got for selling the call, plus you can sell your shares at 7.5% profit at 700. That's double bonanza. **Not only you made money from the calls sold, but also from selling your shares.** Time for smiles :).

So where is the risk in Covered calls?

All good news till now. Time for some bad news.

1. What if HDFC shoots beyond 700? You start losing money in the sold call. However you do not lose anything till 715 – because you got 15 when you sold the call, beyond that there is a loss. But wait, you will still profit from the shares you bought. So essentially there is zero loss. Only problem is that beyond 715, you do not make any money. If there is a no-holds-bar rally in the stock, you will rue your decision to sell the call.
2. What happens if HDFC Bank falls? Yes you do keep the premium, but you make a loss in the shares you are holding. Of course if they are for long term, that's great – but if you wanted to keep the shares for short term you have to sell them at a loss but you keep the premium you got from selling the call so

your losses are slightly reduced.
No other loss in covered calls.
Covered calls is a great strategy if you hold a stock in your portfolio and want to keep it for a long time. If they fall, you keep the premium, else sell both your call and the stock to make sure you do not lose any money and re-enter the stock when it falls down.
One thing to keep in mind is that you need to keep the same number of stocks of that company as its futures shares. For HDFC bank it is 500 shares. If you buy a future of HDFC bank when its at 650 you get a leverage of 650*500 = Rs. 325,000. Therefore in my example I had taken 500 shares of HDFC bank.
You may have to pay only a fraction of that amount when you buy a future or sell a call, but your real risk is 325,000 that is 500 shares of HDFC bank.

Stratergy 10: The Collar Trading

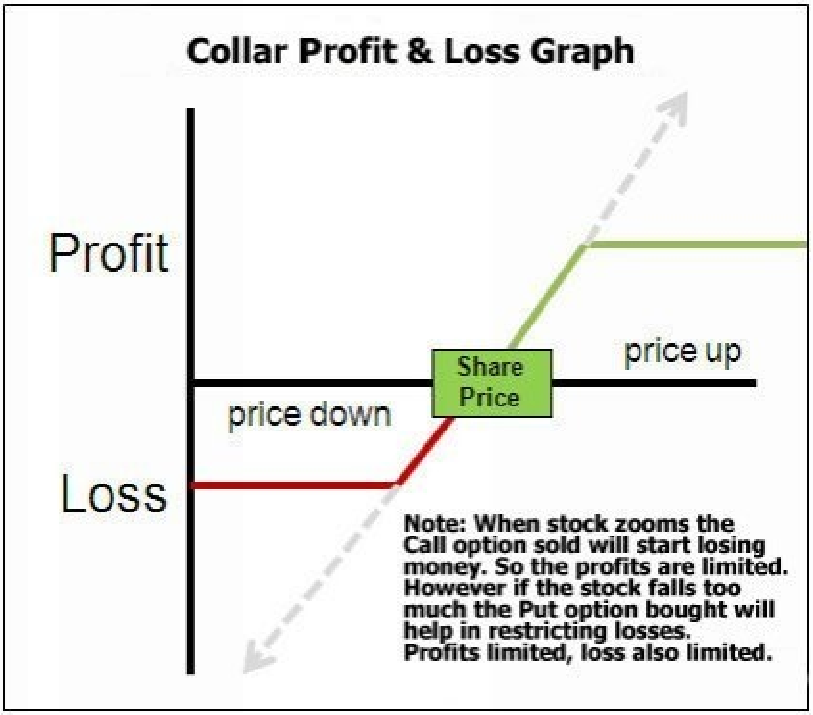
Strategy

The Collar is a beautiful strategy if you own a stock and have a slightly bullish view. However you also fear that the stock may fall in value. Collar strategy will help you to restrict the losses without paying too much for protection. Sometimes you can also make money if stock does not move much. Compare this to some one who owns the same stock and did not deploy the collar strategy.

It is a limited profit and loss strategy.

If you are bullish in nature but also fear a fall in a stock you hold – want to participate in the rally if it comes but protect losses if the stock falls, then “The Collar” is the best strategy to adopt.

Lets look at the graph and then discuss the strategy:



Lets discuss the collar strategy.
The collar strategy will help you to make money if your view was right, and will help you to severely control your losses if your view was wrong. You need not put a stop loss and take your time to get out of the strategy with a limited loss and limited profit.

The Collar strategy involves buying a future (or in cash the equivalent

value of future if you want to do it in any stock), then to manage risk, sell a OTM (not very far) call and buy a ATM put.
As you can see if your view was right and Nifty or the stock rises, the long Future will make money, but the sold CALL and the bought PUT will lose money.

You must be thinking if both CALL and PUT will be loosing money then how will the strategy make money? You see the Future moves 1 point with every 1 point rise in Nifty. However bought PUT has a limited loss. And sold CALL is OTM – so yes it will lose money but not as fast as the Future making money. Overall the strategy will be in profit.

Assuming you bought Nifty future and it starts moving down.

If the view goes wrong and Nifty starts going down – the long future will lose money but the bought PUT and sold call will make money. However since the PUT will not rise 1 point for every 1 point fall in Nifty and the sold call has a limited profit – the strategy still losses money.

But the losses will be limited as the PUT will limit the loss to a large extend. Your loss is limited to the sell price of the OTM Call minus the buy price of the ATM Put plus the profits generated by the bought Put.

Lets take an example. Lets suppose Nifty is at 6000 and you feel Nifty can go up to 6300. Recently it went up to 6300 so your view. You buy a Nifty future, buy ATM Put 6000 valued at 105.00 and sell slight OTM Call of 6300 valued at 50.00. Note that you sell 6300 Call because you think Nifty will not go beyond 6300 – so why should you speculate for that and take profits for the call as well if your view is correct and Nifty does not move beyond 6300 during expiry.
The calculations:
1. If the view was right:

Nifty expires at 6300.

The profit from Futures: 300 * 50 = 15000

The profit from sold Call: 50 * 50 = 2500

Total profit: 15000 + 2500 = 17500

The losses from bought PUT at 105: It expires worthless. 105 * 50 = -5250

Total profit:
17500 – 5250 = Rs. 12250.00
The profits are caped at 12250. Even if Nifty moves beyond 6300 – the strategy will not be able to profit more because the sold call will start to lose money.
2. If the view was wrong:
Nifty expires at 5700.

The losses from Futures: 300 * 50 = -15000

The profit from sold Call: 50 * 50 = 2500

The profit from bought Put: 300 – 105 = 195 * 50 = 9750

Total losses: 9750 + 2500 – 15000 = Rs. -2750.00
The losses are capped at 2750.00 because the bought Put will keep making money if Nifty keeps falling further.
Now lets take the risk-reward ratio.

You are risking 2750 to make 12250. This comes to risking 1 rupee to make 4.45 rupees. Isn't this an amazing strategy?

Who should play this strategy?

This strategy is **great for beginners** as the risk is very limited but the rewards are high. This is one the best risk-reward strategies on playing Nifty futures and options.
The only problem with this strategy is that if Nifty does not move in the predicted direction – you will end up wasting time and money as well. For example if Nifty expires exactly at 6000. You will not be able to make any money in the futures. But you will lose money in the options. And the total loss will be: 5250 – 2500 = 2750.00.

But if 2 times out of 4 you were right – this strategy will make money over a long period of time.
The Collar strategy is therefore best for risk averse traders. Also note that this strategy also works if you are bearish in view. In that case a future needs to be sold, ATM Call needs to be bought and OTM Put needs to be sold. Of course if you are bearish, you cannot play this strategy with cash. You only can play with

F&O.

Unfortunately not many traders in India trade Collar. But frankly if you have a company's stock in cash equivalent to its Future lot size – you can trade collars almost every month to make decent returns from your portfolio. It is a great hedge if the stock falls. And still make money if it rallies. However if a big rally comes, you may not be able to reap in the full rewards because of the sold Call option. Still its a great conservative strategy.