Income Method #6: Give Me My Money NOW!

Here we'll see how a Bear Call Credit Spread can be used to augment an RPM for lower risk and potentially yield a good return. It is interesting how combining strategies can improve an overall position. In a regular Bear Call Credit Spread, we don't want the stock to move up. We want the stock price to remain below the strike price of the short call option and we especially do not want the stock price to rise to the level of the strike price of the long call as this would represent a very large loss for the Bear Call Credit Spread position. However, with the backdrop of stock ownership in an RPM, it can actually be a good thing to see an up move. We'll look at an example later in this chapter that shows how I bulletproofed a trade with IM#6, even with really bad timing.

INCOME METHOD #6 CEGA MODEL -- Plus! CATASTROPHE REPORT

CONDITIONS:

Stock is trading sideways or maybe down. The decay of the protective put's time value may soon become an issue. We need to make a decision about getting some income *now* or close it.

EXPECTATION:

Uncertain. If things go the way they have been (flat or a bit down), it would be good to pick up a little income. However, the stock *could* break to the upside so we don't want to just sell a call.

GOALS:

Income in the near term, but don't necessarily want to get called out yet.

ACTION:

Buy To Open a near term, higher strike price call option, then Sell To Open a call option with same expiry but one strike lower.

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

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

1) If the stock's price at expiration is *between* the strikes or *at* the value of the higher strike, the long call will have no value and we'll be faced with the possibility of delivering the stock. Can this be done without a loss?
2) If the price of the underlying suddenly moves up, the short call may be managed with IM#2 and the long call sold for cash. Can this be done at a profit? Would it be better to close the RPM by selling the put or by using IM#3?

The Bear Call Credit Spread Strategy

...is unique in the fact that it belongs to the category of credit spreads. A credit spread actually puts money in pocket NOW, with the risk being that the underlying will move in the wrong direction.

Bear Call Credit Spreads are formed by Selling To Open a call at one strike price, then Buying To Open another call at a higher price. The result is a net credit; that is, you actually *collect* money to put on this sort of trade. "Bear" means that our Expectation is that the underlying stock will stay flat or move down. The risk, then, is that the underlying will move up instead.

Credit Spreads may have the siren call of money in pocket now, but they may also end up costing you money if you aren't right about price direction. It helps if you think in terms of the Catastrophe Report to understand the risk of a Bear Call Credit Spread.

In the WORST POSSIBLE SCENARIO, say you bought a high strike price call and sold a lower strike price call with the same expiration month. If the stock closes at or above the lower strike, you would then be obligated to deliver stock at the lower strike price. This is regardless of how much it would cost to pick up the stock on the open market.

Fortunately, the long call option protects you from having to pay more than a predetermined amount. Say you own a $65 call, but are short a $60 call. The most you will pay for this spread is the $5 difference. If the underlying trades at $65.01, $66, or $660 for that matter, so what? Your long call entitles you to buy that stock at the discount price of $65. Unfortunately for you, however, you are also obligated to deliver the same stock for just $60. So your total cost for this spread is the $5 difference, MINUS any Income you received for putting on the spread in the first place.

To express this risk/reward configuration as a percent, I like to count the difference of the price I can buy and the price I'm obligated to sell as the total possible cost. If I'm happy with risking that much, the next thing to compute is how the Income from putting this combination together affects the total possible cost. Consider the risk-reward picture of this actual Bear Call Credit Spread:

May 17th, 2007

Priceline.com (PCLN) Bear Call Spread	
STO July $60 2007 call	$2.02
BTO July $65 2007 call	-$0.77
Net Credit	**$1.25**

By selling the $60 call, we have taken on the obligation to deliver PCLN at $60, and can be assigned if PCLN closes above that price. The good news is:

1) We got some money on the front end... the $1.25 difference
2) If the trade moves against us, our loss is limited:

Maximum Cost if Spread Fails:	$5.00
Income Collected:	-$1.25
AT RISK:	**$3.75**

Why Do Income Method Number Six?

Bear Call Credit Spreads are by themselves a limited risk, limited return strategy. In an RPM, however, they can be used as an alternative to selling a covered call for income. The result of putting on a Bear Call Credit Spread is the credit received; so is the outcome of just selling a call "naked". I used to work for an emergency room doctor and found out that most folks should not be naked…

Seriously, though…when an investor sells a call option for income, his or her exposure is unlimited because there is no limit to how high that stock can go. By selling a call option, we've obligated ourselves to deliver the stock at a certain price, no matter what the stock is trading at when we're assigned. This is why we want to be "covered".

Doing a straight Bear Call Credit Spread, as in the above example, carries a pretty high risk, doesn't it! The income of $125 up front that we get to keep, but a nasty bill (of up to $500!) to pay afterwards if we were wrong about the stock's direction. If we own the stock, selling call options or credit spreads against it doesn't add any risk to the position in and of itself. We simply collect income and wait to see if we're called upon to deliver the stock.

Now when I say writing a call option doesn't add risk, I mean that it doesn't take on any more risk in the case of a downside move. On the other hand, there IS the risk of "opportunity cost", e.g., selling for too little premium and/or too low of a strike. I've done IM#1 before and then been made to feel like a chump later, the stock immediately went up in price. If only I'd held on a few more days before writing the call option, then I'd have received much more in pocket!

This is the conundrum that results in hours of staring at stock options price tables. Ooooh. I might sell at too low a price… but if I don't sell, and the stock goes down, I will have missed out on the income I could have picked up… what to do, what to do?

If "ifs" and "buts" were candy and nuts… They say more regret comes from indecision rather than from bad decisions. So, what if I want call option-writing income now, but don't want to get caught with my pants down in case of an upward, explosive move? IM#6 can cover me if my timing is wrong.

Money in Pocket for Picking up a Long Position?

How would you react if I said that I could OWN a long call contract and get paid for taking it on? You know that's not usually how it works… you *pay* to buy long positions, and you *get paid* when you close them or go short. Well, check out this story!

For my Income Method #6 example, I'll be showing an RPM that did exactly the opposite of my expectation, but still turned out all right. The May 17, 2007 Bear Credit Call Spread example above was an actual trade, but again, it was done as an Income Method for a RadioActive Profit Machine I had set up the previous week:

05/11/07 PCLN II RPM Setup

```
PCLN stock at        $56.75
Jan 2008 $60 put   +$ 7.50
Total Invested:      $64.25
Guaranteed Return  -$60.00
Total AT RISK:       $ 4.25 or about 6.6%
```

So, here I was with 100 shares of PCLN, protected with a January 2008 $60 put option, and I think, "Hey. PCLN just had a leg up. Could be a while before she gets moving again. Why don't I pick up some quick Income?" So guess what -- I did! I used PowerOptions tools to find an attractive IM#6 with the exact same Bear Call Credit Spread strategy that we showed you above and put a quick $1.25 in my pocket. Here are the numbers again:

More Info	Company Name	Stock Sym	Last Stock Price & Chg	Sell Option	Expire/Strike & Days To Exp.	Bid	Buy Option	Expire/Strike & Days To Exp.	Ask	% Return	Net Credit
	Priceline.com Inc.	PCLN	57.34 (+2.12)	PUZGM	07 JUL 65.0 (65)	0.70	PUZGN	07 JUL 70.0 (65)	0.30	8.7	0.40
	Priceline.com Inc.	PCLN	57.34 (+2.12)	PUZGL	07 JUL 60.0 (65)	2.02	PUZGN	07 JUL 70.0 (65)	0.30	19.8	1.65
	Priceline.com Inc.	PCLN	57.34 (+2.12)	PUZGL	07 JUL 60.0 (65)	2.02	PUZGM	07 JUL 65.0 (65)	0.77	33.3	1.25

Source: PowerOptions Bear Call Credit by Symbol

May 17th, 2007

```
Priceline.com Bear Call Spread
STO July $60 2007 call          $2.02
BTO July $65 2007 call         -$0.77
Income (so far) from IM#6       $1.25
```

Now my indecision is over. And, of course, the first thing that PCLN does is move up. Slowly at first, then violently. "Bah!" I thought. "Isn't this a dandy? Now, PCLN is moving up so fast that it doesn't make any sense to buy back and sell out the short call (IM#2), and the protective put value is coming down fast as well!"

The Protective Put's Strike Price is $60, and I've obligated myself to selling this stock for $60. As PCLN keeps shooting for the moon, my chances of both buying back the call option and of selling the put option for a decent amount evaporate. I'm stuck…Or am I?

June 20th, 2007 with PCLN @ $66.42

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Priceline.com close one leg of the Bear Call Credit Spread

STC July $65 2007 call $3.00
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Now, wasn't that the same July $65 call we picked up for only $0.77 a month earlier? Wait a minute! When you think about it, I actually got *paid* to pick up that call. Now I'm selling it for nearly four times as much as what it had been trading for at that time. Groovy, huh? Sorry, child born of the Sixties…

So, we got lemons and made lemonade! Selling a call just before PCLN picked up steam was seriously bad timing. It still worked out though. When I sold the long call, I netted $3.00. Added to the $1.25 I had already picked up, this RPM became totally bulletproof. Remember the AT RISK amount was $4.25:

05/11/07 PCLN II RPM Setup

PCLN stock at	$56.75
Jan 2008 $60 put	+$ 7.50
Total Invested:	$64.25
Guaranteed Return	-$60.00
Total AT RISK:	**$ 4.25 or about 6.6%**

And this is the total Income generated by Income Method #6:

PCLN II Income		
STO July $60 2007 call	$2.02	
BTO July $65 2007 call	-$0.77	
Income (immediately) from IM#6	$1.25	5/17/07
IM#6 (leg 2) STC July $65 call	+$3.00	6/20/07
ALL risk canceled…	$4.25	

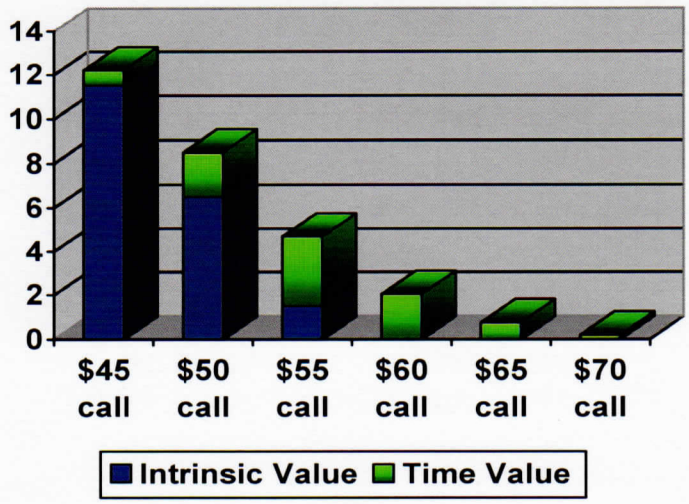
One way of looking at this RPM was that I sold a July $60 call for $4.25 when they were only really selling for $2.02. That's what the net result was, wasn't it? My PCLN shares got assigned. To close the trade I wound up selling the long put option, which was 100% time value, for $300 profit. That was a 4.67% return. Pretty good for nine weeks in the trade combined with bad timing selling the call. It's a lot more than if I had only sold the July $60 call at $2.02. Of course, PCLN *could* have sputtered and lost ground, then picked up again. I think I did the right thing based on my Conditions and my Goals, in both instances of when I put on the IM#6 spread, and when I managed the spread by selling to close the long call option.

Trading RadioActively Gives You The Edge: A Review of The REDLine and ATM Bell Curve

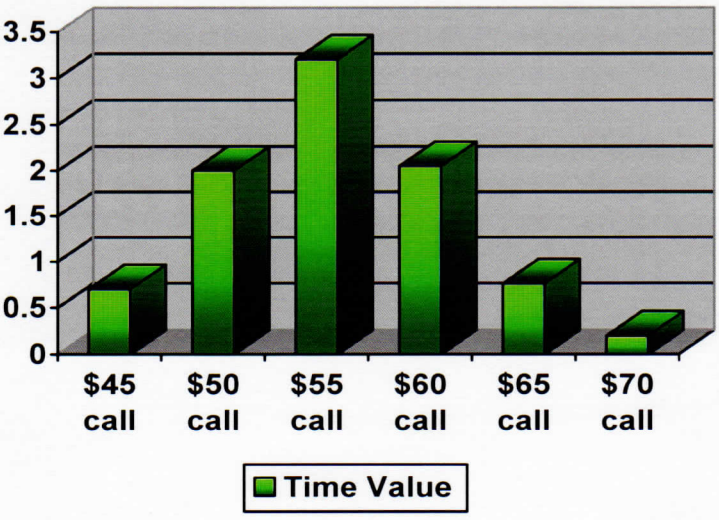
One of the two most sacred maxims* of RT is "Don't time trades… trade TIME". I sold a call at the exact wrong time with PCLN, didn't I? Seems that right after I sold the July $60 call she wanted to blow up, and here I was holding the bag. However, with the PCLN II position, the RPM ended up returning a short-term healthy profit. The difference between this and many other trades whose timing I botched was using the REDLine and ATM Bell Curve principles for finding the best premiums.

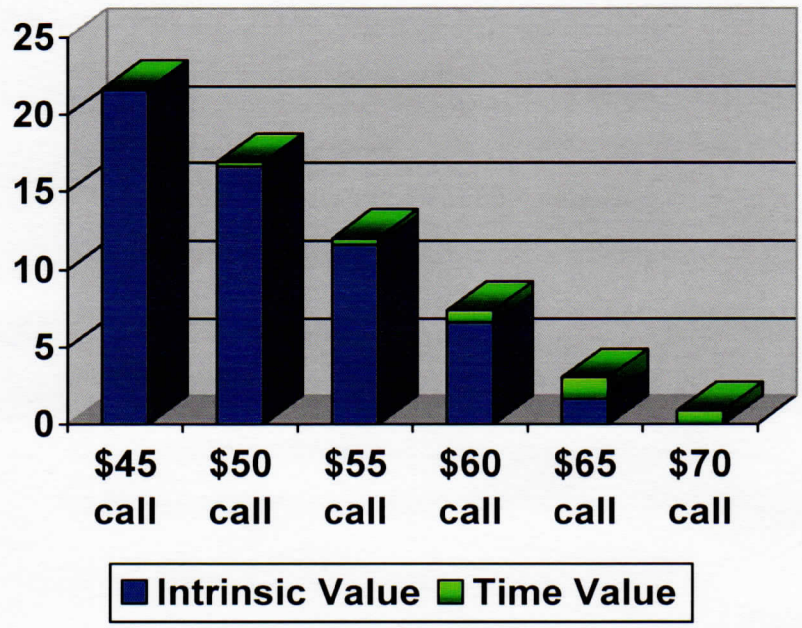
I did in fact pick the worst possible time to sell the $60 call, but I sold it the right way. By picking up a long $65 call option with some of the premium, I covered the bases. My short term Expectation was wrong (I thought PCLN would sit and take a breather, moving sideways or only slightly up), but my trading was not because I sold the correct strike price call option, picked up a long call option with a net credit, and sold the same long call option again for a turbo-charged return.

*** The other most sacred maxim of RT is, "Don't pick stocks, pick STOPS", referring to Force Ideal Sized Trades.**

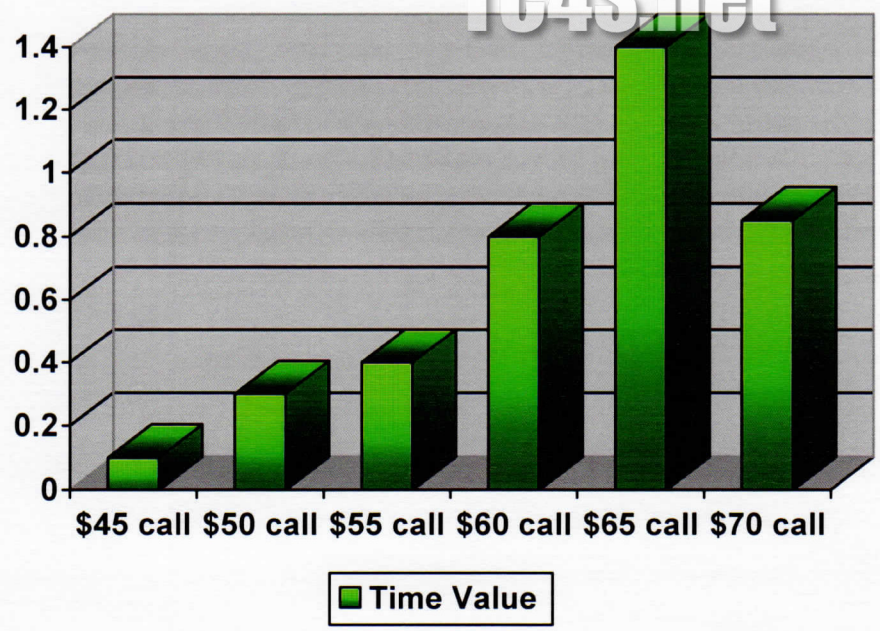


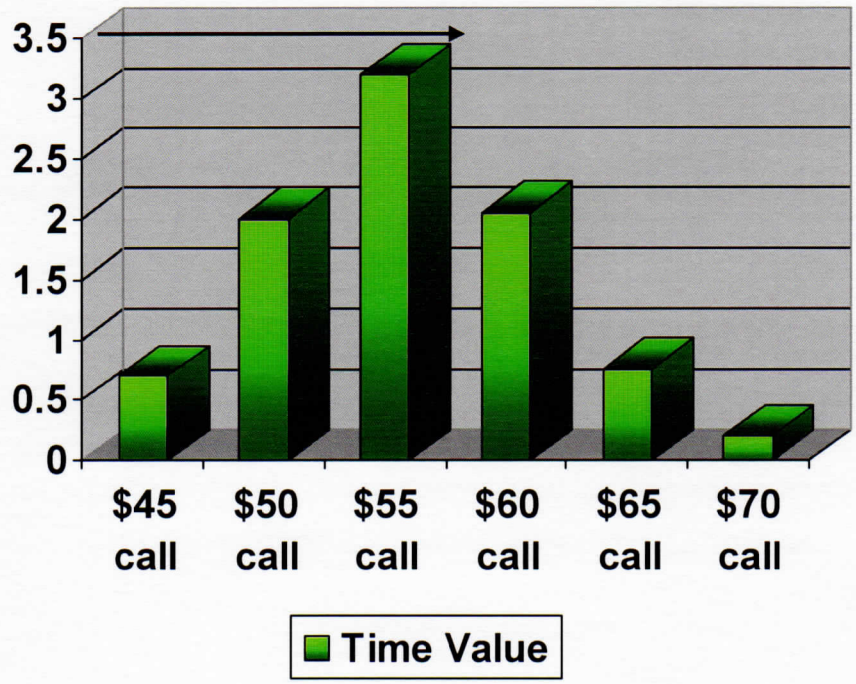
Check out the graphs on the following pages to see the dynamic effect that changing prices have on the ATM Bell Curve… and how to use that effect for fun and profit.
The graphs above and below are based on options price averages for 5/17/07. PCLN closed on 5/17/07 at $56.55. The below chart uses the same data as the one above, but displays the time value only. Can you see the ATM Bell Curve form? On 5/17/07, I Sold To Open the July $60, while at the same time Bought To Open the $65 July call. The $55 call had the highest time value but was disqualified because of the Catastrophe Report; PCLN III was protected with a protective put strike price of $60 and it would have increased risk to sell a call below that strike.



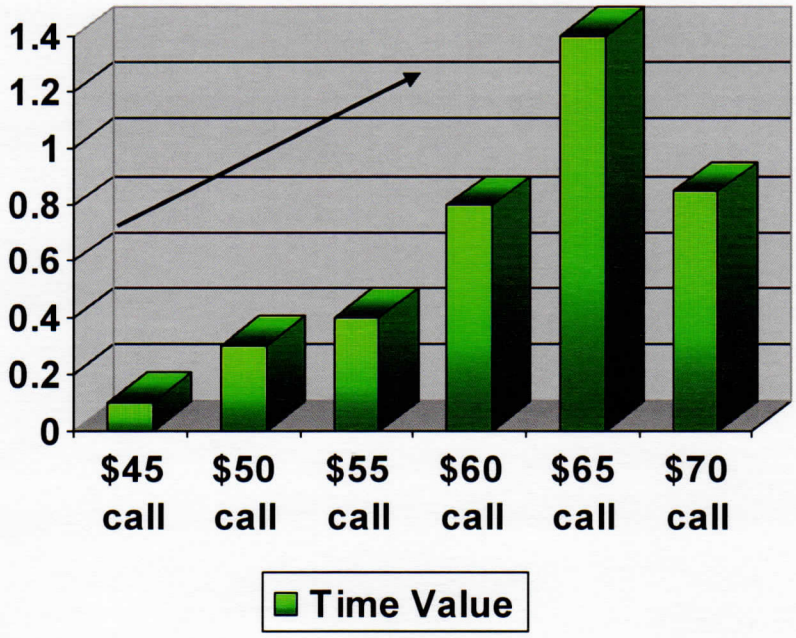


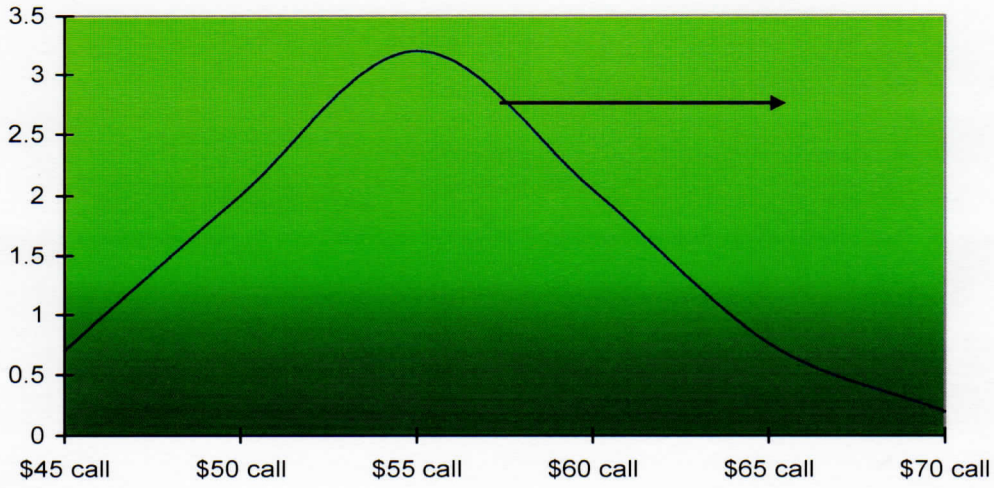
These two graphs (above and below) are the PCLN option price approximations for 06/20/07, about a month later. PCLN closed at $66.60. Look at the "time value only" chart below. Compare this chart's with the same options from 05/17/07 on the previous page. PCLN went from $60ish to just over $65. See how the ATM Bell Curve has traveled over to the right?





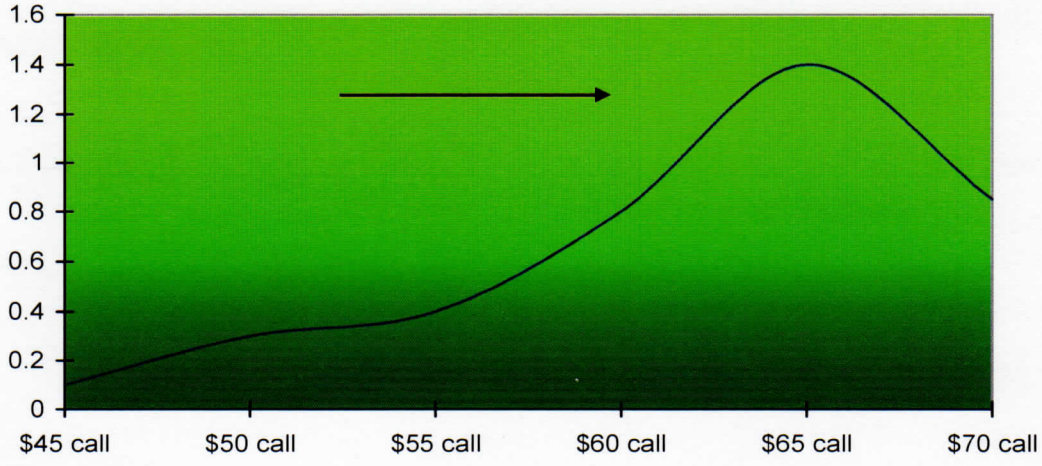
Let's compare the option's time value distribution for the two days again. The time value for PCLN for 5/17/07 is shown above and for 6/20/07 is below. On 5/17, we collected a *credit* from the Bear Call Credit Spread when the $65's were trading at $0.77. By 6/20, the time value had swollen by almost 90%, and the overall price of the $65 call by almost 300%!





Check above and below again. Here are the same two charts with lines "smoothed". Note how on 5/17 $60 was in the Sell Zone (lighter green area), and $65 was in the Buy Zone where it was cheap. As the price of the underlying increases, the time value actually falls for the $60's as the $65's swell. This is where I sold the July $65 call for nearly 4 times what I paid for it. We buy when the time value is cheap, and sell when it's expensive. This is how the RadioActive Trader keeps the edge: by riding the crest of the moving wave! See the ATM Bell Curve rolling to the right as the stock's price changes.

Perhaps soon I'll figure out how to show this effect in an animated program. Until then I think the only way to illustrate this point better would be to picture me at the top of that swell, on a surfboard, holding bags of cash. At least I like that image!



Income Method #6 Summary:

So you've got a RPM on a stock that's up a bit from the purchase price, and you think it might hang out for a while in the same price range, but don't want to feel too silly for selling a call option NOW if there's a sudden upwards move tomorrow. Consider the Income Method #6 strategy when you might normally just sell a call option.

Put on a Bear Call Credit Spread thusly: Sell a call AT (or very near) The Money. At the same time buy a cheap, Out of The Money call with the same expiration, one strike up. The result is a net credit to your account, along with some insurance in case the stock goes blazing up contrary to your Expectation.

Are there other ways to manage an IM#6 trade with a rapidly rising stock than what I've relayed here? Of course! One of the ways is to do something that I couldn't in the PCLN case: roll the short call up and out (IM#2) if it is profitable to do so. You could easily sell or hold the long call along with this idea for an added kick.

Or instead you might use IM#3 to rein in the expiry date of the put, pick up good premiums, and at the same time raise the annualized percent return on your trade.

Perhaps you might come up with another particularly good way to manage an Income Method #6 trade, or for that matter, manage any of the Income Methods. I hope you do! And if you do, I hope you will share your ideas with the whole RadioActive Trading community and me. More and more people are becoming RadioActive every day, with the free RT articles, videos, website, and subscriptions being passed around all over the world.

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.

Risk less Spread Trades...?!?

Aren't those Money Nets amazing? Risk less spread trades, when done in the proper context of the RPM trade, with profits that can outperform the Plain Vanilla Covered Call strategy. Wow...

Take a deep breathe...you are over 50% through the Income Methods! You are doing great! Now would be an excellent time to review these powerful Income Methods in the Money Nets CD. This will walk you through other Income Method #5 and #6 examples, including management techniques while reinforcing the CEGA models and Catastrophe Reports.