The RadioActive Profit Machine

Now we're finally ready to assemble our first RPM, or RadioActive Profit Machine. Before we get started, it's important that we go back to our original exercise from Chapter Two...The Most Important Thing.

Wisdom is knowledge rightly applied. In order to apply the knowledge that we've picked up in the last several chapters, it's paramount to make dec*is*ions about our RPM.

Real radioactive materials, treated correctly and assembled with other substances in a particular way, can greatly benefit mankind. Treat the same materials carelessly, or assemble them in another way, and they become the harbingers of destruction. In order to get the results that we want, we must be very clear as to what we want. The result of ignoring this truth could be disaster. Reread your goals from the first exercise. You've been doing it every day seven times, right? Every decision we make from here on out must be subject to your overall goal; every step we take is a step closer to or further from our goals. We must take thought not to get distracted by the work but keep our minds on the results of the work.

Expectations, Evaluation, Entry... and an Exit Plan

The first decision we must make is about our expectations for the RPM's performance. An RPM can be geared to benefit most from **growth** or from **volatility**. While any stock has the potential both to grow and to move, we want to set up our RPM to capture the best of one situation or the other.

Second, we check on what we have available in terms of raw materials. We scour charts looking for the right mix of stock, protective put, and calls to sell against. If an RPM *can* be assembled that fits our parameters, then we take action. If not, we stand aside and look for another opportunity. Finally, after having assembled the RPM, we check on it once a week or so to see what it needs for better performance according to our expectations. For example, if the stock is growing quickly, we may need to give it room by buying back a call and selling another one further out.

On the other hand, if the RPM is not performing according to our expectations, we may want to close it altogether. This can usually be done at a very small loss, preserving our capital for the next try. This part of trading is the most important, no matter what strategy is being employed. I've even closed RPMs that were ahead (making a profit), to avoid allowing a real gain to turn into a loss.

More About Expectation

The expectation for a **Growth RPM** is that the stock will grow beyond the strike price of the protective put. We earn the most from a Growth RPM by giving it room: you'll see what that means later in the chapter. The expectation for an **Income RPM**, on the other hand, is that the stock will move all over or putter around before settling into a confirmed trend. An Income RPM requires more maintenance because we are looking to buy back calls written cheaply, where a **Growth RPM** does better left alone to appreciate.

We can approach our RPM with either expectation, but it's better to decide beforehand how we're going to treat it. I've made money from Income RPMs by selling calls and buying them back over and over. I've made money from Growth RPMs by setting up the initial assembly, then stepping back.

Here's an interesting point: at the time of this writing, the only times I have ever, *ever* lost money on an RPM have been when I've switched back and forth in my expectation. Just like over watering kills plants, over-management kills RPMs.

That's not to say that you can't change your expectation, but be careful when you do. It's better to be settled about how you'll treat the RPM and run it rather than to allow it to run you.

Now if an RPM appears to switch its behavior twice, I close it whether I'm behind or ahead. It's just a rule; I may miss some opportunities but at least I'm sure about what I'm doing.

The Exit Plan

This is perhaps the most important and yet neglected part of any trading strategy.

We **exit** the RPM at a profit **when our goals are met**, or at a small loss **when it isn't performing** according to our expectations.

For an Income RPM, decide ahead of time what kind of gain you're looking for. I recommend a conservative 10% at first. Buy and sell calls until this number is reached and either exit the RPM or convert it to a Growth RPM. Refrain from switching back and forth!

For a Growth RPM, we don't set a profit target so much as we sell calls to cancel the time value at risk, then allow the stock to grow. For example, a stock may be trading at $60 and you've insured it by buying a $70 put. The put costs at least the difference, $10, *plus* the time value. If the time value is $3.00, sell calls until you recover the $3 and now you're bulletproof.

In this scenario, the value of your RPM can go up as the stock goes up. Because of the protection of the put, it *cannot fail to return* at least what you've invested. Up until the put expires, that is. We exit this kind of RPM at expiry or whenever our growth goal is satisfied.

A word to the wise: *do not* change your expectation if it involves changing a known return to an unknown risk. If you've decided to make your RPM a Growth RPM, don't switch back and use income methods that risk getting the stock called away.

The negative side of exiting an RPM…

Is every bit as important as the positive scenarios above. Here is a proven rule:

Make up your mind to close any RPM if the stock stays below its 50-day moving average more than a few weeks. If you've sold calls against it, buy them back or allow them to expire worthless. Don't sell any calls while it lives there, and give it two weeks or so to break out. If the stock doesn't rally, it may be headed to further downside.

When I close an RPM, first I let the call expire or buy it to close. Then I check and see if it makes sense to exercise the put option, or sell the stock and the put separately. If the sum of the bid price on both the stock and put equal more than the put's strike price, consider selling them separately for a greater total amount.

Following this exit rule will keep you out of trouble! Neglect it and you may end up chasing your RPM to perform while it runs away from you. Always, always close an RPM whose stock has fizzled. You'll find that your losses will be manageable. Pick up a better opportunity rather than trying to force a dead one.

Assignment: Go back over the last ten paragraphs and write them down. It is critical that you to know WHEN, WHY, and HOW to exit if you plan to trade RPMs for yourself as a self-directed trader.

An Important, New Term: Coverage

Before we get into the Key Measurements and Rules for the Income Strategies, I'll introduce a term that's important to understand. **Coverage** refers to the amount a stock can travel into the money of an option you've sold, before the option becomes a liability. This usage of the word **coverage** is unique to The RadioActive Trading methodology and The Blueprint so don't expect it to be used this way in other stock and option trading publications.

Here's what I mean by **coverage**: say you've sold a covered call against a stock for a premium of $1. If the strike price of your call is $20, the stock could go all the way to $21 before assignment turns into a bad thing. If you get called out of your stock at $20, but can get back in at $20.50, it's a good thing to be called out. On the other hand, if your stock soars to $25 and you're obligated to deliver it at $20, that's a different situation. With a near term call, the more coverage you can get, the better. The stock has further to move before the call turns into a liability.

Key Elements for an RPM

To assemble any precision performing device, it takes patience and attention to detail. Before considering entry into an RPM, all of these points must be in agreement:

The Stock

Determine if you can be mobile enough in this stock to execute your buy and sell orders. There's a LOT to consider. The stock must be:

- **Liquid,** with a stock volume of at least 300,000 shares traded daily.
- **Optionable,** with options at all the strike prices that you trade.
- **Open Interest,** I like to see 100 contracts open (or better) in both the put and the call options that are necessary for the RPM's assembly. In the case of a LEAP (very long-term) put, there may be only 10 or 20 contracts open at your strike price, but that's usually all right. As long as there are *some* contracts open, there is liquidity. I wouldn't buy even a LEAP put without some open interest, in case I need to beat a quick retreat.

The Protective Put

Depending on what kind of RPM (Income or Growth) you're assembling, choose a put option with six to twenty-seven months to expiration. Income plays are usually shorter term. Growth is expected over a longer period, though usually not as long as the term of the put. When we get to income method #3, you'll see why we choose a very long term put for this kind of trade. Your protective put is a **HIT** if:

- **Half** or less of the premium is time value, and half or more is real or intrinsic value.
- **In The Money** by as much as 20%.
- **Time Value** of the put is the only thing AT RISK in the married put arrangement. This is determined by first subtracting the put's strike price from the total amount invested in the stock and put option. Then, we divide this number by the number of full months remaining until expiration to find out how much per month we need to recover in order to cancel all the risk. If your near term calls look like they'll cancel this risk, you have a winner.

Example from 2/27/2003: YHOO is trading at $19.80 (ask price) and ZYHME, the January 2005 $25 put is trading at an ask price of $9.10. This makes a total cost of $28.90 to set up a married put worth at least $25 up until expiration. $28.90 minus $25 equals $3.90. This is the most at risk (per share…remember to do this in increments of 100 shares per contract). $3.90 divided by about 22 months to expiration equals 0.1772, or about $0.18 per month.

More about The Protective Put

The most important thing to consider about the protective put is its time value. This is the amount actually at risk in a RadioActive Trade. The time value portion of the put should not equal more than about 10% of the total amount invested. The **maximum risk is something that you set**, but I like O'Neill's cardinal rule of cutting losses at 8%. Much of the rest of the remaining downside risk should be taken care of by the sale of our first call.

In the sales literature for The Blueprint I claim to have a method that limits loss to 5%. If the time value of the protective put is 5% of the actual total amount invested in the trade, there is no way to lose more than 5%. We simply follow the rules and close the trade if something goes wrong, or we use Income Methods #2 and #3 to lock in our gains.

Even if a RadioActive trade is set up that risks more than 5%, it's unlikely that losses will be devastating when the exit rules are followed. However! Check the RadioActiveTrading.com website for the FUSION RPMs that absolutely cap risk.

Let's look again at the YHOO example. With a total amount $28.90 invested, the RPM is guaranteed to be valued at least $25. Therefore, the amount at risk is $3.90. Dividing this number by the total of $28.90 yields the maximum at risk: 13.49%.

One more strike price deeper ITM would bring the total risk down to 5% and still bring the potential for a decent gain. Look at YHOO today…Would I still have made money?

Summary

So, there you have it. RadioActive Trading is the applied knowledge of mathematics and probability that virtually guarantees a return, but limits risk in the case of disaster. It's buying a stock, insuring that stock's value with a put option, and selling calls and puts for income. The RadioActive system for creating wealth is unique because its foundational tenet is the manipulation of time, not the prediction of prices. Some features that are built into the system include:

Hedging
Because the forward flow of time is a positive factor, and because the put protects the investment.

Money Management
Because only small amounts, ideal to the total amount invested, are risked at one time.

Leverage
Because Other People's Money is captured by being on the selling side of options.

Income
Without unloading a stock, we can still pull money out of this kind of arrangement in more than ten different ways.

I could go on and on, in fact I have for about ten chapters! There are many more key principles built into the system, but it's not the system itself that is special. The whole key to doing this, or any trading strategy for that matter, is you. Success in this as well as any competitive activity is dependent on the decisions that *you* make. Depending on how well you are in touch with your own goals and stick to them, you will have success in this as well as in any other endeavor. My best wishes are with you and I hope you'll report both your challenges and successes.

RadioActive Trading, The Blueprint, and the website are a work in progress. I expect to learn more from my pupils than they learn from me. That has been my experience as a martial arts instructor and as a father, and I suspect that it's a universal principle: we learn most effectively when we teach. Therefore, I'm asking that you give me feedback, both on how this book can be improved, and things you're learning "in the field" applying the system. Please send your questions and your feedback to Support@radioactivetrading.com.