

Income Method #3: Rolling the Put In

Income Method #3 can be used in two different ways: It can augment the return on an RPM that has a call sold against it when holding for growth or it can also be used to "Bulletproof" a stock that's up and looks like it may go further in the short term... or CRASH. I like to use IM#3 this way to capture the potential upward move of the stock without being exposed at all to a downward move.

In this Section you'll see how a Member used IM#3 to add to his return from an IM#1 paper trade... as well as how I "bulletproofed" a real-time, real-money stock that I wanted to hold until after an earnings announcement.

INCOME METHOD #3 CEGA MODEL -- Plus! CATASTROPHE REPORT

CONDITIONS:

The price of the underlying stock is approaching or has risen above the strike of the protective put. A call MAY or MAY NOT have already been sold against the stock.

EXPECTATION:

Uncertain. If a call has been sold, IM#3 can be applied with good results for a short term return as an action in light of what has *already* happened. If a call has not been sold and news is expected that could send a stock either way fast, IM#3 can bulletproof the stock but still capitalize on an upward move.

GOALS:

Income – willing to get out in the near term, with good return for the time invested.

ACTION:

Sell the Protective Put (it's all time value now) and buy a different one at the same strike price, but near to expiry.

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

In the case of IM#3, you're essentially deciding to close your RPM early by moving in the expiration date. The worse possible thing that can happen is that your stock waits until after that date, and then appreciates further but without YOU.

Income Method Number Three- What It IS:

IM#3 is applied when we STC (Sell to Close) the put that's protecting our RPM, and simultaneously BTO (Buy to Open) a put that's at the same, or only slightly different strike price but much nearer to expiration. This "puts" money in our pockets right now, while shortening the time that we'll spend in the trade.

Income Method #3: rolling back the put in time can be combined with Income Method #1, selling a covered call, for a powerful one-two punch to create a short-term return.

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One of my favorite applications, however, is to roll back the put *only*. This strategy can be used to "bulletproof" a stock that's run up a bit, without putting a limit on how much more it can grow. SO far, we've only looked at how to extract income from the RPM structure by selling calls against it, but there's a problem with sticking with only that idea: selling calls limits your upside.

The Trouble with Just Covered Calls

One of the big problems with selling covered calls, besides the downside risk of holding a volatile stock, is the limit that selling a call imposes on the upside potential. For example, say you're holding JUMP at \$50 and sell a \$50 call against it for a buck. We know the risk if JUMP dives off a cliff... you could lose up to your entire investment minus the premium from selling a call. This is why we began adding a put to our stocks in the first place; we want to limit our possible losses.

But what if your stock JUMPs *UP*? Now we have a different kind of risk: the risk that we'll miss the upside of this trade. If JUMP makes a run up to \$100 and you have a \$50 call sold against it, it's very unlikely that you'll be able to roll the call effectively using IM#2.

Why Hasn't this Problem of Limiting the Upside Been Solved?

In the world of trader education there's too much emphasis on selling covered calls and little or no attention paid to the *bull* side of using put options. You can spend \$3,000 on a weekend seminar and come out knowing little more than how to get into what I call an "UN" covered call trade - with a volatile stock.

Any time we accept a premium for selling a call, we give up a little control. We're obligated to deliver our stock for the agreed upon price, unless we Buy To Close (BTC) the call.

What if you own a stock and put option and don't want to sell a call, but *do* want income? Here's a play that can *take away all risk* and yet leave the top off in case she blows...

Depending at what level we sell a call, there is a limit on our potential return if the stock is headed up. Income Method #3 is designed to fix that problem; it brings in money without obligation. Bonus..! It's also executed in light of *what the market has already done*, instead of trying to take advantage of a move that may... or may not... happen. SO put away that crystal ball.

How Can You Receive "Income" Without Selling a Call?

Well, you can't make money (at least not honestly) without selling something. Remember that the RadioActive Trader's forte is his understanding of the buying and selling of *time*. Now, when we first set up an RPM, our aim is to get the time cheaply, isn't it? That's why we use The REDLine and the ATM Bell Curve to find where time is selling for the best value.

When we buy an In The Money (ITM) put option, some of the value is intrinsic and some of it is time value (as discussed in the Married Put Setup Section).

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Consider AKAM (Akamai Technologies). This trade was actually NOT put together by me... it was assembled by Member Juan R. from Hawaii. Since it was a paper trade, I felt really comfortable telling him exactly what I would do at points along the way. Now what we did with it involved both Income Methods #1 and #3. But I want to show the IM#3 aspect only here because it graphs so nicely.

Bought 100 shares AKAM @	\$28.91
BTO 1 Nov 06 \$35 put @	<u>+\$ 7.40</u>
Total Invested	\$36.31
Guaranteed Return	\$35.00
Total AT RISK	\$ 1.31 or 3.6%

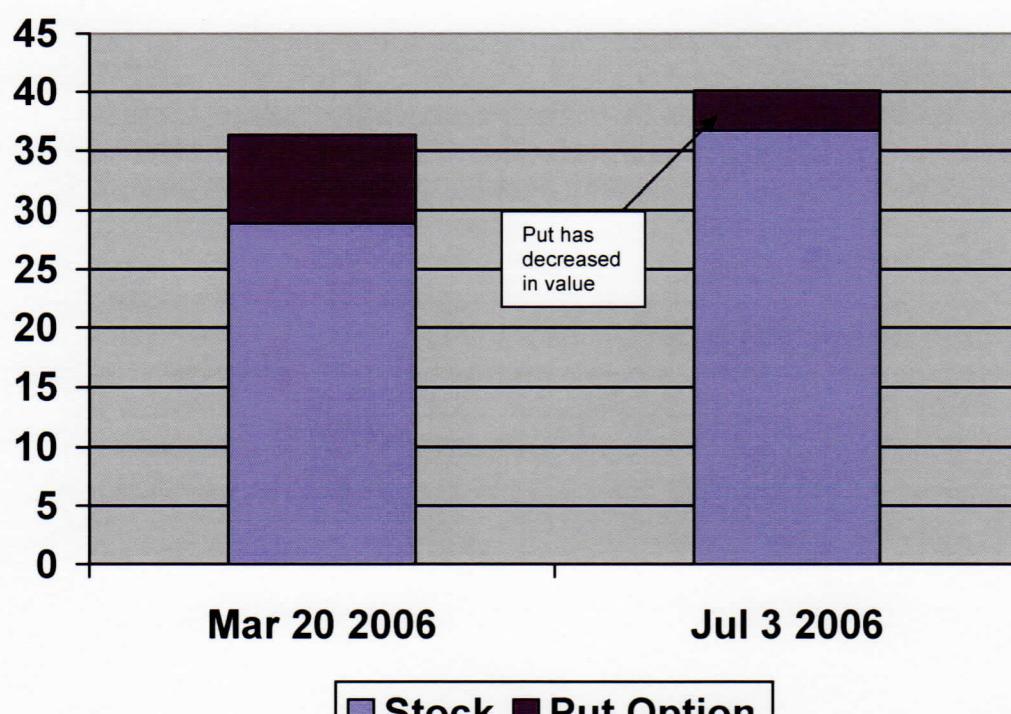
Just over three months later, on July 3, 2006 this RPM position was looking pretty healthy:

July 3, 2006 AKAM RPM

100 shares of AKAM	@ \$36.68
1 Contract Nov 06 \$35P	@ <u>\$ 3.40</u>
TV (Total Value)	\$40.68

(for simplicity, income from IM#1 not included)

Right now I'm going to answer the objection that I get from folks new to Radioactive Trading: Doesn't the put option LOSE value as the stock gains? Well, yes... and no. Some folks actually believe that it's like when you drive a new car off the lot: you instantly lose 20% of the vehicle's value. That's simply not the way a put option works in the real world. First, take a look at the exact data in graph form of the AKAM RPM and how it changed from inception to the date that Income Method #3 was appropriate.

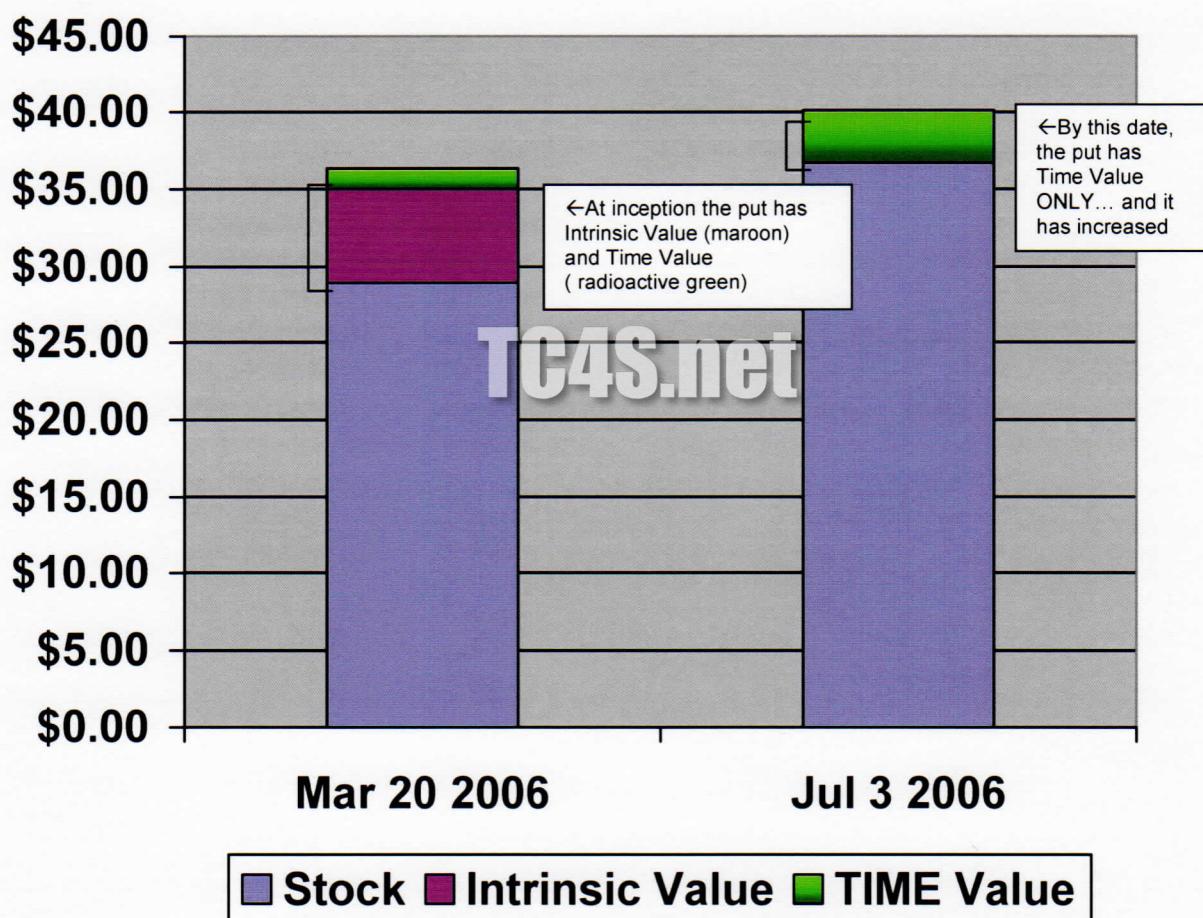


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We see here that the total RPM increased in value, but the purple part (the put option) appears to have decreased, and it *has*, speaking strictly in terms of dollars for the premium.

What folks overlook is this: The ITM (In The Money) put option that we purchased on the front end had two values, intrinsic and extrinsic. As the intrinsic part goes down, it's because the price of the stock is going up, dollar for dollar.

The "IN"trinsic amount is how much the option is "IN" the money. As the stock rises, then the intrinsic value of the put option does go down. But here's the phenomenon I noticed that we use to our advantage: the extrinsic, or *time value* of the option actually goes UP! Can you believe it? Let's break down the put option using the same example and look at both components: the intrinsic "real" value and the "time" value:



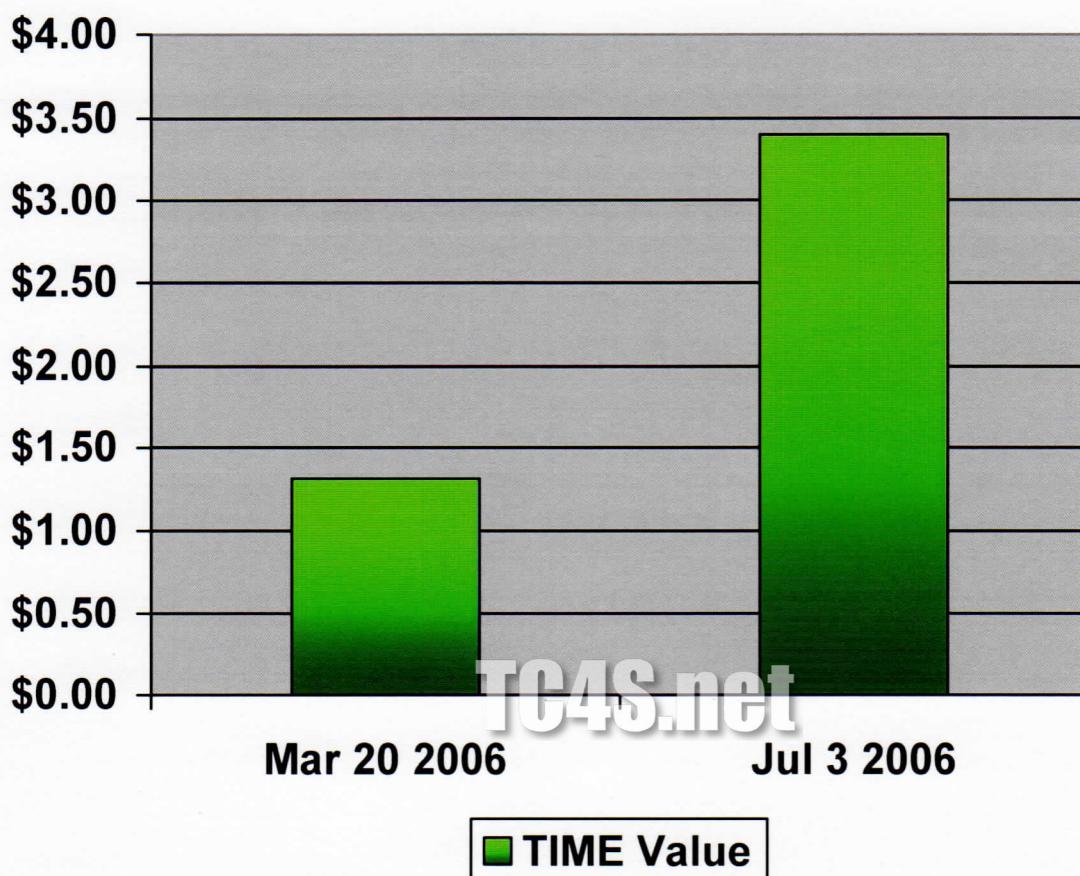
Maybe the value of the put option did go down as the stock went up. But consider that the stock's value increased, dollar for dollar, as the intrinsic value went down. Your gains don't disappear -- they just change columns. You don't lose even one dollar.

Let's view the same data displayed once more in the graph below. This time, the stock and intrinsic value of the put is taken out.

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After all, as your stock gains a dollar, the intrinsic value of the put loses a dollar, so it's a wash. On the other hand, your time value is booming! It RISES in accordance with the ATM Bell Curve.

It's this gain in the time value portion of your RPM that we're going to manipulate for profit.



Wow, That's Great Kurt. So What Do I DO About That?

In the case of this RPM, what we did was to sell the protective put for cash. But wait! What if AKAM crashes? If we sell the protective put, then there's nothing insuring the value of the stock anymore.

Sure there is! At the exact time we sold the protective put, we also bought a new one, only closer in time before expiration. So while we took the money, we didn't run from the responsibility of keeping AKAM insured against loss. Check out this July 3 move:

July 3rd 2007

STC (Sell to Close) 1 Nov \$35 put	\$3.40
BTO (Buy to Open) 1 Jul \$35 put	<u>-\$.90</u>
Income Method #3	\$2.50

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That's \$250 cash in hand! The time value portion of the RPM was going to do nothing but erode away, and what do we RadioActive Traders do with time? Why, we sell it dear and buy it cheaply, right?

Now, here's something especially remarkable. You can do Income Method #3 regardless of whether or not you have sold a call against the RPM. In this particular RPM, which was a paper trade, Juan recorded his first sold call to Bulletproof it less than a month after assembly. If you'll recall, he had \$1.31 AT RISK at that time, but he sold a call for \$1.45, making his RPM Bulletproof.

This Income Method #1 trade we closed for a nickel (we virtually Bought To Close the call at .05) when AKAM took a brief dive. Then, by July 3, 2006 AKAM had climbed back up above the protective put's price again. I sent out a real time email in which I applied Income Method #1 (I "sold" a Covered Call... remember that this is paper money) and also the Income Method #3 trade that's detailed above at the same time.

The result? A virtual 15.12% return for this RPM in just a few months, and the best part about it was that AKAM never risked more than 3.6%. In fact, there was nothing at risk at all after the first few weeks but it returned a very handsome profit for Juan's first paper trade.

Assignment

Run the Trade Simulator Tool with 3.6% in the loss limit, and 15.12% in the win goal columns.



Now, I do real trades as well as paper ones. This one just had a real nice profile, and I'm particularly happy to feature Member trades as well as my own. Later on in Section on Combining Income Methods, we'll look at how some Members and I have put Income Method #3 together with other Income Methods to make REAL money.

Though it can be profitable to combine with others, the primary reason for using Income Method #3 is to bulletproof a stock you're bullish on, when you have the concern that the bottom may drop out. Here's a trade I did with Research in Motion:

September 5, 2007

Bought 100 shares RIMM @	\$ 84.04
BTO 1 Jan 09 \$100 put @	<u>+\$ 24.70</u>
Total Invested	\$108.74
Guaranteed Return	<u>\$100.00</u>
Total AT RISK	\$ 8.74 or 8.03%

Just to be clear, there was \$10,874 in this trade with \$874 AT RISK because we traded 100 shares and a contract that controls those 100 shares on a per share basis.

By September 27, just a few weeks into this trade, RIMM was up around \$100 already! I knew I had a winner, but I thought that the upcoming earnings announcement might have

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a devastating effect if the news was disappointing. It doesn't make sense; a company might be doing GREAT and their earnings may be UP... but let's say that earnings were projected by some analyst to be \$0.50 cents a share and the report says \$0.48... that two cents per share difference means that piles of investors bail... on a company whose profits are booming... driving down the price several DOLLARS per share.

Ah, me. What's a RadioActive Trader to do? Well, with an impending announcement of RIMM's earnings, three weeks and a day after I bought RIMM I was looking at a "paper" gain... meaning I wasn't going to lock in a gain until I sold... and the very real possibility of having a loss...

I did this trade to take away all my worries:

September 27, 2007

STC Jan 09 \$100 put	\$19.80
BTO Oct 07 \$100 put	-\$ 7.20
Income Method #3 return	\$12.60

Now remember... I started with \$874 AT RISK in this RPM. The \$1260 income from this spread completely covered any risk I had. I was bulletproof!

Every time I do a trade like this, right away I update all my Fusion' Members with an email announcement. The title of this particular mail was "I know the FUTURE" and in this sense I did: I knew that the morning after the earnings announcement, I would be gloating. Here's why...

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Original Total Invested	\$108.74
Income Method #3 cancels	-\$ 12.60
NEW Cost basis	\$ 96.14
Guaranteed Return is still	-\$ 100.00
Total AT RISK	-\$ 3.86 bulletproof!

See, a negative number in the AT RISK place means NO RISK. "Bulletproof" is a term I've been using in **The Sketch** and **The Blueprint** since October 2002 to mean a state in which a stock market investment with a married put CAN make money, but CAN'T lose.

When I wrote my **Fusion'** Members that I knew the future... that the morning after the earnings announcement I would be gloating... it was for real. Because the \$386 real dollars that I had secured here was mine to keep no matter what, BUT..! If RIMM continued her rise to glory, I would get to roll right along as well. My RPM had gone from 8.03% AT RISK to a guaranteed 3.54% gain (\$368/\$10874) and unlimited potential upside. Don't forget that this bulletproof status happened three weeks into the trade... I could not possibly take in less than three and a half percent, short-term gain and stood to make much more if the stock went my way.

What eventually happened to this RPM was that RIMM did in fact have a nice earnings announcement... nice enough that I ended up selling 100 shares by Oct 19 at an average price of \$114.74. That makes a six week, 17.1% profit. Yippee!

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That's kind of a huge benefit of having options control your exit price. If you are the HOLDER of the option, you have all the choices and no obligations.

Hey! Let's use the PowerOptions historical options screen to see what I might have done instead by selling a covered call!

Strike	Call Sym	Opt Bid	Opt Ask	Curr. Opt. Vol.	Open Int.	Implied Volat.	Delta	% Dnsd. Prot.	% If Unch.	% If Asqnd.	% Time Value	% In Money	% Prob. Above
Research In Motion Ltd. (RIMM) \$ 99.86													
75.00	RFYJT	25.20	25.50	46	5946	0.70	0.96	25.2%	0.5%	0.5%	0.3%	24.9%	94.4%
80.00	RFYJP	20.70	21.00	257	3890	0.71	0.91	20.7%	1.1%	1.1%	0.8%	19.9%	89.1%
85.00	RFYJX	16.60	16.70	545	8472	0.71	0.84	16.6%	2.1%	2.1%	1.7%	14.9%	81.5%
90.00	RFYJR	12.90	13.00	2037	12401	0.71	0.75	12.9%	3.5%	3.5%	3.0%	9.9%	71.8%
95.00	RULJS	9.70	9.80	2632	14880	0.71	0.65	9.7%	5.4%	5.4%	4.9%	4.9%	60.9%
100.00	RULJT	7.10	7.20	6293	18519	0.71	0.54	7.1%	7.7%	7.8%	7.1%	-0.1%	49.6%
105.00	RULJL	5.00	5.20	1491	0	0.71	0.43	5.0%	5.3%	10.7%	5.0%	-5.1%	38.9%
110.00	RULJB	3.50	3.70	5694	11025	0.72	0.33	3.5%	3.6%	14.2%	3.5%	-10.2%	29.4%

Source: PowerOptions Historical Option Chain Sept. 27, 2007

Here we see that I could have instead sold a covered call against the RIMM RPM and brought in \$7.10 premium... which might have been GOOD, but it would not have fully canceled my \$8.74 AT RISK... plus it would've obligated me to sell RIMM at only \$100.

Income Method #3 was a better choice for me here, not only because it generated more income and made me bulletproof... but also because I had the choice to sell RIMM when I was darn good and ready to, and at my price. Selling a Covered Call would have obligated me to deliver RIMM at the \$100 price, but I had no such obligation with Income Method #3: Rolling Back the Put.

A BAD Choice for Income Method #3

Now Income Method #3 is not a universal panacea. It is possible to limit your wins even when you use it... I personally like to use it in conjunction with other IMs or when there's an impending news item that may cause the stock to soar or stumble. It's best used when the near term is very uncertain. On the other hand, when you wish to bulletproof and not limit your time in the trade to just a few more weeks, there are alternatives to IM#3.

When we do any action in the market, it needs to line up with our own personal CEGA: Conditions, Expectations, Goals, and the Catastrophe Report before taking any action.

This next example is of an Income Method #3 trade that SHOULD have been an Income Method #4 play instead. Had I used my CEGA model properly, I would have gained quite a bit more. I'll wait until next Section to show you how this trade should have been done. This is what I did do with Lockheed Martin (LMT):

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Lockheed Martin (LMT) RPM Setup August 2, 2006

LMT stock:	\$81.66
Jan 2008 \$90 put:	+\$10.40
Total Investment:	\$92.06 or \$9206 per 100 shares
Guaranteed Return:	-\$90.00
Total AT RISK:	\$ 2.06 or \$ 206 per 100 shares: 2.23%

Now, LMT had risen pretty well and my original intention had been to hold it for the long term. But I got a little squirrelly with this much in one trade even though only \$206 was AT RISK. LMT was up, but in my mind behaving a little strangely, so I got concerned about safety. On August 24th, 2006 I posted this Income Method #3 trade, which made this RPM bulletproof:

STC 1 Jan 08 \$90 put @ \$9.20
BTO 1 Oct 07 \$90 put @-\$7.00
Income Method #3 \$2.20 bulletproof!

Now, this little transaction *did* make my RPM bulletproof... the \$220 in income balanced out the \$206 AT RISK. But the problem is that selling the far put and buying one closer-in put a shorter LMT on how long this stock was able to climb. I didn't lose on LMT... it was made bulletproof by this move... but my gain was so infinitesimal that I don't even want to tell you what I made! Ah well... part of the learning process I guess. NOW I have a web site that shows me a number of bulletproofing options at a glance, so I can compare and make better choices. Wish I had the PowerOptions tools then...

Because LMT actually went up well over \$100 a share by Jan 2008. I would have made a lot of bank if I had only applied IM#4 instead. We'll take a look at a hypothetical for LMT in the next Section, as well as some other Income Method #4 trades that some *Fusion'* Members and I actually did do.

Income Method #3 Summary

Sometimes a stock that we own in an RPM shoots up past the protective put's strike price. This is always a happy thing! Trouble is, we have a dramatically altered situation: right now the protective put is ALL TIME VALUE. If we hold our stock, and it continues to rise, our put's price is the highest it will ever be today.

Income Method #3 uses this fact by selling the fatter, further out put and exchanging it for a cheaper, nearer one. The insurance in the trade is the same; if the underlying stock crashes, the RPM's value is still protected at the same strike price.

A short-term investor that fails to recognize the Income Method #3 opportunity may give his gains back to the market. When the stock shoots up to or past the strike price of the protective put, the value of that put may well be the highest it will ever be again and can be used to "put" money in pocket. Missing this opportunity can put the trader right back where he started if the stock comes back down.

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Having said that, some of the best RPMs I've ever had the good fortune to get into were held for longer. Choosing Income Method #3 just depends on what your individual Goals are as well as what Expectations the market is serving up for continued growth. Using this Income Method you are expecting a shorter-term exit because you are moving in the put time to expiration.

If you're considering doing Income Method #3, remember the CEGA model. If the "Goals" part of your CEGA is to nail quick returns then IM#3 is a good choice. On the other hand if you're going for long-term growth *check out the next Section* for perhaps a better alternative for manipulating the time value of your protective put.

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, Expectations, your individual Goals, and that you're okay doing them in light of the worst possible outcome.

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