

THE ANDREW KEENE PLAYBOOK: 5 Winning Options Strategies



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Who Is Andrew Keene?

To say that Andrew Keene has had a successful career would be putting it lightly.

Andrew Keene was an independent equity options trader on the Chicago Board Options Exchange for 11 years, and from 2006-2009, he was the largest independent on-the-floor **Apple** (AAPL) options trader in the world.

He also served as a market maker in over 125 stocks, including Apple, **General Electric** (GE), **Goldman Sachs** (GS), and **Yahoo** (YHOO).

Recently, along with his trading success, Andrew has become a rising media star with regular appearances on major television networks like CNBC and Bloomberg TV.

Andrew recently published his first book, *Keene on the Market: Trade to Win Using Unusual Options Activity, Volatility, and Earnings.*

Now, he's partnered with Minyanville to create <u>Keene On Options</u>, an all-new options service for the serious investor. With fresh trading ideas every single day, weekly market strategy reports, and 100% interactive webinars, this is the premier product for traders looking to generate more profits in options.

As an introduction to Andrew's trading style, he has put together a list of his top money-making options trading strategies, divided into five categories:

- 1. Debit Spreads
- 2. Credit Spreads
- 3. Straddles and Strangles
- 4. Butterflies
- 5. Iron Condors

Andrew has an expert level of options knowledge, with a deep understanding of the mathematical nuances of pricing as well as the "softer" aspects of reading the market – particularly when it comes to unusual trading activity.

However, all of the strategies discussed here are easy to understand and can be put to work in your own investing activities today.

Please note that the trade examples presented in this white paper are for educational purposes only. Some numbers were rounded to illustrate the math in the simplest possible way.



1. Debit Spreads

The Basics

A debit spread is simply a vertical spread in which the two options used net out to a debit.

In other words, a cash outlay is required to establish these positions.

Vertical spreads can also be classified as bullish or bearish.

Putting Them to Work

A trader would use a **bull call spread** to express a moderately bullish outlook on an underlying security.

A bull call spread is constructed by purchasing a call option, and then selling a higher-priced call option with the same expiration.

As an example, let's say we are moderately bullish on Apple. We could construct a bull call spread with the following contracts:

- Buy the July \$400 call for \$13.00
- Sell the July \$410 call for \$8.00

This trade would cost us \$5 (\$13 - \$8), or \$500 per lot, which also represents the maximum downside risk on the trade. The potential reward is \$5, which is calculated as the distance between the two strikes (\$10), minus the cost of the spread (\$5).

Our breakeven point at expiration would be \$405, which is calculated by taking the low strike (\$400) and adding the debit paid of \$5.

The advantage of this strategy over a straight long call purchase is that it costs less to set up the trade, which reduces downside risk in dollar terms.

The disadvantage is that the reward is capped at the higher strike, which in this case is \$410. Even if Apple went to \$450 by expiration, profit potential is limited at \$5 per lot.

And since this is a long-premium position, time decay (a.k.a. theta) has a negative effect on the position's value.



Now, let's look at the bull call spread's polar opposite.

A **bear put spread** is a strategy used when a trader has a moderately bearish outlook on an underlying security.

The trade involves simultaneously buying a put while selling a lower strike put against it.

So let's say we were moderately bearish on Apple.

We could execute the following trade:

- Buy the July \$400 put for \$11.00
- Sell the \$390 put for \$7.00

This trade would cost us \$4 (\$11 - \$7), or \$400 per lot, which also represents the maximum downside risk on the trade. The potential reward is \$6, which is calculated as the distance between the two strikes (\$10), minus the cost of the spread (\$4).

Our breakeven point at expiration would be \$396, which is calculated by taking the high strike (\$400) and subtracting the debit paid of \$4.

The bear put spread has the same advantages and disadvantages as the bull call spread. A bear put spread enables us to put on a trade at a lower upfront cost, but the main disadvantage of this strategy, like the bull call spread, is that it has a capped profit potential. If Apple collapsed to \$350, our maximum upside would still be limited to \$6.

And like bull call spreads, since this is a long-premium strategy, time decay has a negative effect on the position.



2. Credit Spreads

The Basics

A credit spread is a spread where the two options traded net into a credit.

In other words, cash is received when establishing these positions.

Credit spreads can be classified as bullish (bear call spreads) or bearish (bull put spreads).

Putting Them to Work

A trader would put on a **bear call spread** if he or she had a moderately bearish to neutral view on the underlying security. The trade is set up by selling a call (a bearish trade), and buying a higher strike call against it. This strategy requires less capital than going outright long put options, and also benefits from time decay and decreasing volatility.

As an example, let's take a look a possible trade on **Google** (GOOG):

- Sell the August \$860 call for \$38
- Buy the August 870 call for \$34

The maximum reward for this strategy is limited to the credit received when establishing the position, which in this case is \$4 (\$38 - \$34). The trader would keep the \$4 if Google expired below \$860, rendering both options worthless.

The maximum risk of this trade, which would be incurred if Google closed above \$870 at expiration, is limited to the distance between the two strikes minus the net credit received, which in this case is calculated as \$10 - \$4, or \$6.

On the flip side, a trader would put on a **bull put spread** to express a moderately bullish to neutral view. The trade is set up by selling a put (a bullish trade), and buying a lower strike put against it.

So let's look at a bull put spread on Google:

- Sell the August \$870 put for \$33
- Buy the August \$860 put for \$29



The maximum reward for this strategy is limited to the credit received when establishing the position, or in this case, \$4 (\$33 - \$29).

The maximum risk is limited to the distance between the two strikes (\$10) minus the net credit received (\$4), which in this case equals \$6.

This strategy requires less capital than going outright long call options and also benefits from time decay and decreasing volatility.



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3. Straddles and Strangles

Straddles are the purest way to speculate on volatility.

The buyer of a straddle is expecting a wild move up or down in the underlying stock, or a large increase in implied volatility – all of which would increase the value of the straddle.

To construct a straddle, a trader would take a stock and buy equal quantities of at-themoney call and put options with the same strike price and the same expiration.

Let's look at one of the hotter momentum stocks in recent history – **Tesla Motors** (TSLA), trading at \$100.

If we wanted to speculate on a big move in Tesla, we could put on the following trade:

- Buy the September \$100 call for \$14
- Buy the September \$100 put for \$13

The maximum downside risk at expiration is the cost of the straddle, or \$27, which is simply calculated by adding the cost of both options. This loss would be incurred if Tesla was at \$100 at expiration, leaving both options worthless.

Note that with a straddle, there are two breakeven points at expiration: 1) the strike price plus the premium paid, and 2) the strike price minus the premium paid.

In this case, those breakeven points would be \$127 (\$100 + \$27) and \$73 (\$100 - \$27).

So at expiration, the position would be profitable if Tesla were below \$73 or above \$127, and on the upside, the profit potential is actually theoretically unlimited since this position is not hedged.

The main disadvantage of a long straddle is that it can be expensive, especially with fast-moving stocks with high implied volatility.

And given their construction from both long call and put options, long straddles are very sensitive to changes in implied volatility, and time decay has a strongly negative effect on the position.

Strangles are also direction-neutral strategies, but instead of using at-the-money options, they use out-of-the-money options.



So let's examine a possible strangle on Tesla:

- Buy the September \$110 call for \$11.00
- Buy the September \$90 put for \$8.00

As you can see, the advantage of a strangle over a straddle is that the initial premium outlay is much smaller because out-of-the-money options are priced lower than in-the-money ones. In the case of Tesla, our strangle costs just \$19 (\$11 + \$8) vs. \$27 for the straddle.

Like long straddles, the maximum risk of a long strangle is limited to the premium paid (\$19 in this case), and the reward potential is theoretically unlimited on the upside.

There are two breakeven points at expiration, calculated by 1) adding the premium paid to the call strike price, and 2) subtracting the premium from the put strike price.

In this case, those breakeven points would be \$129 (\$120 + \$19) and \$71 (\$90-19).

So while the upfront cost of this trade is lower than that of the straddle, the breakeven points are a bit further out, so the stock needs to make an even more attractive move to generate profits.

As with straddles, the main disadvantage of a strangle is that time decay is very harmful to the position, and thus a very large move in the underlying is required for the position to be profitable. Plus, strangles benefit from increases in implied volatility and are harmed by decreases in volatility.



4. Butterflies

A **butterfly** is a trade used to speculate on a stock hitting a specific price at expiration.

They are constructed with a combination of two vertical spreads -- one long and one short. Butterflies can be constructed using call spreads or put spreads, though for the purposes of this white paper, we will focus on a simple butterfly call spread.

If done at the money, the trader has a neutral outlook.

If done out of the money, the trader is taking a bullish or bearish view.

Ideally, a trader would want the long spread to expire at maximum value while the short spread expires worthless.

So let's assume a neutral outlook on the **S&P SPDR ETF** (SPY), using an at-the-money butterfly call spread:

- Buy 1 July \$156 call for \$4.20
- Sell 2 July \$158 calls for \$2.90 (a total of \$5.80)
- Buy 1 July 160 call for \$1.80

If you'll notice, buying the \$156 call and selling the \$158 call is a bull call spread (a bullish position).

And selling the \$158 call and buying the \$160 call is a bear call spread (a bearish position).

By combining them, we create a butterfly call spread.

In this, case, we are paying a debit of \$0.20, since it costs us \$6 for the \$156 and \$160 calls, offset by the \$5.80 we receive for the \$160 call.

The maximum reward is calculated by taking the distance between the strikes in the butterfly spread (in this case, \$2), and subtracting the debit of \$0.20, which gives us a maximum profit of \$1.80, or 800%.

Now to get that maximum reward, the stock would have to trade at \$158 at expiration, resulting in the following: 1) The bull call spread would be worth its maximum value of \$2, and 2) the bear call spread would expire worthless.



Taking \$2 and subtracting the \$0.20 debit we paid for the position gives us the maximum return of \$1.80.

In terms of profitability without hitting the middle strike right on the dot, the breakeven points of a call butterfly are equal to 1) the low strike plus the debit paid, and 2) the high strike minus the debit paid.

In this case, we would break even at \$156.20 (\$156 + \$0.20) and \$159.80 (\$160 - \$0.20).

That \$0.20 represents the maximum risk for the trade.

However, while butterflies have enormous profit potential, they require the trader to be extremely accurate in selecting a target price.



5. Iron Condors

An **iron condor** is a four-legged credit spread used when a trader has a neutral view, expecting little to no movement in the underlying stock.

The main advantages of this trade are that it is established for a net credit, has limited loss potential, and can profit if the stock stays in a specific range.

You can look at this trade as simultaneously selling an out-of-the-money bear call spread and an out-of-the-money bull put spread. This is a short premium strategy that also has a trader short implied volatility.

As an example, let's say we wanted to bet that the **iShares 20-Year Treasury ETF** (TLT) would not move.

We could put on the following trade:

Component 1: Bear Call Spread

- Sell the July \$110 call for \$1.00
- Buy the July \$111 call for \$0.70

Component 2: Bull Put Spread

- Sell the \$107 put for \$1.40
- Buy the \$106 put for \$1.10

With this trade, we would receive a credit of \$0.60 – by chance, each side of this particular trade gives us a \$0.30 credit.

This \$0.60 credit represents the maximum potential profit on the trade, and would be attained if TLT closed between \$107 and \$110 at expiration. In this range, both of the spreads (which we are short) would expire worthless.

The maximum loss potential is \$0.40, which would be incurred if TLT traded to \$106 or \$111. At that point, one of the spreads would be worth \$1, which, offset by the \$0.60 credit, leaves us with a \$0.40 loss.



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The breakeven points are calculated by adding the credit of \$0.60 to the \$110 call and subtracting that same \$0.60 from the \$107 put. So at expiration, the position would be profitable anywhere from \$106.40 to \$110.60.

Iron condors don't often set up for a good reward/risk ratio, so they work best in times of heightened implied volatility, especially when there is good reason to believe volatility will decrease.

Here are some examples of when options premiums will be "rich":

- Ahead of earnings
- When there are drug announcements
- When there are new product announcements
- When there are economic data releases

A trader would look to set up an iron condor during one of these periods if he or she believed the subsequent move in the underlying will be smaller than expected.



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