

Wiley Trading Series

BIG MONEY, LESS RISK

TRADE OPTIONS

MARK LARSON

The background of the cover features a light green gradient. In the lower half, there is a semi-transparent image of a stack of US dollar bills, with a \$100 bill prominently displayed in the foreground. The text 'FEDERAL RESERVE NOTE' and the serial number 'HB 19895036 I B2' are visible on the bill. To the left of the bills, a faint bar chart with several vertical bars of varying heights is visible.

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Big Money, Less Risk
Trade
Options

Mark Larson



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Technical Charting for Profits

Trade Stocks Online

12 Simple Technical Indicators that Really Work Course
Book and DVD

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Foreword

The world of options is often daunting and confusing on many levels. First, the terminology is highly specialized with a lot of cross-over use of expressions, especially when describing strategies. Second, quantitatively evaluating risk is elusive because the possible range covers the entire spectrum when trading options.

Mark Larson has compiled a book that features a series of common sense option strategies every trader should master. He explains these in straightforward language and expands examples with graphics, definitions, and sidebars. Larson has made the mastery of a few valuable concepts easy for every investor and trader.

Anyone who has tried to read books explaining how to trade options may be discouraged by the complexity and technical jargon of this industry. But rather than giving up, traders need to go through Larson's book. The options market has grown to become a major factor in the market today, and this trend is going to continue into the future. Tomorrow's successful trader will include options as a matter of course, to enhance profits, hedge risks, and protect profits in stock and other positions. Options have been available to the public only since 1973. That year, only 1.1 million contracts were traded. In 2007, according to the Chicago Board Options Exchange (CBOE), nearly 2.9 billion contracts were traded. This includes options on stocks, indices, futures, and mutual funds. The expanse of the market itself has broadened in recent years.

Perhaps the greatest cause for this expansion has been the Internet. Today, you can trade options without a stockbroker. You can use online discount services, which enable you to complete a round-trip trade (buy and sell) for

less than one-quarter of a point in trading fees. This is a vast improvement over the past. When you had to use a stockbroker to execute an options trade, it was much more expensive; and the time delay made many strategies ineffective or impractical. Making matters worse, many stockbrokers, although licensed to execute options trades, really didn't understand the market.

With Mark Larson's book, you gain a good start in the market of options, where you can leverage your capital, control the level of risk, and use a range of strategies to manage your portfolio. There is nothing new about the options concept, but for the modern American investor or trader, the application of the principles behind options make trading more flexible than ever, and potentially more profitable as well. Larson shares some insider secrets and provides valuable tips for using options effectively, picking the best and safest strategies, and coordinating option selection with a few basic technical indicators to help you better time your trades.

Don't let the options market intimidate you. Rather, look at this market as an opportunity to beat the averages, improve portfolio returns, and cut losses. There are so many ways that options can be put to work for relatively little investment that virtually every trader will benefit from Mark Larson's book.

—Michael C. Thomsett Best-selling author of *Getting Started in Options*, *Mastering Technical Analysis*, *Mastering Fundamental Analysis*, and over 40 other trading and investing titles

Preface

The preface of a book is often the second place one goes after reading the inside cover of the book. If you're reading this section and haven't yet purchased this book, I can assure you that *Big Money, Less Risk: Trade Options* will be a book you will have a hard time putting down. It will also be a book that will teach you things about the stock market that you may not have known existed. I'm not talking about why the stock market goes up or down; I'm talking about how to make money when it goes up or down. I'm talking about investment strategies that allow you to have huge returns on your money with the use of very little money. I'm talking about how to purchase good stocks at discount prices. I'm talking about placing option type trades that allow you to be wrong and still make 10, 20, 30% return on your money in one month.

I wrote each chapter with a lot of thought, taking over 10 years of teaching and trading experience to help you learn the various types of investment strategies that the experts use to make money, such as writing covered calls, selling naked put options, and placing vertical spread trades or iron condors. This book is based on my belief that success in the stock market is determined by how much money you can make each and every month, instead of waiting to see how much you might have when you retire.

As you read, I would encourage you to keep in mind that no book will determine your wealth; it's the experience of what you've learned and the coaching/mentoring that will determine your true financial wealth. We often look for the shortest path of resistance or the most inexpensive way to learn something; I ask that you please be willing to properly educate yourself and not just take what you read for granted.

Please do not place your hard-earned money at risk until you have perfected your investment strategies of choice. As I have always said to my students, if you were to look in the dictionary for the words “education,” “knowledge,” “money,” and “wealth” you would see that wealth comes last, and there’s a good reason for that. As you make your final decision to purchase this book or other educational material, please don’t look at the cost. Instead, look at the value that this knowledge will bring. I assure you that this information is priceless, and that this book will more than pay for itself.

As a matter of fact, I would ask that you purchase a second or third book for the people that are closest to you. Give them the gift of learning how to let their money work for them. Know that you’re giving them an incredible opportunity to learn how to truly make money in the stock market regardless if it goes up, down, or even sideways.

I want to thank you from deep down in my heart because I will donate a percentage of each book that is sold to the Alzheimer’s Foundation in honor of the thousands of lives that are lost to this disease, including my father who passed away at the young age of 63 on January 18, 2005. I’m saddened by his death in so many ways; wishing he could be here trading with me, wishing we could be fishing together, but more so wishing my son Mason could have been able to see what a great father my dad was. Unfortunately, my dad passed before Mason was able to meet him.

Soon, the day will come when I will sit down with Mason and tell him what a great father my dad was. I will also promise Mason that being able to spend time with him is my first priority because the thing I regret is that I didn’t spend enough time with my father. At that time, I will encourage Mason, as I would you, to “learn how to let your money work for you” instead of always working for your money.

Remember, a wise man or wise woman is not one who measures wealth with his or her financial balance; it is one who measures his or her wealth with knowledge. Knowledge is priceless; you can take all of my money but you can't take my knowledge, which gives me the ability to create and keep my wealth. Enjoy your journey as you read each of these powerful chapters.

—Mark Larson

Acknowledgement

I have so much to be thankful for and so many to thank, but I must begin with my family because without their support I wouldn't have the freedom to write this book and help others. Having family time is the most important reason I trade the market.

I would like to thank all the people at Traders' Library for publishing my book along with the other educational programs I've produced; the family at Investools for giving me the opportunity to travel the world and teach others how to become successful investors; and the family at thinkorswim for giving me the awesome tools to trade the market. And, of course, I'd like to thank you for purchasing this book and supporting me. You, the student, are my greatest inspiration. If you continue to learn, I'll continue to teach.

Introduction

IN THIS CHAPTER

- Investing in good and bad times

- Making your money work for you with options

- Focusing on rate of return

Who am I and why would I write a book about the stock market? I'm a sponge for knowledge that decided in 1998 to search out the biggest known names in the stock market and learn what makes them successful. I knew nothing about the stock market when I began; yet, with a small amount of money, the right education, dedication, and inspiration, I changed my financial life beyond my greatest dreams. Today, my greatest inspiration is sharing with others how they too can increase their rate of return, reduce their risk, and create a plan of financial consistency within the stock market. My drive as a writer is to simply create the best stock market options book. Now, don't get me wrong, there are several great books out there written by the giants of this industry such as Larry McMillan and Bernie Schaffer. I consider this book as another step forward.

In this book, I'll refer to basic options as "get rich strategies" and advanced options as "stay rich strategies." I'll also cover the importance of option pricing, implied volatility (how much an option may be over-priced), the Greeks such as delta, theta, and gamma, and the probability of your option expiring profitable. I will also share with you how to properly use the Greeks and how you can use a probability calculation to determine the odds of your option trade making or losing money. Most important, I will walk you through some of my favorite indicators and show you how they will form the basis of your options trading success.

As you read, I want you to keep in mind that success at any level will not be obtained unless you have a blueprint to follow. One of the most important rules within my blueprint is “when to sell,” and this is something I will teach you within these pages.

Why Do You Need This Book?

I’ve always believed that what goes up most come down. As I stated in my second stock market book titled *Technical Charting for Profits*: “then came April 2000 when the bull decided to quit running and appeared to give in to the bear as we began a true stock market correction, one that many investors never experienced before.”

Why am I sharing this with you? Because you need to be better than buy and hold, and you need to be able to identify when to sell so you can avoid large losses. Just eight years later, in January 2008, we seem to be beginning another bear market correction or what I would even call a crash.

As I’m writing this (the first week of January 2008), the stock market has stopped moving up and is quickly heading lower into a bearish market, making it the worst January since 1932 and soon-to-be the worst January ever. This comes after the Dow Jones reached an all-time record high of 14,200 in October of 2007 before dropping 2,000 points to about 12,000, most of which occurred in the first half of January 2008. Then came January 22, 2008: the market opened down even lower as the Dow Jones dropped another 450 points prior to the open of the market, which created a drop of over 2,500 points. The S&P 500 also reached a record high in October 2007 of 1,575 before dropping over 250 points by the third week of January 2008. This took it

right back to its price during mid-2006. And, since the explosion of the dot-com era, the NASDAQ hasn't been able to do much at all.

You Need to Know How to Invest During Good Times and Bad

What should this information tell you? If you're an investor, then you need to be able to take profits off the table, and, more important, you must know how to trade the downside of the market. The bear market of 2000-2003 was different than the 2008 correction. In 2000, we saw an over-inflated dot-com boom, while in 2008, we saw a crash related to the broad economy but more specifically, the housing industry and the subprime mortgages.

Housing costs skyrocketed between 2000 and 2005 because interest rates were low enough that homeowners and investors could still afford to buy. Yet, those that didn't time the housing market right could not flip the house for a profit and were quickly in danger of losing the home in a short-sale to the bank or foreclosure. This created more homes for sale than buyers while interest rates climbed higher and higher and bad sub-prime loans with 5-year balloon payments forced the Federal Reserve to step in and make an emergency rate cut of 75 base points. Did this sudden rate cut stop the problem? Not at all, many say it was just a bandage as the housing industry continued to have trouble for years to come.

An old saying states that if the month of January ended positive, then the year would end higher than where it began and visa versa. I don't know if the market will move higher or lower by year-end, but I can share with you a chart showing that the stock market was showing great signs of

weakness. If you're going to hold stocks after viewing this chart ([Figure I.1](#)), then I would do so only using a small bag of money. There are sure signs to "SELL" and to limit your risk, which might even mean that your money sits in a money market account until the bull market returns.

Figure I.1 Dow Jones Chart

For color charts go to: www.traderslibrary.com/TLECorner • Chart by: thinkorswim.com



Caution

The Buy and Hold Mindset

Many people mistakenly believe that if they buy a stock and hold it over a long enough period of time, then they will eventually make money on that stock. This belief stems from the fact that over the course of history, the stock market as a whole has always trended higher.

However, this reasoning is faulty. First, your particular stock does not have to trend higher and can in fact dive all the way to zero. Second, buy and hold investing is not an educated strategy: you need to be able to actively manage your money. And that means taking responsibility for it in up, down, and sideways markets. This book is a good first step in learning how to make your money work for you instead of wishing for a market miracle.

If today is January 22nd 2008 and the Dow Jones opens down over 450 points, then who is selling if you're not? The large institutions are selling. Remember, you need more sellers than buyers for the market to drop and more buyers than sellers for the market to increase. It's a business of opportunity and any time the largest investors see an opportunity to take profits and move the markets up or down, they will. In this case, it was time to take the bullish profits off the table and short the market and drive it down. If you are buying and holding, you are helpless to this movement.

[Figure 1.1](#) is a reference as to when the market showed bearish signs. You'll notice a large line—this is the 200-day moving average, which we will discuss in more detail later. When the Dow dropped below that level in December at the price of 13,250, this warned investors that the market was going to drop. And it did drop: a whole 1600 points. A second sign of weakness was seen when the stock price dropped below 12,750, which was the Dow Jones support level. When stocks drop below their support levels, this also is a sign of downward weakness. We will discuss these concepts later in the book.

If you find this type of chart (with technical indicators) to be helpful, you'll really enjoy chapter one as I outline some of the most rewarding technical indicators and how to use them to determine when to trade both the bullish (upward) and the bearish (downward) markets.

You Need to Change Your Mindset

Based on examples like this one, you'll need to make a commitment to break out of buy and hold if you want more consistent returns. If you're going to be successful, you'll need to learn new strategies like the ones in this book. Many times when you choose to sell, it's often because you're forced to do it. You need a mindset change to your financial blueprint; this will allow you to approach the market as a business opportunity for purposes of generating monthly cash flow. A great book to help you change that mind set and create a financial blueprint for success is *Secrets of the Millionaire Mind* by T. Harv Eker.

Make Your Money Work for You

Your money needs to be working for you or you'll never be able to stop working. If you're watching the stock market drop again for the second time in eight years, then you're not doing something right. This book will be of great help but please don't think that a book by itself will make you successful at trading the stock market. Its purpose is to share the many ways that professional traders trade the market. Hopefully, this will inspire you to continue your education on the markets.

Let me give you this thought before moving on: “more money is spent on a new automobile than financial education.” Statistically, households paid more for their cars than they did to learn how to manage their investment accounts. So, if your investment accounts, or even better yet your retirement accounts, are larger than the cost of your car, and you paid more for your car than the education to manage your money, then you’re going about it the wrong way. When you retire from your current employer/occupation, you need to know how to create enough monthly income to cover your expenses or the cost of inflation may affect your family and lifestyle.

Your ultimate goal is to have a large enough bag of money (which I call the “stay rich” bag) that, if need be, can take care of your family two generations below you. Five percent of the wealthiest people have financially planned for two generations lower, and for some of you, it may be one generation above you if your parents (or worse your grandparents) did not adequately plan.

The “Get Rich” and “Stay Rich” Money Bags

Let’s talk a little about the two different bags of investment money and what each one of them represents. The first bag or the “get rich” bag consists of no more than 10% of your total stock market net worth and should only be used for high risk trades that can offer higher rates of return, such as buying either call (bullish market) or put (bearish market) options. We’ll refer to these types of trades as directional trades because the stock must move in the direction of your investment or you’ll lose your investment due to expiration.

Let’s break the numbers down and say that if your total investment in the stock market was \$100,000, then your “get rich” bag would only consist of \$10,000 for the use of

buying call or put options. Your rates of return would be much greater than those within your “stay rich” bag. The \$10,000 bag should not affect your family’s lifestyle if you were to lose the entire amount. On the other hand, the second bag of money, or the “stay rich” bag, which in this example will consist of \$90,000, would affect your family’s lifestyle. For this reason, you would be making more conservative trades such as purchasing stock for covered calls, or even better yet spread trades, with this bag of money.

Let me address the 10% “get rich” bag. Your rates of return will be typically much larger simply because you’re using leverage. For example, if you were to spend \$3,000 and purchase 5 option contracts, you could see the investment increase to \$4,500 or greater; this would give you a rate of return of about 50%.

The important thing you must remember about buying call or put options is that the stock must move in your selected direction (calls up and puts down) or you will lose the entire \$3,000, unless you’re using a stop loss order (which I’ll discuss later).

Let me give you a better example of a call option: Apple Computer was trading at \$140.85 on March 24th and the purchase of a \$140 call option cost \$3.85 per share; so, the purchase of 5 call option contracts cost \$1,925. On April 2nd the call option was trading for \$12.85 per share for a profit of \$9 per share ($\$12.85 \times 500 = \$6,425$) and a rate of return of 234%. That’s leverage at its best, when it allows a 234% return on a stock that moved up from \$140.85 to \$150.35. Now as for the “stay rich” bag of money, you won’t see those types of returns; they will be more along the lines of 15 to 24% per trade (average of 4 week trades). This type of an investment, however, can allow for the stock to move up, down, or sideways and still be profitable. In other words, your “get rich” bag of money doesn’t allow much room for

error and your “stay rich” bag does. You may find yourself moving more to the “stay rich” bag as you get closer to retirement; this will reduce your risk and create more consistency.

Lingo

Rate of Return is what you gain or lose on an investment over a specific time period. It is expressed as a percentage increase over the initial investment cost. (Source: Investopedia.com)

Rate of Return = Your total profit/Your capital × 100

In this example: $\$0/3.85 \times 100 = 234\%$

The Four Quarters Of Your Working Life

Age 25 – 34 First Quarter

Age 35 – 44 Second Quarter

Age 45 – 54 Third Quarter

Age 55 – 64 Fourth Quarter

If you are near retirement, then you’ve worked four quarters of your life to build this bag of money; now it’s time to learn how to keep what you’ve worked so hard for and learn how to let your money work for you. Although we often make more financial mistakes earlier in life, you must have built your net worth by the end of the fourth quarter of your working life. At this point, you must know how to have your money work for you or you will be forced to go back to work. If you build your wealth before the end of your fourth quarter and you know how to successfully trade the stock market, I’d say that you’re in a better position of retiring early and staying retired.

Understanding the Power of Options for Retirement

My goal is for you to understand the power of purchasing put options in bear markets and call options in bull markets. These tools will help you not only weather any financial

storm but make consistent profits during one. This will become essential during retirement when you will be reliant on the income from your investments.

Let's go back to January 2008. I can think of only one reason for the big drop—inflation. This equals bad money management. The cost of living continues to increase year over year and 95% of the people in the world are not educated on how to plan for inflation increases. I know we can blame the President, the war, the cost of gas, the cost of medical care, the bad sub-prime real estate loans, maybe even that fact that the baby boomers began collecting Social Security early beginning on January 1, 2008. All of these are good reasons for the stock market to go down, but does it really matter why the stock market or economy isn't doing well? No; because if you have a good financial blue print, then the cost of such things as gas and health care shouldn't affect your family. It's a simple concept: spend less than you make.

The key to a good retired life: spend less than you make and know how much your investments are generating each month.

I recently had lunch with a couple of my stock market students and asked them: "How is it that you've been able to live a good retired life?" Their answer was "spend less than you make and know how much your investments are generating each month." They are happy with an extra \$2,000 to \$3,000 of income each month. Would that money help you? Or is it \$5,000 to \$6,000 per month? This really boils down to how well you have prepared for your retirement and how well your money will be working for you.

As you read, I can only hope that you become more inspired to live the dream of financial independence, and more so, that you take the right steps to build and keep your wealth. Take a look at my financial calculator, which will give you a better idea of what you'll need to do to be