OPTION TRADING CHEATSHEET

MASTERING WHEN TO USE EACH STRATEGY

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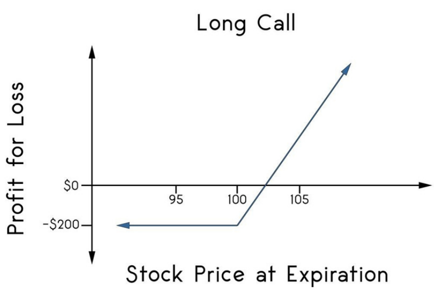
BUYING CALLS

Buying calls is very bullish – This is the most beginner and based on Goldman Sachs and my experience there is ONLY 2 ways to do it.

Goldman Sachs' options research team has long advocated buying calls on stocks set to report earnings. In fact short-term calls are ONLY good on stocks reporting earnings. This was the trade I made behind LULU, which turned $970 into $2,680 in 3 days. If you buy call options do so on stocks set to report earnings that week and buy a call option 3 to 5 trading days before. The results are: investors who bought call options on the first 13 percent of the companies to report earnings have seen a return of 105 percent on the premiums they laid out.

The image below is buying a call option. After some initial premium you have to pay you can make money from a stock rising without having to own 100 shares!



LEAPS

You may buy any call option you wish as long as it has a minimum of 9 months until expiration and a maximum of 2 years out until expiration. **You want to buy a LEAPS call that is deep in-the-money.**

A general rule of thumb to use while running this strategy is to **look for a delta of .80 or more** at the strike price you choose.

For a stock with 6 months performance of 20% or higher and implied volatility of 50% or higher and RSI of under 80 you may pick as low as 65 delta. Hedge fund research states the most important return for buying a LEAP option is the 7-month return. This was back-tested data over 10 years. 6-month returns will work just fine as well.

CONCLUSION FOR BUYING CALLS

Buying call options is a leveraged activity. Leveraged instruments means they allow traders to amplify their returns, while risking smaller amounts than would otherwise be required if trading the underlying stock itself. A standard option contract on a stock controls 100 shares of the underlying security! That means both a call and a LEAP leverage your portfolio for greater returns. But follow the rules above as greater leverage works both ways as a double edged sword!

SELLING CALLS

You want to sell calls between a 25 delta up to 45 delta. This depends on a few factors.

Volatility – HIGH IV is your friend with selling calls. Highest IV stocks such as Tesla are best off close to a 25 delta. This is because you will get compensated with capital appreciation if/when the stock rises.

LOW IV – This is actually referred to as an equity bond during my time at Goldman Sachs. An equity bond is a low IV stock, which you sell calls on at-the money for a 50 delta or slightly out for a 45 delta. Here it makes sense to sell at the money as you have a higher risk of the stock doing NOTHING. Therefore, aggression pays more.

Dividend – Following up on LOW IV close to the money covered call we have the double dividend strategy. Selling calls on dividend stocks has been shown to add 3.5% yearly alpha. Alpha is the rate at which you beat the market. Considering most high yield stocks pay 3.5% an additional covered call premium of 3.5% on top on VERY low volatility is a whale strategy. A whale strategy is what hedge funds and wealth managers refer to as a lucrative strategy for the rich. This is a strategy that is best implemented once your portfolio reach larger values but is also great for adding a hedge to a risky portfolio.

SELLING CALLS

Momentum – covered calls are best on stocks that have high IV but are in the middle of the Bollinger band. That’s because statistically given random walk theory a stock near the middle of it’s moving average and Bollinger band has greater central tendency. That’s fancy say for a stock in the middle of multiple indicators is likely to stay there. Sell covered calls and open up your pockets for the dollar bills!

SELLING PUTS

Higher yield and less risk than buying stocks

Goldman Sachs found that choosing stocks and strikes based on Free Cash Flow (FCF) yield dramatically improved put selling returns. Selling puts on stocks with FCF yield in the top quintile each month led to annualized return that beat buying stocks.

Selling puts is best done on a weekly or monthly basis as you make more money. Passive put selling generated annual returns of 7.1% over the past 10 years with monthly volatility one-third less the S&P 500. Although, this only matches the market return with less risk selling puts on stocks with IV above 50% can annualize 3 times more! Compound returns of 21%, matching Warren Buffett. Since 1965, Berkshire has provided 20% average annual returns, almost double the annual returns of the S&P 500. Premium collected selling 1 month puts on S&P 500 (the market) in 2008 would have collected 62% over 12 months. Look to duplicate results like this by picking the right stocks i.e (HIGH IV, Near Bollinger Band Low, Under 60 & 90 day moving average)

SELLING PUTS

Selling further out-of-the-money (OTM) puts increased the Sharpe ratio of the strategy, but reduced the absolute annual returns. This is why I aim to sell puts at 25 delta for a large portfolio of 6-fiures but need to crank it higher toward 35 or 40 delta for smaller portfolios. Higher delta means you will get puts more often and have to run the wheel strategy.

Strike choice methodologies vary across investor types and depends on risk so the general rules are great but can vary. In fact selling 70 delta puts on S&P 500 was proven to have the highest return but I would recommend not going higher than 50 delta. Below you can see further statistics.

Exhibit 4: Fully Collateralized 1-month passive put selling performance from Jan-2003 to Jan-2013

1-mo put selling strategies, index weighted for all optionable stocks; closest listed strike to target delta, moneyness, premium

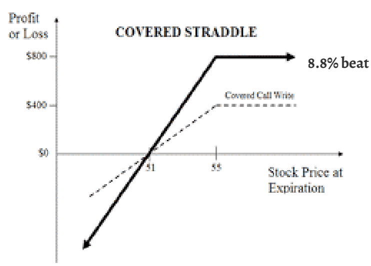
	Annualized		Monthly Return (%)						Option Statistics				SPXTR Risk	
	Compound Return (%)	StdDev	Sharpe Ratio	Mean	Median	Min	Max	StdDev	Avg. % OTM	Avg. Prem (%)	Bid-Ask Spread (%)	% times exercised	Equivalent CAGR	Risk Equivalent % collateralized
S&P 500TR	7.3%	18%	0.49	0.72%	1.7%	-24.9%	13.3%	5.1%						
Strategy: Specified Moneyness (1 month puts)														
0% OTM	7.1%	12%	0.65	0.63%	1.6%	-20.8%	9.1%	3.4%	-0.1%	3.4%	7.3%	45%	10.1%	67%
2% OTM	6.6%	11%	0.66	0.59%	1.4%	-20.1%	8.6%	3.1%	1.8%	2.6%	8.7%	35%	10.4%	60%
5% OTM	5.9%	9%	0.68	0.51%	1.1%	-18.4%	7.8%	2.6%	4.6%	1.8%	11.3%	23%	10.7%	51%
10% OTM	5.5%	7%	0.80	0.47%	0.9%	-15.5%	6.4%	2.0%	9.1%	1.1%	15.0%	12%	13.0%	40%
15% OTM	5.0%	6%	0.85	0.42%	0.7%	-14.2%	5.2%	1.7%	12.4%	0.9%	17.6%	10%	13.8%	34%
Strategy: Specified Delta (1 month puts)														
70Delta	7.4%	15%	0.55	0.69%	1.8%	-23.7%	11.3%	4.3%	-5.0%	6.5%	5.4%	70%	8.4%	85%
60Delta	7.1%	14%	0.57	0.65%	1.7%	-22.7%	10.9%	3.9%	-2.6%	4.8%	6.1%	58%	8.8%	78%
50Delta	7.1%	12%	0.63	0.63%	1.6%	-20.8%	9.9%	3.5%	-0.3%	3.5%	7.2%	46%	9.8%	68%
40Delta	6.6%	11%	0.67	0.59%	1.4%	-19.8%	8.4%	3.0%	2.0%	2.5%	8.6%	34%	10.5%	60%
30Delta	5.9%	9%	0.71	0.51%	1.2%	-17.8%	6.4%	2.5%	4.4%	1.7%	10.6%	24%	11.1%	49%
20Delta	5.0%	7%	0.76	0.43%	0.9%	-15.0%	4.7%	2.0%	7.2%	1.1%	13.3%	16%	12.1%	39%
Strategy: Specified Premium collected (1 month puts)														
1%Yield	4.3%	5%	0.83	0.37%	0.9%	-11.2%	3.1%	1.5%	8.5%	0.9%	14.5%	15%	13.4%	30%
2%Yield	5.8%	8%	0.79	0.50%	1.2%	-14.3%	3.1%	2.2%	4.7%	1.7%	10.2%	28%	12.8%	43%
3%Yield	6.8%	9%	0.75	0.59%	1.5%	-16.9%	3.8%	2.7%	2.2%	2.6%	8.1%	40%	12.0%	54%

BUYING PUTS

Selling Covered Strangles

During a period of 32 months study - strangle sellers outperformed the stock portfolio by 8.8 percentage points while put sellers outperformed the stocks by 7.3 percentage points and call sellers by one percentage point. This study was done in 2010 however is likely to still apply today. Covered strangle means you essentially sell a put, call and own the same stock. Selling a put for a covered strangle for maximum profit is best around 25 to 35 delta, just like regular selling puts. Calls are a bit wider at 25 to 45, again similar to a pure covered call strategy. HIGH IV is very beneficial for this strategy. Indicators are less important. This strategy places a high importance of wanting to own the stock you are trading. Number 1 mistake is to only chase premium.

To open a short strangle position, you need to sell puts and calls at the same time. It makes sense to monetize the "fear" when it overwhelms during the market downturn. When you see a sell-off this strategy is particularly very good to open in large quantities.

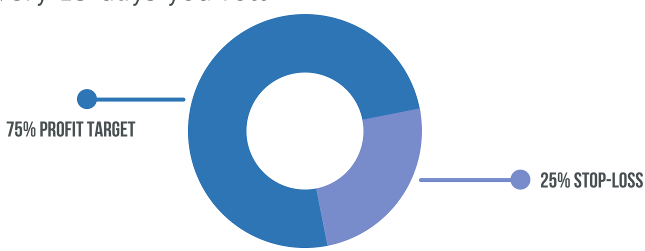


PUT CREDIT SPREAD

Sell an out-of-the-money put and then buy a further out-of-the-money put. This is my favorite small account strategy that is great for medium and large accounts alike. This is where I made the tesla trade that generated $11,000 on $18,000. In a bull market, which we have been in for about 10 years give or take with some pull backs a put credit spread strategy, with proper risk management could make 200% returns annually.

Here is the ruleset.

30 days until expiration
75% profit target – this means at 75% you close the position
25% stop-loss – this means at 25% loss you close the position
Every 15 days you roll



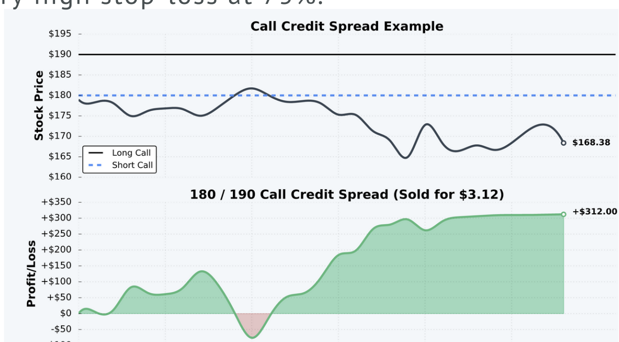
PUT CREDIT SPREAD

The above is back-tested results I ran and got 220% return on over a year period from 2015 to 2020. I did this on a $100,000 portfolio and if you follow a 5% max position rule for risk management you will get the highest risk adjusted return. However, holding until expiration and not rolling gave the highest absolute return of over 250%. That's the reason I hold until expiration and ONLY roll the last day or two. My strategy won often (93%), but its occasional losses were large. That's why I offer the first way to trade put credit spreads depending on your risk apatite.

My strategy that has worked and results in outsized returns is 6-month Tesla put Credit Spreads at a 15 to 20 delta. This strategy has historically achieved 86% gross premiums annualized after accounting for losses. 10 to 20 delta is the sweet spots for all put credit spreads with my favorite falling at right around 14-15 if I had to pick. Notice spreads are much smaller delta than puts and come in at roughly half.

CALL CREDIT SPREAD

Time decay, or theta, works to the advantage of the call credit spread strategy. This is as close as you can get to selling call options that are naked, which you cannot and should not do! Bear call spreads can be rolled out to a later expiration date to extend the duration of the trade at a 75% loss to collateral. Call credit spreads are best used on stocks that have HIGH P/S ratio. P/E does not matter much! Look for a high P/S ratio that is sitting at a 52-week high. Check the image below. This is the perfect example on why I typically hold options until expiration or have a very high stop-loss at 75%.



Call credit spreads are best done on a 1-month expiration basis. This has had the highest back-tested results.

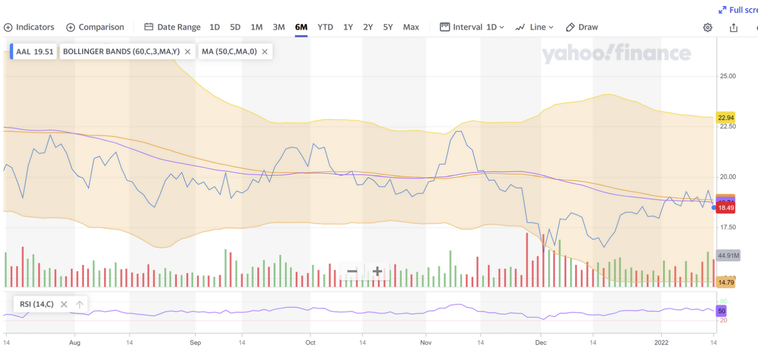
IRON CONDOR

Iron Condors are a popular strategy among option traders and are simply a combination of a **put credit spread** and a **call credit spread.** The goal is to go wide enough that the stock never shoots up toward your calls or down enough to your puts. I do have strict limits at 75% of the iron condors collateral amount. It's important to cut an iron condor which has had one of it's legs completely consumed. That means if you have a 95/90 put spread and 105/110 call spread and the stock just surpassed $100 per share that I close the trade and take the premium that it is worth at that time. This avoids a complete loss even though the stock has reached past one of the upper or lower protecting legs.

IRON CONDOR

The trade aims to make a profit from stable stock prices and/or a drop in implied volatility the direction usually doesn't matter. Stable isn't that necessary as long as implied volatility as near an all-time high and is expected to fall lower.

Check the image below.



The image above is AAL for the past 6 months. In fact for the past year AAL has had great Implied volatility and stayed range bound. An Iron condor is best on stocks that visually have a pattern of going nowhere. If a stock has a 6 month performance of say -5% to +5% with lots of volatility in between this is a good candidate to run iron condors on.

WHEEL STRATEGY

The wheel is an interesting one – it's essentially both a neutral and bullish trading strategy. The wheel is a life-long money making machine on a stock where you reduce your cost basis and generate cash. It is both bullish and neutral at the same time. Depending on how far out of the money you sell options it can be very bullish or very neutral if you are selling at the money options.

Rule number 1 : follow the put selling rules

Rule number 2 : follow the covered call rules

The wheel is ideal for medium and large accounts. It's one of the best strategies in option trading and has been a top amongst income investors. Selling options has proven to work. The market has very little anomalies. After all everyone is looking to exploit it. You aren't the only one. But multiple hedge funds I've worked at have proved that selling puts is a strategy that works and continues to provide excess returns. The reason is due to pension funds having requirements to hedge portfolios. Certain big institutions are required to have portfolio insurance to minimize potential large drawdowns. Over a long period of time a put seller will outperform the market. Once in a position follow the selling call rules.