

## Income Method #5: Increase Your Payout

The purpose of this Section is to show how adding a ratio call spread to your RPM can further lower your risk and generate income at the same time. For Income Method #5 we will look to purchase call options equivalent to the number of shares that are owned, while at the same time selling twice as many calls at a higher strike price. The premium received from the sold calls will pay for the call(s) that are purchased, resulting in a net credit. You may think this results in holding short calls that are naked, or uncovered, but remember you still own shares of stock. Half of the sold calls are covered by the stock, the other half of the sold calls are covered by the purchased long call. This creates a covered call position with a Bull Call Debit spread added on. Some investors refer to this trade as a Stock Repair Strategy, but since we trade RadioActively, we can use this technique to lower our risk and further generate income.

### **INCOME METHOD #5 CEGA MODEL -- Plus! CATASTROPHE REPORT**

#### **CONDITIONS:**

The sold calls are one strike or more above the call that is purchased, and the sold call premium is more than half of the price for the long call.

#### **EXPECTATION:**

The stock's price at expiry will finish at or near the strike price of the sold calls.

#### **GOALS:**

Income – with a little extra punch for a stock that's holding its value.

#### **ACTION:**

BTO (Buy To Open) near term At or In-the-Money Calls, then sell twice as many calls with the same expiry but one strike up.

#### **CATASTROPHE REPORT ... What if the worst possible thing(s) happened?**

If the stock's price finishes *below* all the calls, we have received income and have no obligations – no problem there. There are two other possibilities:

- 1) If the stock's price finishes *between* the strikes... Above the purchased call strike price but below the sold calls strike price. The short calls will expire worthless, the net credit remains in your account and the long call(s) can be sold for extra income.
- 2) If the price of the underlying finishes *above* the strike of the upper calls, the Bull Call Debit spread will reach full profit but one of the sold calls must be managed with IM#2 or the RPM should be closed. Can this be done at a profit?

## Income Method #5

### Spread Trading – A High Return, Limited Risk Strategy... IF You Respect The Martingale

Before we get into Income Method #5, let's review how a Bull Call Debit spread work, and how the spread strategy can generate income.

Using spreads for leverage and limited risk has made many savvy traders wealthy. I met a young man in his early twenties that turned a \$10,000 account into over \$50,000 in about two years using a spread trading system.

After looking at RadioActive Trading in one of my free Webinars, he decided to make a switch. Why? Well, he had a string of losses that cut into his account pretty deeply. He was still up with about \$30,000 left, and was getting ready to begin law school. He wanted a lower maintenance form of investing and he wanted to stabilize, SO he became a Member! I couldn't help but wonder why a trader that had experienced such success with aggressive trading methods would want to switch to RadioActive Trading. After all, taking a \$10K account up to \$50K in two years is no mean feat. Even after losing a significant portion of his gains, the \$30K he was left with still meant *tripling* his money in a short period of time.

In the educational video series on YouTube, I asserted that *all* successful traders use limited loss concepts, whether they're aware of it or not. If you saw the series, you know that I believe that the secret to successful trading is money management. Nobody is right all the time with predicting prices or timing their entries or exits. But you can *always* be right about how much of your account to risk in any one trade. This is the one thing you can control at all times; your commitment to a position.

Even without looking at his trading record, I can pretty much tell you what happened with this young man's account. Let's call our subject Gene (not his real name). At the beginning Gene studied the spread trading strategies in a weekend seminar and with some home study materials. When Gene got started he said, "Okay. This is how much I have to trade, but I'm new at this. I'll only do one or two trades at a time and see how it goes." He was right two or three times, wrong once, "managed" a trade and lost a little, but not enough to break the bank. Then he won again. Having a little success, maybe he felt as though he might loosen up a little.

Gene probably kept raising the amount of funds he was willing to commit to each position until he hit the IDEAL amount – remember Ryan Jones' example with the different money management levels? Risking too little meant not enough profit, risking a bit too much meant the same, but in the middle there was a "sweet spot" that returned almost eight times as much as the higher and lower bets did. Gene probably hit that zone and continued to chug along to a fivefold gain.

THEN, I'll bet our friend turned cocky. He began to feel indestructible. I mean, after all, look at that account! And as a result Gene began to violate what he may not have even been aware that he'd been practicing in the first place: money management. He stopped placing the IDEAL amount at risk in any single trade and began to bet too much. And that's where Mr. Martingale stepped in and started gobbling up his hard-won gains.

## Income Method #5

### Money Management: Let's Use The Risk/Reward Calculator on the Bull Call Spread

Let's view a setup of an actual Bull Call Spread with CELG (Celgene Corp).

On December 4<sup>th</sup>, 2006, Celgene was in an uptrend. The April 2007 \$55 call options, which were In The Money, were trading at \$7.80 bid x \$8.00 ask. At the same time, April 2007 \$60 call options were trading at \$5.00 bid x \$5.10 ask. Remember how a Bull Call Spread is done? You buy the lower call and sell the higher strike call against it. The difference of \$3.00 (\$300 per contract spread) is your total cost, and maximum return is \$2.00 (\$200 per spread) profit if CELG closes above \$60. Here's how a Bull Call Spread entry would look:

#### December 4<sup>th</sup>, 2006 - Celgene Bull Call Spread

BTO April \$55 2007 calls	\$8.00
STO April 2007 \$60 calls	-\$5.00
Total Investment	\$3.00
Guaranteed Return	\$0.00
<b>Total AT RISK:</b>	<b>\$3.00 or 100%</b>

Looks like a lot to risk... and it is. Depending on how much of his account Gene commits to buying and selling this arrangement, he may have as much as ALL of his account AT RISK.

Furthermore, how much CAN Gene gain in this setup? If CELG trades below \$55 at expiration, everything expires worthless. Gene would lose the entire \$3.00 debit. But if it trades above \$60 both options can be closed for intrinsic value, and Gene will receive the \$5.00 difference between the low and the high strike price. Since the initial net debit was \$3.00, the maximum profit on the position is \$2.00. For risking \$300, he may get as much as \$200 profit, or a 66.67% return, but no higher.

So how should Gene sell Celgene? ;-) Seriously, if he has a \$30,000 account, and the cost is \$300 a spread, that means he can afford to buy 100 spreads, right? One good trade with \$30,000 returns 66.67%, putting him back at a \$50,000 balance. Let's see how betting spreads might work out after 100 tries:

Win Target: 66.6%
Loss Limit: 100.0%

#### SUMMARY:

Beginning Balance: \$ 30,000.00

Out of 100 trades

Wins 50

Losses 50

Low Value: \$ (1,923.75)  
High Value: \$ 83,099.10

Ending Balance: (62.86)

## Income Method #5

Hmmm... not an attractive trading record. He was up to \$83,099.10 at one point, but ended up in debt in the end.

Wait! What if Gene used the same kind of strategy, but managed his money differently? If Gene only bought 10 contracts instead of a hundred, betting 10% of his total account instead of 100%, everything would divide by ten *including* the risk. Now we have a different picture:

Win Target: 6.7%
Loss Limit: 10.0%
<b>SUMMARY:</b>
Beginning Balance: \$ 30,000.00
Out of 100 trades
Wins 51
Losses 49
Low Value: \$ 1,055.42
High Value: \$ 30,000.00
Ending Balance: 1,088.72

Well I guess that's better than being in debt, but it is still a devastating loss for an account that started with at \$30,000. If this is the way spread trades go, how is it that Gene could get his account up to \$50,000 from \$10,000 to begin with?

Well, I know that when I was going to "spread trade school" they showed us how to manage a failing trade. When you knew that a spread was moving against you, you could get out before a loss became the MAXIMUM loss.

Let's assume that Gene learned these same techniques at his weekend workshop and home study course. Rather than just placing spread trades and forgetting them, he would close the winners as soon as they were In The Money and would close losers before they became BIG losers. So instead of losing 100% on the losing spread trades, he would only lose 25%, take his money, lick his wounds, and get back in.

Let's run the calculator and see what would happen with a 25% loss limit and 66.67% win goal per contract. Oh, and let's only commit 10% of the account to any one trade. Then BOTH the risk and the max reward are divided by ten because only one tenth of the account would be tied up at a time.

With a 2.5% loss limit and 6.67% win goal, what does the Trade Simulator Calculator say now?

## Income Method #5

Win Target: 6.7%
Loss Limit: 2.5%

### SUMMARY:

Out of 100 trades	Beginning Balance: \$ 10,000.00
Wins 50	Low Value: \$ 10,000.00
Losses 50	High Value: \$ 52,748.01
	Ending Balance: 52,748.01

Hmm. I'm beginning to see how a twenty-something kid multiplies a \$10,000 account into \$50,000. As I said earlier, he probably began conservatively and increased his boldness to the place where he was trading quite well; then at some point he got cocky from the victories in the market and began to risk too much. That's when Gene met up with the Martingale.

### What does all of this have to do with Income Method Number Five?

Well, first of all I wanted to show that great returns are available with spread trading, but so are great losses. The one deciding factor that separates two traders with the same markets to trade, the same strategies, the same entry-exit rules are the only thing over which we have control: how *much* we put AT RISK.

Buying a Bull Call Debit Spread, or selling a Bear Call Credit Spread (next Section) is a limited risk, limited gain proposition. Done by itself it can be a great way to get some quick cash, but computing how much of one's total account to trade is *vital*. Here's the interesting thing about trading a spread in the context of a married put: position size is already computed. Plus, imagine doing a Bull Call Debit Spread in which you cannot lose if the underlying stock goes down!

Instead of doing a "plain vanilla" Bull Call Spread trade on CELG, let's do it in the context of a married put position that's moved up in price from the entry price. First, the married put setup:

### CELG RPM -- Quotes as of 10/27/2006 3:12:58 PM ET.

CELG stock at	\$50.29
Jan 2008 \$60 put	+\$12.60
Total Invested:	\$62.89
Guaranteed Return	-\$60.00
<b>Total AT RISK:</b>	<b>\$ 2.89 or about 4.6%</b>

## Income Method #5

### Now, For Something Completely Different

SO let's return to our December 4, 2006 example with the Celgene call options, and see what we may do with them against the backdrop of the married put position. Remember the following Bull Call Spread from just a few pages back?

**December 4<sup>th</sup>, 2006**

#### Celgene Bull Call Spread

BTO April \$55 2007 calls	\$8.00
STO April 2007 \$60 calls	<u>-\$5.00</u>
Total Investment	\$3.00
Guaranteed Return	<u>\$0.00</u>
<b>Total AT RISK:</b>	<b>\$3.00 or 100%</b>

At this point, CELG was trading very close to \$60, making the \$60 calls the fattest in terms of time premium according to the ATM Bell Curve. Here's an interesting proposition: rather than BUYING a Bull Call Debit Spread, how about getting paid to put one on? All we need is a little more than enough to pay for the spread. We'll use Income Method #1: Selling a Covered Call to pay that difference.

See the April 2007 calls trading for \$5 above? In Income Method #5, we sell a covered call and take the proceeds to pay for a Bull Call Debit Spread. We'll buy one, but sell two calls like this:



#### December 4<sup>th</sup>, 2006 - Celgene Bull Call Spread

STO two April 2007 \$60 calls	\$10.00
BTO one April 2007 \$55 call	<u>-\$ 8.00</u>
Total Income	\$ 2.00

Isn't that a pretty picture? Instead of paying \$3.00 and putting it **AT RISK** for this Bull Call Debit Spread, we receive a credit of \$2.00. This is a move I actually did on December 4<sup>th</sup>, 2006, canceling nearly all of the \$2.89 that was **AT RISK** in the initial married put position. The first \$60 call was sold against the \$55 call that I Bought to Open, while the second \$60 call was sold against the stock part of the married put, just as it would be in IM #1. The result is a Bull Call Debit spread that adds to the position, but is financed by selling a call against the stock. No added risk, but there is added profit potential.

When I first discovered this idea, I just about cried. Here was a way to sell calls against a stock, and not care in the least if the stock continued to move upwards. I'll bet Gene got a little misty, too, because "managing" a sick spread is easier on the heart when you've received a credit rather than pay a debit. Now, before we get too excited, we need to understand the importance of all the implications that come with this new position. First, if CELG tanks, we're not too concerned because we have collected income for selling calls. Perhaps we'll let them expire, take the money and run. On the other hand, if CELG is hovering between the \$55 and \$60 strike price on expiration Friday, that's an added bonus. We get to keep the \$2.00 credit already received; we don't have to deliver the

## Income Method #5

stock, plus our long \$55 strike call has gained in value. We can sell that call at intrinsic value and generate bonus income.

As you might imagine, the very best scenario is if CELG closes right at \$60 a share on expiration Friday. The short \$60 calls can be closed for a minimum price, while the \$55 call will have an intrinsic value of \$5.00, on top of the \$2.00 we collected for putting IM#5 in place. That would be a total of \$7.00 collected on this Income Method alone. Not shabby!

The next possibility takes some thinking, though. Say CELG shoots up way beyond \$60. We are still obligated to deliver 100 shares at \$60 per share. This is a more management-intensive situation. Actually, it's not as bad as it may sound, seeing as we already collected \$7.00 and there was only \$2.89 AT RISK. We actually have a few choices, depending on the Conditions and Expectations for CELG:

- 1) We could "manage" by Buying To Close one of the \$60 calls, then Sell To Open one further out in expiry and higher up in strike... IM#2.
- 2) We might at this time Sell To Close the Jan 2008 \$60 put option and Buy TO Open a much cheaper, April 2008 \$60 put option... IM#3.
- 3) We may just do nothing... that's right, allow the stock to be assigned, collect the \$5.00 difference for the Bull Call Debit Spread (we do this in example #1 and #2 above also), and hold onto the put to wait for a sudden dip, get back into another RPM, or simply to sell put spreads against it.

How about Income Method #5? Now, it's not for all Conditions, but it sure does pack a wallop for an RPM when the Conditions ARE right! The trick in employing IM#5 is to always run the Catastrophe report. The worst possible thing that can happen with a regular Bull Call Debit Spread is that the underlying falls and stays below the lower strike price. The worst thing that can happen with IM#5 is that the underlying blows its doors and never looks back. You will then have a short call to manage, unless you just want out now.

Remember this sage advice from the Income Method #2 Sections? Sometimes a stock that we've sold a call against shoots up past that call's strike price, and we find that we've obligated ourselves to sell at too low a price. Most of the time this problem can be avoided by properly selling the first call with enough coverage. Make sure that getting called out at the upper strike price wouldn't bother you, then go ahead.

In case you run into the problem of your stock running up, it doesn't have to stay a problem. Other Income Methods like IM#2 or IM#3 can be used to further augment the return from your RadioActive Profit Machine. Just always remember to run a new Catastrophe Report for each scenario.

This Income Method may seem complex at first, but there are tools available on PowerOptions to help you identify, build and analyze these spreads on your married put positions.

The first tool available at PowerOptions is the Stock Repair Strategy tool. Initially this tool was designed to help long stock investors repair stocks that had fallen in price. Once the investor entered in their number of shares and cost basis, the tool would identify the

## Income Method #5

possible ratio call credit spreads to help them get back to break-even at a lower price. For RadioActive members, the cost per share would equal the total cost of the initial married put position. The initial CELG position had a total investment amount of \$62.89:

Stock/Index Symbol	Your Cost/Share	# Shares				
CELG	62.89	100	<b>Submit</b>	<a href="#">Lookup Symbol</a>		

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Credit Repairs for... CELG: \$ 56.08							
Target Month For Repair	Lowest Stock Cost	Highest Stock Cost	Buy Strike	Sell Strike	Net Credit	Break Even	Trade Details
DEC 2008	\$ 56.08	\$ 65.50	55.0	60.0	\$ 0.50	\$ 58.70	<b>Repair Details</b> <b>Analyze Trade</b>
JAN 2009	\$ 56.08	\$ 66.60	55.0	60.0	\$ 1.60	\$ 58.15	<b>Repair Details</b> <b>Analyze Trade</b>
APR 2009	\$ 56.08	\$ 69.20	55.0	60.0	\$ 4.20	\$ 56.85	<b>Repair Details</b> <b>Analyze Trade</b>

Source: PowerOptions – Stock Repair Strategy Tool.

Once you have entered in your values, the Stock Repair Strategy tool will identify various repair spreads, or Income Method #5's for you to consider. To see the specifics of the trade, simply click the 'Repair Details' button next to the available spreads. Please note that the results above are based on the initial CELG example and cost basis, but we are analyzing the position as if the 2009 JAN \$60 strike put option was purchased as we are passed the 2008 JAN expiration date. If you wished to build your own Income Method #5's and test out different possibilities, you can simply use the 'Custom Spread Tool' on PowerOptions. This will allow you to quickly create and analyze potential IM #5's to help you generate income. Below is screen shot for the CELG position (again, moved forward to 2009) and the profit/loss chart for the position. The initial setup for this tool is:

Custom Spread Builder					
<b>Underlying Stock (Lookup):</b> <input type="text" value="CELG"/> <a href="#">View Options</a>					
Symbol	Desc	Action	[Optional] Quantity	[Optional] Price	
<input type="text" value="CELG"/>	Celgene Corp.	<input type="button" value="Buy"/>	<input type="text" value="100"/>	<input type="text" value="50.29"/>	<a href="#">clear</a>
<input type="text" value="LQHML"/>	CELG Jan 2009 60 Put	<input type="button" value="Buy"/>	<input type="text" value="1"/>	<input type="text" value="12.60"/>	<a href="#">clear</a>
<input type="text" value="LQHAK"/>	CELG Jan 2009 55 Call	<input type="button" value="Buy"/>	<input type="text" value="1"/>	<input type="text" value="8.00"/>	<a href="#">clear</a>
<input type="text" value="LQHAL"/>	CELG Jan 2009 60 Call	<input type="button" value="Sell"/>	<input type="text" value="2"/>	<input type="text" value="5.00"/>	<a href="#">clear</a>
<input type="button" value="Submit"/>					

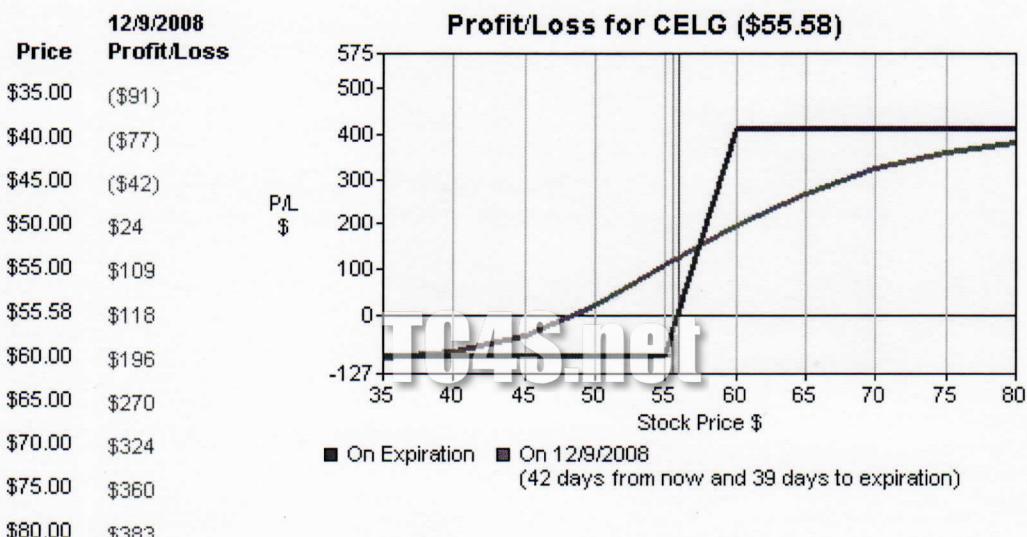
Source: PowerOptions – Custom Spread Tool.

## Income Method #5

You can easily change the third and fourth rows to show other call options at different strike prices or in different expiration months. When you click Submit, the Custom Spread tool will calculate the potential return, maximum risk and build a Profit/Loss chart for the position:

### IM #5 Profit/Loss for CELG (using 2009 put option):

Current Stock Price ■: \$55.58	Total Cost:	\$6,089.00
Break Even ■: \$55.89	Monetary Requirement:	\$0.00
	Total Requirement:	\$6,089.00
	Max Risk:	\$89.00
	Max Profit:	\$411.00
	% Return:	6.7%
	% Max Risk:	1.5%



Source: PowerOptions – Custom Spread Tool

In addition, you will be able to run ‘what if scenarios’ and analyze the Catastrophe Report using additional features on the Custom Spread tool. This will help you analyze the gain or loss on the total position if the stock is trading at any given price on any day between now and expiration.

If you’re considering doing IM#5, remember the CEGA model. If the “Goals” part of your CEGA is to get as high a return in as short a time as possible then IM#5 may be a good choice. On the other hand if you need a little income but think you want to hold for the long haul, check out the next section for perhaps a better alternative.

**REMINDER: With all the Income Methods, we want to use our CEGA model and Catastrophe Report. Make sure that your Actions are appropriate to the Conditions, Expectation, your individual Goals, and that you’re okay doing them in light of the worst possible outcome.**