



# THE MONTHLY INCOME MACHINE

**The One Best Investment Technique  
For Producing Monthly Income!**

**Lee Finberg**

Former Vice President - Investments  
Paine Webber (UBS) and Prudential  
Securities



# The Monthly Income Machine™

*My choice as the ONE BEST investment technique for monthly income!*

**by Lee Finberg**

**Former Vice President - Investments  
Paine Webber (UBS) and Prudential Securities**

**Third Edition  
Fourth Printing**

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First Edition: July, 2010  
Second Edition: August, 2012  
Third Edition – 1<sup>st</sup> Printing: February 2013  
Third Edition – 2<sup>nd</sup> Printing: August 2013  
Third Edition – 3<sup>rd</sup> Printing: March 2014  
Third Edition – 4<sup>th</sup> Printing: December 2014

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**Dorian Products LLC  
The Monthly Income Machine**

**Sanford, FL, 32771  
U.S.A.**

**[www.SaferTrader.com](http://www.SaferTrader.com)**

**Contact Author: [Lee@SaferTrader.com](mailto:Lee@SaferTrader.com)  
Contact Customer Service: [info@SaferTrader.com](mailto:info@SaferTrader.com)**

**ISBN-13: 978-0-615-53691-0  
ISBN-10: 0615536913  
Bar Code: 68946630483**

This book is dedicated to: my dear friend Vivian who encouraged me to share this blueprint for reliable monthly income; to my eagle-eyed friend Jerry who spotted and brought to my attention several tangled thickets of prose needing pruning; to my wife and proofreader extraordinaire (who holds the North American record for number of times reading this book in the pursuit of each typo); and to you dear reader who finds the contents of the book a useful part of his or her financial life. Thank you.

## *Activate All of Your "Machine"*

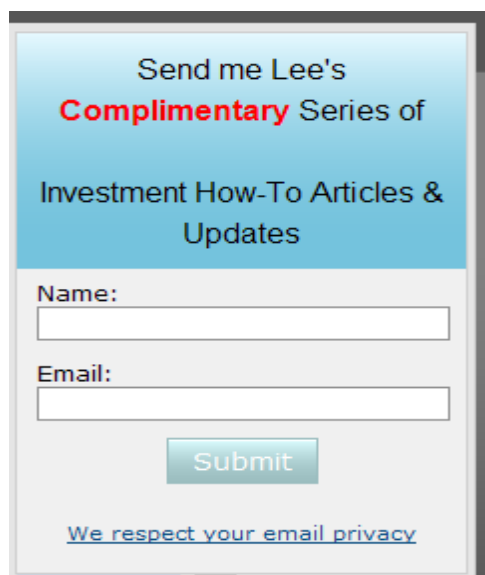
In addition to the book itself, there are three (3) very important companion parts to "The Monthly Income Machine" that you are entitled to receive at no additional cost.

You need to *register* now to obtain these related services that include:

1. Direct coaching by the author if you have questions. Lee typically is able to provide responses to your questions within 48 hours.
2. Lee's ongoing series of "how-to articles" and alerts covering "The Monthly Income Machine" related investment tips, opportunities, expanded explanations and book updates. The alerts are sent to you, as they are released, at the e-mail address you specify when you register.
3. Access to the members-only Safer Trader FORUM, where community participants - including Lee - share trade candidates they have identified, discuss market opportunities, etc.

You should register for the rest of your free services now, before you even begin reading the next section.

To Register: Go to [www.SaferTrader.com](http://www.SaferTrader.com) and at the top of the page, enter your name and email address in the registration box pictured below. It goes without saying - but we'll say it anyway - we NEVER share our community members' names or contact information with anybody, for any reason.



The image shows a registration form with a light blue header and a white body. The header text reads: "Send me Lee's **Complimentary** Series of Investment How-To Articles & Updates". Below this, there are two input fields: "Name:" and "Email:". A green "Submit" button is centered below the email field. At the bottom, there is a link that says "We respect your email privacy".

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# *About Lee*

Lee Finberg, the creator of “The Monthly Income Machine,” includes a strategy, a step-by-step how to book, a FORUM, an ongoing series of “white paper” articles and tips, direct access to the author when you have a question, and a separate (optional) screening candidate subscription service.

These features are open to all registered individuals seeking to generate a monthly income stream from the markets, using the concepts, trade entry "rules," and trade management techniques presented in this book.

Tellingly, after three decades devoted to participating in the financial markets as a professional with ContiCommodity, Paine Webber, and Prudential Securities, and trading stocks, bonds, options, commodity futures, currencies, and precious metals both for his clients and for his own account, Lee’s own personal accounts are now devoted exclusively to Monthly Income Machine and covered call trades.

He began his education by entering college at age 16 and earned a B.Sc. in Pharmacy at the Philadelphia College of Pharmacy and Science and continued his MBA graduate work at Temple University. Lee then joined pharmaceutical giant Merck as an Economic Research Analyst and ended that phase of his career as Vice President of Marketing at the American Optical Division of Warner-Lambert.

In parallel with his first career, he became extremely interested in the financial markets, successfully trading his own accounts and then launching his second career by joining the industry as a broker.

## The Monthly Income Machine

While with Paine Webber (now UBS), he began writing a syndicated column on investing and also accepted invitations to speak at investment symposia throughout the country and abroad. Invitations for interviews on CNBC followed and Lee ultimately worked with individual clients and money managers from all over the world as head of the Finberg Group at Prudential Securities.

Over the years, his philosophy of personal investing changed from one of high-stress pursuit of capital gains to one of seeking to comfortably and reliably extracting a significant monthly income from the markets.

This philosophy culminated in the development of "The Monthly Income Machine."

One of the readers of the book, who faithfully uses the concepts and follows the "rules" presented in it, wrote that, "It changed my life."

As you use the blueprint provided herein, Lee invites you to share your own results with him and other members of the Monthly Income Machine community at **[www.SaferTrader.com](http://www.SaferTrader.com)**.

# *Introduction*

## **The Monthly Income Machine™**

***Perhaps the ONE BEST investment technique for conservatively producing monthly income!***

I mean each word of the title and subtitle.

Monthly Income: your net profit income is realized in your account on a monthly basis, in rising, falling or stagnant markets. Our often achievable target is 4 - 8% return on margin investment per MONTH.

Machine: an apparatus consisting of interrelated parts with separate functions, used in the performance of some kind of work. Like any machine, “The Monthly Income Machine” is based on doing the same thing, i.e., placing the same kind of orders and managing the trades, the same way, every month.

One Best: From an investment standpoint, there are many markets and techniques for seeking profits and/or income. Over the past 30+ years I have been involved in stocks, bonds, options, precious metals, futures, and currencies both professionally and for my own accounts.

This book will show you what I have learned from these decades as a stock broker, branch manager, investment advisor, newsletter and syndicated column writer, book author and personal investor to be one of the best techniques for seeking income from the markets and doing so conservatively and routinely. It is essentially the only investment vehicle I use personally now, and – along with covered call writes - the only one I expect to use in the future.



## The Monthly Income Machine

Reliable: “The Monthly Income Machine” is not intended to produce “home run” capital gains (nor stomach churning losses) in your account.

It is geared to generating substantial *income* and it provides me, and can provide you, with very significant returns most EVERY MONTH with limited time investment and minimal concern about market direction.

“The Monthly Income Machine” helps provides me with a great deal of free time with my family (a wonderful wife and our beloved Shetland Sheepdogs) and my life-long hobby (stamp collecting).

### IMPORTANT NOTE

*I believe “The Monthly Income Machine” to be a suitable strategy for even the most conservative investor’s account, including IRA’s and other retirement accounts, even though the targeted rate of return is relatively large and it employs an often misunderstood (and even more often misused) investment vehicle. Results, however, cannot be guaranteed and you should read and heed Disclaimers and Disclosure information at the end of Chapter 9.*

# *Chapter 1*

## INVESTMENT MYTHS AND REALITIES ...LET'S DISPEL A FEW OF THE FORMER

Myth: Buy-and-Hold is the “correct” investment strategy.

Reality: Buy and Hold is a favorite TV talking-head mantra. Today, many investors have learned through experience that buy-and-hold being the “correct” strategy is really an unsubstantiated generalization. Nevertheless, TV pundits frequently proclaim its merit despite the fact that it is often a losing strategy resulting from financial upheavals, world events, new technologies, and new competitors.

Consider what happened with a few highly respected widows-and-orphans stocks of the past: GM, CitiGroup, Lucent, and near-criminal or over-leveraged enterprises masquerading as attractive growth companies like Enron and AIG, or even federal government “blessed and backed” companies like Fannie Mae and Freddie Mac.

If you sadly held on to those “buy and hold” portfolio stalwarts during the last 10-20 years, your portfolio has truly suffered. Trends change, and fighting trends by stubbornly sticking with your losers - or worse, buying more to “average down” – can be dangerous to your financial health.

Myth: Purchasing stock options is the way to use a highly leveraged investment vehicle and a small amount of money to generate mega-profits with low risk. Your only risk is the premium you pay when you buy options.

Reality: Well the last part about risk being limited to the premium you pay is true. But that's of little consolation if you often lose that premium! Be aware of this widely known, repeatedly proven, and terribly grim statistic: 80-90% of option *buyers* lose money over the long run. The fact that most investors who *buy* options lose money is the primary reason options have the reputation of being “very risky.”

## The Monthly Income Machine

That reputation is well deserved based on the way most investors use options (buying out-of-the-money Calls or Puts outright), but it is not the way “The Monthly Income Machine” employs them, as you will see. Our approach is a conservative one that profits from the great risk option buyers take!

...so, if 80-90% of options traders lose money,

WHERE DOES THAT MONEY GO?

*Hint: If you employ “The Monthly Income Machine” exactly as I am going to show you, some of it can go to you. Every month.*

# *Chapter 2*

## OPTION BASICS

### WHO WINS, WHO LOSES, AND WHY

*Even if you are an experienced investor, if you skip past the following “BASICS” Chapter you will miss some important items. Although you may be familiar with parts or all of the basics, here we are going to review them using examples and illustrations of what NOT to do, as well as what to do - and why.*

*That way, even before we cover the step-by-step details of correctly using the "Machine," you will gain insight into why I insist “The Monthly Income Machine” is the ideal technique for making money in up, down, or sideways markets... and why you can have confidence that the strategy and procedures I explain in later chapters can work for you.*

### ***The Key Aspects of Stock, ETF and Index Options***

There are five basic aspects of a stock, ETF or index option that we need to understand: (1) Calls and Puts and their Strike Prices; (2) Distance of the Strike Price from the underlying; (3) Long and Short; (4) Premium; and (5) Expiration and Last Trading Day Dates. “The Monthly Income Machine,” in part, is based on selecting the correct combination of these factors and placing, and then managing, your trades accordingly. We’ll review these five components of all stock options. But first, let’s be sure we understand what an option is.

Options on Stock, Index, and ETFs (Exchange Traded Funds) are investment vehicles that are traded, like the underlying instruments themselves, on registered, regulated exchanges, most notably the Chicago Board Options Exchange (CBOE).

Just as the individual stock option trades in relationship to the underlying stock, Stock Index Options trade in relationship to the underlying index, a basket of stocks. Actively traded index options include those on the S&P, the Nasdaq, the Russell 2000, etc. Similarly, ETFs (exchange traded funds) are typically composed of multiple, related or specialized underlying instruments.

As with stocks themselves, options have a “bid” price (what investors are willing to pay for the option) and an “ask” price (what investors are willing to sell it for).

When an option and its underlying stock, ETF, or index are actively traded, and/or the underlying price is close to the option strike price, the bid and ask prices will tend to be closer together than the bid-ask spread would be for a relatively infrequently traded, or far out of the money, option. When the “bidders” (buyers) and “askers” (sellers) agree on price, a trade takes place.

The price at which an option is quoted or traded is also known as the Premium, the price the buyer pays for the option and what the person on the other side of the trade, the seller, collects for selling the option. Incidentally, you do *not* need to already own the option when you are establishing a new position that involves selling an option. We will cover this important concept – the “short” - in detail later.

### ***Calls and Puts and Their Strike Prices***

Now let’s look at the two basic flavors of options: Calls and Puts. Both types of options can be converted to (usually) 100 shares of an underlying stock, prior to or at expiration, if the owner wishes. For indices, cash settlement is used since there are no underlying “shares” involved.

The buyer of a Call option has the right, but not the obligation, to buy the underlying stock at one of a series of specified prices – the Strike Price – any time up to and including the Last Trading Date of the option (typically the third Friday of each month).

An investor buys Calls if he believes the underlying stock or index is going to rise above his chosen Strike Price significantly. If the underlying rises far enough above his Strike Price at expiration day, he could sell the Call for a profit. He could also sell the Call option at any time *before* expiration, at a profit or a loss, depending on the price of the underlying, how close it is to his strike price, and the amount of time remaining until expiration.

## The Monthly Income Machine

But, if the price of the underlying is *at or below* the Strike Price of his Call Option when the option expires, the option expires worthless (bad news for the *buyers* of the option; all smiles for the folks - like “The Monthly Income Machine” practitioners - who *sold* them those options).

Therefore it makes absolutely no difference how far the stock price is below the Strike Price of a Call option on expiration day. Even if the stock price and option Strike Price are identical at expiration, the *buyer* of the option loses whatever he paid for the Call option (the Premium) in its entirety if the underlying has failed to exceed the strike price.

The buyer of a Put option, on the other hand, expects the price of the underlying to go down significantly. Owning a Put option gives him the right to sell the underlying stock at the Strike Price of the Put he owns. He would buy a Put with a Strike Price he thinks the underlying stock will be below when the option expires. If the price of the stock is indeed below the Strike Price of his put at or before expiration, he could sell the PUT at the Strike Price and immediately realize a profit.

If, however, the stock’s price remains above the Strike Price of his Put on expiration day, he loses and the option expires worthless. His loss is the Premium he paid for the Put when he bought it. As with Calls, the owner of a Put can sell his Put any time he wishes and need not wait until expiration day.

### ***The Long and Short of it.***

Let’s be very clear about “Buying Long” and “Selling Short.”

If an investor expects a *substantial rise* in a stock or index, he could BUY a CALL (“buy Call long”) on that underlying stock, ETF, or index. If that underlying does go up enough, and does it sometime at or before expiration day, he could then sell the Call at a higher price and thus close out the transaction with a profit.

## The Monthly Income Machine

If he expects a *substantial decline*, he could BUY a PUT (“buy Put long”). If the underlying does go down enough, and does so at or before expiration day, he could Sell the Put at a higher price and thus close out the transaction with a profit.

Buying (going long) Calls or Puts, as described above, is what most option traders do; they are seeking highly leveraged profit gains.

If an investor is neutral to mildly bullish, and believes the price of the underlying will remain above a particular price, he could SELL SHORT a PUT (“sell PUT short”) at that Strike Price. If the price of the underlying does remain above the Strike Price, the premium (option price) will decline and he could later buy the Put back at a lower price and thereby close out the transaction with a profit, or ideally he could simply allow the option to expire worthless in which case he has made the maximum possible profit on the short sale.

Conversely, when an investor is neutral to mildly bearish, and expects the price of the underlying to remain below a particular price, he could establish his bearish position by SELLING SHORT a CALL (“sell CALL short”) at a higher Strike Price. If the price of the underlying does indeed remain below the Strike Price of his Call, he would be able to later buy the Call back at what will be a lower price and thus close out the transaction with a profit, or, as in the short Put scenario, allow the option to expire worthless (at zero) and thus realize the maximum possible profit on the transaction.

Incidentally, selling a Call option short *if you do not also own the underlying stock or a similar “long option,”* is extremely dangerous as will be discussed later.

The only real difference between an outright long vs. an outright short transaction is that in the Buying Long case the bullish investor buys first and sells later (hopefully at a higher price) to close out the transaction. While in the Selling Short case, the bearish investor sells first and buys back later (hopefully at a lower price) to complete the transaction. Only the ORDER in which the buy and sell takes place is different.

## ***Example of a “Long” and a “Short” Option Transaction***

John is very bullish on Option A, expecting it to go up from its current \$5 price, so he Buys that Call Option:

First:	Buys (goes long) Call Option at \$5 to initiate transaction.
Second:	Underlying does go up and he Sells back Option later at \$7 to close out transaction.
Result:	Bought at \$5; Sold at \$7 for a \$2 profit.

Henry, however, is bearish and expects Option A to go down in price so he Sells Short the Call Option:

First:	Sells Short (goes short) a Call Option at \$5 to initiate transaction.
Second:	Underlying does go down and he Buys back Option later at \$3 to close out transaction.
Result:	Sold at \$5; Bought at \$3 for a \$2 profit.

In both cases, going long, or going short, the outright investor sold the Call for \$2 more than he bought it for, so he profited by \$2. Only the order in which the buy and sell were done was different, not the financial outcome since the sell price was \$2 higher than the buy price in both cases.

*The above example transactions are intended to illustrate the difference between going long and selling short. However, NEITHER the above outright buy nor sell short transactions would be executed as part of "The Monthly Income Machine."*

## ***Summary: How Bulls and Bears use single option (non-spread) transactions***

If one were quite bullish on an underlying stock, he could Buy the Call outright.

If he were mildly bullish on an underlying stock, he could Sell a Put short outright.



If he were quite bearish, he could Buy a Put outright.

If he were mildly bearish, he could Sell a Call short outright.

This grid summarizes the four possibilities of a transaction involving a single outright (non-combination, i.e. non-spread) market position:

	BUY	SELL
BULLISH	Call	Put
BEARISH	Put	Call

“The Monthly Income Machine” does not involve *any* of these common, single-option outright strategies, because the likelihood of profiting long-term from buying options is relatively low, and the risk associated with “naked” short selling of call options is much too high. (A naked short option refers to a short option that does not have a protective long underlying stock or option position associated with it.)

### ***Premium: The Price at Which an Option Trades***

A stock, ETF or index option Premium price is made up of either one or two components, depending on where the option’s Strike Price is compared to its underlying’s price.

If the price of an underlying is *above* the Strike Price of a Call option (that is, the option is “in-the-money”), the premium the buyer pays or the seller earns is made up of both “intrinsic value” and “time value” (extrinsic value).

Intrinsic value is just the arithmetic difference between the price of the stock and the Strike Price of the option. If XYZ stock is trading at \$60, the Call with a \$55 Strike Price has exactly \$5.00 of intrinsic or “real” value. It is in-the-money to the extent of \$5.00. The mere passage of time has no effect on intrinsic value.

However, when an option is in-the-money, the Premium the option trades at will include *both* its current intrinsic value *and* some amount of “time value.” The additional time value component of the option’s Premium is referred to as “extrinsic value.”

A Call option trading at a Premium of \$7.00 might be in-the-money (have an intrinsic value of) \$5.00. The extra \$2 dollars over and above the \$5.00 intrinsic value is for “time value,” since buyers are willing to pay more than the current intrinsic value because the underlying stock – and therefore the call option – could go even higher during the time remaining before option expiration.

If the price of the underlying stock, ETF or index is *below* the Strike Price of the Call, the entire Premium is for “time value,” since there is no intrinsic value at that time, i.e., the option is “out-of-the-money.” “The Monthly Income Machine” only deals with out-of-the-money options where the entire Premium is made up of only time value (extrinsic value).

### ***The Significance of Time Value***

“Time value” is constantly declining. It erodes away faster as expiration day approaches, and really fast during the last 10 trading days prior to expiration. If the Call option expires with the underlying at or below the Strike Price of the Call, or at or above the Strike Price of the Put, the premium falls to 0 and the option expires worthless since there is no intrinsic value and no remaining time value.

Keep in mind that the buyer of Calls or Puts need not keep the option until expiration day. He can exit from the option whenever he wants (at a profit or a loss) up to and including the last trading day before expiration. In practice, the owner of an option (Call or Put) almost never exercises it, i.e. exchanges it for the underlying stock.

Instead, he either sells the option (if he was “long”) or buys it back (if he was “short”) at a profit or a loss before expiration; or, if the market is moving nicely in his favor, he does nothing and watches it expire worthless on expiration day if the underlying is still out-of-the-money, i.e. below his Call Strike Price or above his Put Strike Price.

## ***The Appeal of Options: A Successful Stock Trade vs. a Successful Options Trade***

Here's a simple example that illustrates the typical option transaction. Again, it is NOT the kind of transaction you will employ with "The Monthly Income Machine." Rather, it represents the mind-set and resulting actions of many - if not most - non-professional option market participants.

Joan sees that the stock in XYZ company is trading at \$48/share. She thinks the stock price will reach \$55/share or more in 30 days. She could just buy 100 shares of the stock itself and, if the stock were at her \$55 target in a month, she would have a paper profit of \$7/share. She paid \$4,800 ( $\$48 \times 100$ ) for the 100 shares of stock, and in this example it's worth \$5,500 next month if the stock price reaches \$55. She has \$700 profit at that point. \$700 profit on \$4,800 investment is a 14.5% rate of return. Not too shabby, but unfortunately this doesn't happen very often in such a short time period.

But that's not what she does. Joan understands the power of "leverage" and instead of spending \$4,800 of her available investment capital, she buys an XYZ out-of-the-money Call option with a Strike Price of \$50, which gives her the right to buy 100 shares of XYZ at \$50/share anytime up to and including the day the option expires next month.

She pays, let's say, 40 cents for the Strike Price \$50 Call option. This is the Premium, and since the underlying stock price of \$48 is currently below the option's \$50 Strike Price, that \$0.40 premium she pays is entirely made up of "extrinsic (time) value." This Call option costs her  $\$0.40 \text{ premium} \times 100 \text{ potential shares} = \$40$ . If, as in this example, the XYZ stock is at \$55 next month at option expiration day, her Call option with the \$50 Strike Price would now have intrinsic (actual) value of \$5.00 (compared to the \$0.40 she paid for it!) because she could, if she chose to, exercise her option to buy the stock at the \$50 Strike Price, and then immediately sell the stock for the then market price of \$55 to realize a \$500 profit.

She wouldn't actually exercise the option, of course; she would simply sell the Call option at the \$5.00 premium, which is  $\$5.00 \times 100 \text{ potential shares} = \$500$ , to take her profit on the transaction.

Now let's compare the buy-the-stock and the buy-the-Call approaches when the stock goes from its current price of \$48, to the \$55 price it's at when the option expires. Her rate of return is much, much higher by buying the Call option instead of the underlying stock. Had she bought the stock itself, excluding commission transaction costs she would be ahead \$700 on a \$4,800 investment; instead, by buying the Call option, she is ahead by \$460 (she paid \$40 for the call and sold it for \$500) on a \$40 investment.

That's 1150% profit on the buy-the-option approach vs. a 14.5% profit on the buy-the-stock approach. This kind of potential outcome is what tempts most option traders to *buy* individual options outright.

You remember of course that this approach of buying out-of-the-money options outright (and paying the Premium to do so) is exactly what most option traders do, and it is why most option traders lose money over the long run trying for a home run trade like the one we just described.

Remember this: according to the CBOE, *80%+ of out-of-the-money options purchased expire worthless*. You will soon learn why this is a very important, and a very desirable, statistic for "The Monthly Income Machine" investors.

### ***Expiration Day for Options: A Monthly Occurrence***

As noted earlier, a given month's *Stock* or *ETF* Options expire following the close of the 3<sup>rd</sup> Friday of that month and the options can be bought or sold up till the end of that Friday's trading day. Although *Index* Options also expire after the close on that Friday, Index Options *cease trading* the day before, i.e., on the *Thursday* before the 3<sup>rd</sup> Friday of the month.

## ***Expiration Day: For Some, Smiles; For Others Frowns***

In short, seeking large percentage profits by buying out-of-the-money stock options outright - even though you *know* the grim statistic that on balance the approach usually doesn't work over time - is at least a questionable strategy. In fact, it is this wrong-headed allure operating with many option traders that provides *you* with the income from the "Monthly Income Machine."

In the real world, most of the time the underlying stock does *not* make the desired move beyond the strike price, or does not do it in time before the option expires. The buyers' options usually expire worthless and the Premium paid for them *is lost to whomever sold them the options*.

Incidentally, examples shown in this book do not take commissions into account, but commissions on both stocks and options traded online are reasonably minimal nowadays and should not be a major factor unless you are day trading (which you better not be doing!)

## ***What About Weekly Options?***

The relatively new "weekly" options that are increasingly available can be quite useful for certain applications. However, they are usually not appropriate for "The Monthly Income Machine" or - in my opinion - for credit spreads in general when entered with only a week until expiration. When there are only 5 or fewer days until expiration, the risk/reward ratio is *not* favorable at the distance required between underlying and the credit spread. We'll go into this in more detail in a later section.

## ***What About Mini Options?***

The even newer "mini" option contracts can be employed appropriately with credit spreads and "The Monthly Income Machine" strategy. As the name implies, these are options that represent a smaller amount of the underlying stock but currently they are limited to relatively few, very

actively traded stocks. (See the “white paper” on mini options at <http://safertrader.com/mini-options-do-they-fit-your-income-investment-game-plan.>)

# *Chapter 3*

## THE INFORMATION WE NEED ... AND WHAT TO DO WITH IT

### ***The Option Chain: Strike Price, Premium and Expiration***

Having reviewed the major components of all options, we'll turn now to considering how those components fit into "Machine's" conservative monthly income trades.

Below is an important tool for a trader in options. It is called the "Option Chain" and it shows you at a glance where things stand at that moment in time you are looking at it and/or are contemplating placing your order.

We will focus on three of the key elements we consider with any option trade: Strike Price, Premium, and Expiration.

### ***Option Chain Example***

First, though, we'll use a hypothetical transaction that assumes the trader has not read this book and is hell-bent on buying an option outright in hopes of making a big profit.

Trader Joe intends to buy Call Options on Apple Computer because he's expecting a favorable earnings report that will lead to a big and rapid jump in the price of the stock.

(Note: the following example is for illustrative purposes only; "The Monthly Income Machine" would NEVER make this trade since it NEVER buys options outright... because we know such a strategy is usually a losing proposition over time.)

Apple Computer (symbol AAPL) is selling (pre-split) at \$604.30

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Because he is banking on a quick spike in Apple stock based on an upcoming earnings report due later in August before expiration of August options, Joe elects to use August Calls, whose option chain table is depicted below.

The more time there is until expiration, the greater the premium cost, all other things being equal, because there is more time for the hoped for move in the underlying stock to take place. Recall that “time” (extrinsic value) is really what one is paying for in the Premium for an option when the option is out-of-the-money, i.e., when the current stock price is below the Strike Price of a Call or above the Strike Price of a Put.

Here is an actual Option Chain table (courtesy of OptionsXpress):

Option Chains for AAPL

Quotes as of 7/21/2012 11:29:11 AM ET

S&P Options Reports

Futures

Option Prices | Core Calls | Straddles | Put Spreads | Call Spreads | Collars | Calendar Puts | Calendar Calls | Delta & Imp.

Symbol  
AAPL

Range  
All

Type  
Calls And Puts

Expiration  
Aug12

View Chain

Find Symbol / Futures

Include Adjusted / Non-standard Options

Apple Inc.

Symbol  
AAPL

Last  
604.39

Change  
-10.02

Bid  
603.82

Ask  
603.92

Vol  
0

AAPL Expiration Months: Jul09 | Jul12 | Aug12 | Sep12 | Oct12 | Jan13 | Apr13 | Jan14

Calls

Disable Roll Overs

Last Chg Bid Ask Vol Opnt Action

Aug12 Calls (27 days to expiration)

AAPL @ 604.3

16.24 0 16.10 16.40 00 8,274 Trade | Detail

13.53 0 14.15 14.20 00 11,207 Trade | Detail

12.23 0 12.10 12.30 00 9,433 Trade | Detail

10.55 0 10.40 10.60 00 8,771 Trade | Detail

9.10 0 9.00 9.05 00 4,339 Trade | Detail

7.70 0 7.80 7.75 00 8,622 Trade | Detail

6.53 0 6.40 6.60 00 5,056 Trade | Detail

4.76 0 5.45 5.60 00 22,714 Trade | Detail

4.75 0 4.55 4.70 00 4,044 Trade | Detail

3.90 0 3.80 4.00 00 6,351 Trade | Detail

3.39 0 3.20 3.35 00 2,980 Trade | Detail

2.78 0 2.70 2.75 00 4,387 Trade | Detail

2.34 0 2.26 2.35 00 4,275 Trade | Detail

1.99 0 1.94 1.95 00 5,921 Trade | Detail

1.68 0 1.65 1.69 00 1,412 Trade | Detail

1.45 0 1.40 1.44 00 4,510 Trade | Detail

1.23 0 1.20 1.25 00 1,252 Trade | Detail

1.07 0 1.05 1.07 00 9,472 Trade | Detail

0.93 0 0.89 0.93 00 1,549 Trade | Detail

0.81 0 0.77 0.81 00 1,772 Trade | Detail

0.67 0 0.67 0.71 00 531 Trade | Detail

0.59 0 0.58 0.62 00 1,081 Trade | Detail

Puts

Last Chg Bid Ask Vol Opnt Action

27.00 0 26.95 27.25 00 2,694 Trade

30.00 0 29.80 30.20 00 3,953 Trade

32.20 0 32.95 33.35 00 1,295 Trade

36.20 0 36.20 36.60 00 1,760 Trade

39.16 0 39.55 40.20 00 1,386 Trade

43.10 0 43.10 43.55 00 2,516 Trade

45.85 0 47.10 47.75 00 915 Trade

50.75 0 51.15 51.70 00 1,253 Trade

52.42 0 55.25 56.15 00 555 Trade

56.75 0 59.05 60.30 00 1,510 Trade

56.99 0 63.45 64.70 00 640 Trade

61.17 0 67.85 69.20 00 510 Trade

72.69 0 72.45 73.60 00 694 Trade

74.50 0 77.05 78.55 00 594 Trade

75.85 0 81.55 83.00 00 360 Trade

84.55 0 86.40 87.75 00 564 Trade

89.55 0 91.15 92.65 00 282 Trade

96.05 0 96.15 97.45 00 764 Trade

91.80 0 101.05 102.55 00 337 Trade

104.40 0 105.80 107.50 00 241 Trade

113.95 0 110.65 112.50 00 224 Trade

115.60 0 115.95 117.35 00 160 Trade



## The Monthly Income Machine

The Option Chain table above shows AAPL Calls on the left, and AAPL Puts on the right, for the range of Strike Prices we are interested in for this example. In the middle of the table are the various Strike Prices available for the options that expire in August. This table is a snapshot taken after the market closed the day before.

You will note that the table, always available online at your brokerage firm, identifies the type of option (Call or Put), the Strike Prices and current Premium prices for each Expiration Month (we are concerned with the August ones in this case.)

The various available Strike Prices are shown in the middle column, and Joe decides that Apple stock can jump more than 10% above the current price of the stock (\$604.30) on what he expects (hopes) will be a surprisingly good earnings report, so he decides to use the August 665 Calls. Because the Strike Price is so far above the current price of Apple stock, the premium cost is relatively small.

The table tells him under the "Last" column, the price the option closed at the previous day. With the underlying AAPL stock at \$604.30, the August 665 Call finished the trading day with the "bid" at \$3.20 and the "ask" at \$3.35; it settled at \$3.30, which is the Premium. One call option would therefore cost Joe approximately \$330 ( $\$3.30 \times 100$  potential shares) + commission. Joe decides to place an order to buy 10 Apple August 665 Call contracts at \$3.30 which costs him \$3,300 ( $\$3.30 \times 100$  potential shares  $\times 10$  contracts) and, since each call represents 100 shares of the underlying stock, he is controlling 1000 shares of Apple for \$3,300 (10 Calls at \$330/call), instead of the \$604,300 he would need to buy 1000 shares of the stock itself!

As noted at the beginning of this example, this is decidedly *not* a "Machine" trade. It can hardly be categorized as conservative. It's very much an all-or-nothing speculation.

*To just break even*, excluding commission cost, the stock would have to rise from its current price of \$604.30 to \$668.30 by options expiration day... less than a month away (strike price of \$665, plus the \$3.30 premium paid for the option).

Yes, the trade could work out to be very successful. The earnings report might "beat" the street expectations by a mile and result in a big move in the stock to well above the 665 strike price. However, as evidenced by many studies, including those of the options exchanges themselves, buying far out-of-the-money options in hopes of a big move in a short period of time is a very difficult enterprise if one is aiming for a recurring stream of profits. That's the polite way of saying that over the long run, most outright buyers of out-of-the-money options do not make money.

In our hypothetical, if AAPL rose in roughly one month from \$604.30 all the way to \$668.25 at options expiration day (just \$0.05 short of his break-even \$668.30 price), the trade loses little money. If AAPL is below the 665 strike price of the option at expiration, *all* of the \$3300 + commission paid for the options is lost.

Nevertheless, Joe plows ahead with his plan to buy AAPL Call options outright.

### ***The Option Chain: Open Interest and Volume Liquidity***

The options chain table also includes an Open Interest (Opint) column, which is the total number of outstanding long and short option contracts that have not yet been closed out by an offsetting transaction, and the Volume (Vol) column that is the number of options of that Strike Price traded during the day.

Joe notes that there is significant Open Interest to provide liquidity in the event that he later decides to sell his Calls before expiration. The Vol (volume) column shows zeros on this table because there are no trades as the market is not yet open today.

When the market opens, he goes to his brokerage firm website and looks at this Option chain table online. Now the bid, ask, and last traded prices, the volume, the price of Apple stock, etc. will change moment by moment for each Strike Price as trading takes place and he can decide what Strike Price and associated Premium appeals to him if he wants to place an order.

## The Monthly Income Machine

Just as one is able to do with any stock order, after he places his option order and before it is filled, Joe can change the Premium (price) he is willing to pay, increase or decrease the size of the order, make the order good only for today, or have it “good till cancelled,” or simply cancel the order anytime he wishes - so long as it has not already been filled, of course. He can also place and/or modify separate protective stop loss orders, contingent stop loss orders, etc. at any time as with a stock.

# *Chapter 4*

## GREEKS, VIX ... AND OTHER OPTIONS GIBBERISH

Lastly in this background review section, we will visit briefly with the Greeks, Volatility, and VIX.

“The Monthly Income Machine” does not require that you employ these tools in its operation (except for one of the “Greeks” - Delta). In any case, the values are easily obtained from an Option Calculator, on your brokerage firm website, and throughout the Internet in free, downloadable format.

For the most part these considerations are already built into “The Monthly Income Machine” rules without the need for the user to work separately with the “Greeks,” other than Delta.

The “Greeks” are the analytical tools that provide insights into the risks associated with a given option or position.

### *Delta*

is derived from a theoretical pricing model that attempts to measure how much the price of an option will change as a result of a \$1 change in the price of the underlying stock.

Delta also provides insight into the mathematical probability that an option will finish (expire) “in-the-money” (meaning that the underlying is above the strike price of a Call option, or below the strike price of a Put option).

### *Gamma*

is used primarily by professionals managing a large position. Essentially, while Delta measures change in option *price* as underlying stock, ETF or Index price changes, Gamma measures changes in *Delta* as the underlying price changes... i.e., Gamma measures changes in the changes.

### *Theta*

measures the impact of TIME on an option's value. Just remember that the value of an option declines as time passes. This time deterioration is for all options, especially significant for those that are "out-of-the-money," i.e., stock price still below the Call option Strike Price, or stock price still above the Put option Strike Price.

When an option is out-of-the-money, the premium the option sells for (made up entirely of extrinsic or time value) is based on several factors, including how much time is remaining until expiration and how far the underlying stock price is from the Strike Price, and how volatile the underlying is. While price movement in the underlying stock, ETF, or index may move in favor or against the value of the option, the passage of time is always working against the out-of-the-money option's value. It should be noted that it is this "time value decay," constantly reducing the value of the option, that tends to kill the trader who buy options outright. "The Monthly Income Machine" investor is often his beneficiary!

### *Rho*

Measures changes in option price that would theoretically occur because of changes in interest rates. This is not particularly useful unless the option has many months to go to expiration, and even then is considerably less significant than Delta. Because "The Monthly Income Machine" uses the current option expiration month or the one after it, Rho does not usually come into play in a meaningful way.

## ***VOLATILITY: SIGNIFICANCE***

The volatility of individual stocks, indices, and the markets they comprise, are very important in working with options. In general, volatility refers to how much price *movement* is taking place,

or is expected to take place, in the underlying stocks, ETFs or indices associated with the related options.

There are three common measurements of “volatility” that we should understand.

### ***VOLATILITY: BETA***

Beta is a measure of a stock, ETF or index’s price volatility in relation to the rest of the market.

The higher the Beta, the more volatile the price gyrations and, therefore, options based on “high” Beta stocks or indices will typically have relatively bigger premiums than “low” Beta ones.

### ***VOLATILITY: VIX***

VIX stands for Volatility Index and is a measure of market *expectations* with respect to volatility and whether or not current market sentiment is excessively bullish or bearish. It is often referred to as the “fear index.” VIX values greater than 30 are generally associated with a large amount of market volatility as a result of investor fear or uncertainty, while values below 20 generally correspond to less stressful, even complacent, times in the markets. VIX values are quoted throughout the trading day on the Dow, S&P, Nasdaq, Oil, etc.

In general, the higher the VIX, the greater the Premiums on related options will be.

### ***VOLATILITY: IMPLIED VOLATILITY (IV)***

Implied volatility has a significant impact on the pricing of options. Only the amount that the price of the underlying exceeds the strike price of an option represents the option’s “intrinsic value” cost.

The additional (time value) cost of an out-of-the-money option - over and above its intrinsic value - is affected by: time remaining to expiration, distance of the option’s

strike price from the underlying, prevailing interest rates, and the trader's opinion of the future volatility of the underlying stock during the remaining life of the option. The impact on option pricing of the last item – the market's opinion of the future volatility of the underlying – represents the Implied Volatility of that option.

As Implied Volatility expectations rise, option cost (premium) rises.

Thus, since credit spreads involve net *selling* of premium, relatively higher Implied Volatility works for the credit spread seller.

Option price sensitivity is greater for longer dated options, for options that are near-the-money or in-the-money, and for options whose underlying is approaching important "headline" dates such as earnings reports.

Since we are typically establishing option positions that have 5 - 60 days until expiration, and that are far out-of-the-money, our spreads will be relatively (but not totally) less sensitive to Implied Volatility changes.

However, Implied Volatility is included in our conforming trade identification in that it is part of the calculation of the Delta value we use in our screening.

In point of fact, Implied Volatility (IV) and Delta are essentially two faces of the same coin.

# Chapter 5

## THE FOUNDATION OF “THE MONTHLY INCOME MACHINE” ... AND WHY IT WORKS

Now let's dig into “The Monthly Income Machine” itself, beginning with why and how it works, followed by a step-by-step explanation of the simple, specific rules for using it properly to work at reliably generating monthly income.

I posed this question earlier regarding stock, ETF, and index options: “If 80-90% of options traders lose money, WHERE DOES THAT MONEY GO?”

The Answer, as you surely have already deduced, is that the losses go to the option SELLERS! They are the ones to whom the option buyers pay those premiums. Many, if not most professionals and market makers are typically SELLERS, not BUYERS of options.

But there is more we need to understand in order to put the “Machine” to work. Simply selling options outright – called “naked shorting” - and collecting the premiums the outright option buyers so willingly and often foolishly pay, not only will not work over time, it is as we discussed in an earlier chapter the most dangerous thing you can do short of a swan dive off the top of what used to be the Sears Tower.

Never, under any circumstances, should you sell a Call short “naked,” because the profit potential is small, while the risk is mathematically unlimited.

### ***Key Principles Summary:***

1. We don't want to *buy* out-of-the-money Call or Put options outright because the statistics are overwhelming that those traders who do lose money over time. They lose it because “time value decay” continually drives option prices lower and buyers can only



## The Monthly Income Machine

profit if the underlying stock or index goes up or down enough and does so fast enough, before option expiration. When you Buy a Call or a Put, you are fighting a losing battle against time decay and must live with the reality of having bought a depreciating asset.

2. But we don't want to *sell short* Call options outright either (unless we already own the stock) because if we do sell them "naked," we are risking financial annihilation. (Note: there is one strategy, not part of the "Machine," where it does make perfect sense to Sell a PUT short<sup>1</sup>.)
3. There's the conundrum. How do we somehow safely sell options, because that is the route to collecting rather than paying premiums, and thus be an option seller who makes the money the option buyers lose?
4. We understand that we ESPECIALLY want to sell "out-of-the-money" options and collect the premium because then the immutable effect of "time value decay" works for us, driving the premium down toward zero at expiration as we desire. The deck would truly be stacked in our favor if we were able to sell an out-of-the-money option, whose premium is by definition entirely made up of depreciating time value, without assuming the huge risk of naked short selling.

<sup>1</sup>See "white paper" on the naked put trade at: [www.SaferTrader.com/sell-the-put-option-youll-get-paid-while-you-wait](http://www.SaferTrader.com/sell-the-put-option-youll-get-paid-while-you-wait).

The solution to this dilemma *is* the foundation of "The Monthly Income Machine."

A "The Monthly Income Machine" trade involves holding BOTH an out-of-the-money short option position at a particular Strike Price AND a protective long option position whose Strike Price is further out-of-the-money. This is a Credit Spread.

It's called a *Credit* Spread because you will RECEIVE money (your account will be credited) when your order is filled, rather than spending money as with outright purchases of options or debit spreads). Credit Spreads may also be referred to as a type of Vertical Spread.

A properly positioned credit spread – one that follows the "Entry Criteria" rules to be covered in Chapter 7 - allows us to safely "short" (sell) a call or a put (it will not be naked), because we will also have a related long position that eliminates the unlimited risk potential - and high margin requirement - of a naked short position.

Thus, although we are also "buying" an option as a necessary part of "The Monthly Income Machine" credit spread, we use the option we are buying only to protect our short position and to greatly reduce our margin requirement. Accordingly, we are not making the mistake of following the option trader herd, i.e., the outright purchase of out-of-the-money options that are not part of a spread.

### ***Combination Options Strategies (Spreads)***

There are a myriad of option strategies employing credit spreads and various other combinations of options, and options in tandem with stocks, that investors can use. They often have rather colorful names: butterflies, condors, straddles, collars, strangles, (hmm, how about a collar that strangles?), vertical spreads and ratio spreads to name a few. If time lies heavy on your hands, you can look into all of them, but we will only refer to one of these exotics in particular - the Iron Condor - since it applies directly – and very advantageously - to "The Monthly Income Machine."

# *Chapter 6*

## “THE MONTHLY INCOME MACHINE” OWNER’S MANUAL

### ***Overview of the Process***

1. Select specific, monthly stock, ETF or index options that conform to all of our “Entry Criteria.” (Time-wise, this identification step is 95% of the Process.)
2. Establish a particular type of position called a CREDIT SPREAD, or its glorious subset: the IRON CONDOR.
3. Record date, price, etc. at which order is filled.
4. Check on closing prices of your positions occasionally until the last trading day: the 3rd Friday of the month for stock and ETF underlyings, or in the case of index underlyings, on the 3rd Thursday, of the month.
5. You should also place protective stop loss orders to protect your positions against an adverse move that could go beyond your maximum acceptable risk limit level for the trade.
6. Make adjustments to the position along the way, if necessary.
7. Smile!
8. Repeat process for the next month.

### ***The Credit Spread and the Iron Condor – the Foundation of “The Monthly Income Machine”***

#### **1. The Bear Call Credit Spread**

As discussed earlier, we know we want to collect the premium that will be our monthly income, and that the investor collects the premium when he is the SELLER of an option. We also know that selling an option (selling short) “naked” is a major no-no. As noted, the solution to the

## The Monthly Income Machine

dilemma is to simultaneously SELL an option at one Strike Price and BUY a related option at a Strike Price even further from the underlying.

Here's how it works. Assume that, based on Apple's 604.30 closing price on Friday, 7/20/12, we wanted to consider a credit spread using Apple options. We consider it unlikely that Apple would get as high as 695 by expiration day on 8/17/12. So we are again looking at the Option Chain for August 2012 Apple options.

Option Chains for AAPL

Quotes as of 7/21/2012 11:29:11 AM ET

S&P Options Reports\*

Futures Optio

Option Prices | Cow Calls | Straddles | Put Spreads | Call Spreads | Collars | Calendar Puts | Calendar Calls | Delta & Imp Vol | Prev

Symbol

AAPL

Range

All

Type

Calls And Puts

Expiration

Aug12

View Chain

Find Symbol / Futures

Include Adjusted / Non-standard Options

Apple Inc

Symbol

AAPL

Last

604.30

Change

+10.02

Bid

603.82

Ask

603.92

Volume

0

AAPL Expiration Months: JulWk4 | Jul12 | Aug12 | Sep12 | Oct12 | Jan13 | Apr13 | Jan14

Calls

Deable Roll Overs

Stop

Last

Chg

Bid

Ask

Vol

OptInt

Action

Strike

Last

Chg

Bid

Ask

Vol

OptInt

Action

Aug12 Calls

(27 days to expiration)

AAPL @ 604.3

Aug12 Puts

16.24

0

16.10

16.40

00

8,274

Trade | Detail

615.00

27.00

0

26.95

27.25

00

2,694

Trade | Detail

13.53

0

14.15

14.20

00

11,207

Trade | Detail

620.00

30.00

0

29.80

30.20

00

3,953

Trade | Detail

12.23

0

12.10

12.30

00

9,433

Trade | Detail

625.00

32.20

0

32.95

33.35

00

1,295

Trade | Detail

10.55

0

10.40

10.60

00

8,771

Trade | Detail

630.00

36.20

0

36.20

36.60

00

1,760

Trade | Detail

9.10

0

9.00

9.05

00

4,339

Trade | Detail

635.00

39.16

0

39.55

40.20

00

1,386

Trade | Detail

7.70

0

7.60

7.75

00

8,622

Trade | Detail

640.00

43.10

0

43.10

43.85

00

2,516

Trade | Detail

6.53

0

6.40

6.60

00

5,056

Trade | Detail

645.00

45.85

0

47.10

47.75

00

915

Trade | Detail

4.78

0

5.45

5.60

00

22,714

Trade | Detail

650.00

50.75

0

51.15

51.70

00

1,253

Trade | Detail

4.75

0

4.55

4.70

00

4,044

Trade | Detail

655.00

52.42

0

55.25

56.15

00

555

Trade | Detail

3.90

0

3.80

4.00

00

6,351

Trade | Detail

660.00

56.75

0

59.05

60.30

00

1,510

Trade | Detail

3.30

0

3.20

3.35

00

2,980

Trade | Detail

665.00

56.99

0

63.45

64.70

00

640

Trade | Detail

2.78

0

2.70

2.78

00

4,387

Trade | Detail

670.00

61.17

0

67.85

69.20

00

510

Trade | Detail

2.34

0

2.26

2.35

00

4,275

Trade | Detail

675.00

72.69

0

72.45

73.60

00

694

Trade | Detail

1.99

0

1.94

1.98

00

5,921

Trade | Detail

680.00

74.50

0

77.05

78.55

00

594

Trade | Detail

1.68

0

1.65

1.69

00

1,412

Trade | Detail

685.00

75.85

0

81.55

83.00

00

360

Trade | Detail

1.45

0

1.40

1.44

00

4,510

Trade | Detail

690.00

84.55

0

86.40

87.75

00

564

Trade | Detail

1.23

0

1.20

1.25

00

1,252

Trade | Detail

695.00

89.55

0

91.15

92.65

00

292

Trade | Detail

1.07

0

1.05

1.07

00

9,472

Trade | Detail

700.00

96.05

0

96.15

97.45

00

764

Trade | Detail

0.93

0

0.89

0.93

00

1,549

Trade | Detail

705.00

91.80

0

101.05

102.55

00

337

Trade | Detail

0.81

0

0.77

0.81

00

1,772

Trade | Detail

710.00

104.40

0

105.80

107.50

00

241

Trade | Detail

0.67

0

0.67

0.71

00

531

Trade | Detail

715.00

113.95

0

110.65

112.50

00

224

Trade | Detail

0.59

0

0.58

0.62

00

1,081

Trade | Detail

720.00

115.60

0

115.55

117.35

00

160

Trade | Detail

## The Monthly Income Machine

We see that the Call for the 695 Strike Price last traded at a \$1.28 premium. And two strike prices higher, the 705 Call last traded at \$0.83.

The net “spread premium” between the two is \$1.28 paid - \$0.83 received = \$0.45 net premium.

If that were to meet our “Entry Criterion” for distance from the current market (and it does) - and all other entry criteria requirements that we will be covering are also met - we could place a credit spread order as follows:

Sell to Open 1 Aug 695 AAPL Call

Buy to Open 1 Aug 705 AAPL Call

... day order,

... for a credit of \$0.45

NOTE: When placing credit spread orders to establish a new position (or to enter a protective “stop loss” order on an existing position), we place a single order on the entire spread, not a separate order for each leg of the spread.

In order to place this order, we need to have at least \$1,000 in our account to meet the brokerage firm's margin requirement for the trade.

As soon as the order is filled, if and when it is, \$45.00 will be *credited* to our account (\$0.45 x 100 potential shares the option represents = \$45.00). That, of course, is why it's called a “credit spread.” No money (except about \$1.50 commission per contract on orders of multiple spreads) leaves our account. Instead, our account value *increases* by the amount of the net premium we collected. If our account started at, say \$4,600, our account value is now \$4,645.

NOTE: The reference to \$1.50/contract commission assumes the order is for more than one single spread... which is usually the case when investing in credit spreads. If an order were for

## The Monthly Income Machine

a single spread (sell 1 XYZ Dec 45 call, buy 1 Dec 50 XYZ call at \$0.35 premium, the commission would likely be substantially higher than \$1.50/contract.

In case you didn't notice, if all goes as planned, that \$45 will be earned on our \$1,000 margin in one month, for a 4.5% return in one month, which will be fully "banked" when and if the option expires worthless at the end of the option month.

In order to do a credit spread, we must have enough money in our account to meet the "margin" requirement. The required margin is based on the difference between the two Strike Prices, which in this case is  $\$705 - \$695 = \$10.00$ . That \$10.00 difference between strikes equates to  $\$10.00 \times 100$  potential shares of stock = \$1,000 margin required.

So, for any credit spread on any stock, ETF or index option with Strike Prices \$10.00 apart, the margin is \$1,000/spread. (Actually, a little less is required because the net premium that was credited to your account is subtracted from the required margin figure.) Predictably, the margin requirement on any option credit spread whose Strike Prices are \$5.00 apart would be \$500 ( $\$5.00 \times 100$  potential shares = \$500).

The funds that must be in our account to meet the margin requirement represent the theoretical maximum amount - except in one very unusual situation a SaferTrader would never find himself in - that could be lost on the trade if for some reason we took no corrective action and instead allowed the price of AAPL stock to rise to, or above, \$705. Above \$705, there are no additional losses because every additional dollar we lose on the short Call (the 695 Call), we would gain on the long Call (the 705 call).

It is not a coincidence that the brokerage firm's margin requirement exactly equals the maximum theoretical risk associated with your credit spread. Rather it makes abundantly clear that the firm is not in the business of taking a trading risk on your investment, no matter how unlikely such a loss may be.

## The Monthly Income Machine

Of course, we can exit from our credit spread any time, with some profit or loss, and should do so long before a trade that appears to be going very much the wrong way is in danger of reaching the theoretical maximum loss.

Thus, the credit spread net premium is the difference between the premiums of the two Strike Prices when we enter a credit spread trade. When correctly establishing a credit spread, the premium we receive on the option we sell will *always* be greater than the premium we pay for the option we buy.

Just remember that the credit spread margin requirement is based on the difference between the two Strike Prices that comprise the credit spread...

and that you need to have at least \$500 in your account to collect the premium on a credit spread with Strike Prices \$5 apart, and \$1,000 if the strike prices are \$10 apart.

Our “entry criteria,” tracking what is happening to prices along the way to expiration, and taking corrective action if needed, are all geared to enhancing the likelihood of banking our premium if the trade goes as expected... and preventing or minimizing a loss if it doesn’t.

So, unlike the unlimited risk associated with a “naked short” option, because we have a *spread* that includes both a short and a long option, our maximum theoretical risk is defined and limited... and manageable. Our maximum profit is also defined; it is the net premium credit we collected up front.

Remember: we have collected the net premium since the option Strike we sold brought in more premium than the cost of the Strike we bought. (That's why it's called a *credit* spread.)

Once we sold the credit spread, we want the net premium on the spread to *decline*, hopefully expiring worthless on expiration day. And it will expire worthless at expiration as long as the underlying stock, ETF, or index price does not reach the short Strike Price leg of our credit spread.

The credit spread in this example is called a *Bear Call Spread*, because we are using calls and are “bearish” on the likelihood of Apple stock reaching our nearest Strike Price (the short 695 Call) prior to expiration. It makes no difference whether the Apple stock in our credit spread example stays where it is, or goes down, or goes up, as long as it is under 695 on option expiration day.

Understand that it is the *short* option in the credit spread – the 695 Call - that we are really concerned about. The underlying AAPL stock must stay below that 695 strike price.

If the bear call credit spread trade is not working out, because the underlying is rising rapidly, it is because the premium on the 695 short leg of the spread will rise against us faster than the protective 705 long leg will rise in our favor, thus widening the premium spread rather than contracting it as we want.

In essence, the very important purpose of the long leg is simply to prevent us from being in a “naked short” position (with its unlimited risk).

Having the long 705 leg also provides another very valuable benefit: it keeps our margin requirement low! If we were to just be naked short the 695 Call, and didn't have the long 705 Call with it, the margin requirement would be much greater than \$1,000.



### **2. The Bull Put Credit Spread**

Everything we just covered under “The Bear Call Spread” works exactly the same way for the “Bull Put Spread.” Only now, we are doing a credit spread with Puts rather than with Calls. We use a Bull Put Spread to collect our spread net premium when we expect the price of the underlying to remain above a particular strike price, i.e., we are bullish on the underlying remaining above a particular price at expiration. We would place the “short” leg of our spread at that strike price and the protective “long” leg at a strike price below it (i.e. the long leg will be further from the underlying thus further out-of-the-money).

As before, we collect a premium on the Put we sell, and we pay a smaller premium for the one we buy. The net difference in the premiums is what we earn when both options expire worthless, which they will so long as the price of the underlying is at or above the strike price of our “short” put leg at expiration. Let’s turn again to the Option Chain we used in defining our Bear Call Credit Spread. This time, our focus will be on the Puts side of the chain.

## The Monthly Income Machine

Option Chains for AAPL

Quotes as of 7/21/2012 11:29:11 AM ET

S&P Options Reports

Futures Opti

Option Pricing | Cov Calls | Straddles | Put Spreads | Call Spreads | Collars | Calendar Puts | Calendar Calls | Delta & Imp Vol | Piv

Symbol

AAPL

Range

All

Type

Call And Put

Expiration

Aug 12

View Chain

Q: Find Symbol / Futures

☐ Include Adjusted / Non-standard Options

Apple Inc.

Symbol	Last	Change	Bid	Ask	Volume
AAPL	604.30	-10.02 ▼	603.82	603.92	0

AAPL Expiration Months: Jul04 | Jul12 | Aug12 | Sep12 | Oct12 | Jan13 | Apr13 | Jan14

123.10	0	118.50	121.25	00	356	Trade   Detail	485.00	0.86	0	0.85	0.89	00	2,396	Trac
118.50	0	114.50	116.25	00	1,673	Trade   Detail	490.00	0.96	0	0.96	1.00	00	2,802	Trac
112.24	0	109.35	111.70	00	383	Trade   Detail	495.00	1.10	0	1.09	1.12	00	3,452	Trac
106.00	0	105.15	106.45	00	2,235	Trade   Detail	500.00	1.23	0	1.24	1.25	00	10,785	Trac
103.00	0	100.20	101.60	00	746	Trade   Detail	505.00	1.38	0	1.39	1.41	00	2,307	Trac
97.45	0	95.60	96.90	00	1,160	Trade   Detail	510.00	1.59	0	1.60	1.64	00	4,980	Trac
91.88	0	90.85	92.00	00	665	Trade   Detail	515.00	1.82	0	1.83	1.88	00	3,108	Trac
86.90	0	86.10	87.30	00	1,523	Trade   Detail	520.00	2.08	0	2.10	2.15	00	5,404	Trac
82.40	0	81.40	82.65	00	822	Trade   Detail	525.00	2.43	0	2.42	2.45	00	3,521	Trac
77.90	0	76.80	77.50	00	1,700	Trade   Detail	530.00	2.80	0	2.79	2.87	00	7,270	Trac
73.90	0	72.20	73.40	00	833	Trade   Detail	535.00	3.20	0	3.20	3.30	00	3,620	Trac
68.50	0	67.65	68.70	00	1,891	Trade   Detail	540.00	3.70	0	3.65	3.80	00	5,724	Trac
65.15	0	63.20	64.30	00	1,043	Trade   Detail	545.00	4.27	0	4.25	4.40	00	4,399	Trac
59.40	0	59.00	59.65	00	5,798	Trade   Detail	550.00	5.00	0	4.95	5.10	00	13,557	Trac
55.64	0	54.55	55.60	00	1,777	Trade   Detail	555.00	5.65	0	5.75	5.90	00	3,655	Trac
51.50	0	50.50	51.30	00	4,388	Trade   Detail	560.00	6.70	0	6.70	6.85	00	6,324	Trac
47.70	0	46.90	47.45	00	2,268	Trade   Detail	565.00	7.69	0	7.75	7.85	00	4,201	Trac
43.71	0	43.00	43.60	00	6,008	Trade   Detail	570.00	8.70	0	8.90	9.00	00	7,280	Trac
39.74	0	39.10	39.75	00	4,226	Trade   Detail	575.00	10.00	0	10.20	10.40	00	9,881	Trac
36.15	0	35.70	36.05	00	4,819	Trade   Detail	580.00	11.60	0	11.70	11.85	00	6,582	Trac
33.00	0	32.40	32.75	00	2,815	Trade   Detail	585.00	13.40	0	13.30	13.50	00	6,676	Trac
29.30	0	29.25	29.55	00	4,655	Trade   Detail	590.00	15.00	0	15.10	15.35	00	5,753	Trac
26.48	0	26.25	26.50	00	2,810	Trade   Detail	595.00	17.10	0	17.05	17.35	00	2,082	Trac
23.64	0	23.60	23.75	00	18,682	Trade   Detail	600.00	19.15	0	19.35	19.60	00	6,480	Trac
21.00	0	20.80	21.15	00	7,576	Trade   Detail	605.00	21.45	0	21.65	21.95	00	5,065	Trac

Assuming our Entry Criteria (the next section of the book) indicate the proper Bull Put Spread could involve the short 510 and long 500 strike prices, we see that with Apple stock (the underlying) at \$604.30, this Put option credit spread closed this day at a net premium of \$0.36 (\$1.60 - \$1.24). If we were able to enter this spread at the net \$0.36 premium, we would have a \$36 profit potential on our \$1,000 margin, or a 3.6% return on our margin investment in just one month, so long as the underlying Apple stock was at any price at or above \$510 on expiration day.

### 3. The Wondrous, Fantastical IRON CONDOR

We said that with the Bear Call Credit Spread, all we care about is that at expiration day Apple's price be below the Strike Price of the short leg of the Call spread (\$695), and that with

the Bull Put Spread, our only concern is that on expiration day Apple be above the short leg of the spread (\$510).

Obviously, we can do both spreads - and bank both net premiums - so long as Apple stock finishes between the two short legs, i.e., below \$695 and above \$510. What's more, at an "options-friendly" brokerage firm, we do *not* need to use additional margin for the second spread!!

The reason: Remember that sufficient margin is required to be in an account to cover the possibility, no matter how remote, of a spread moving the maximum possible amount against you (the \$10 difference between the strike prices  $\times 100 = \$1,000/\text{spread}$  in these examples). Well, it's clearly absolutely impossible for Apple to be *both* above \$695 *and* below \$510 at expiration, so only one margin should be required. (Nevertheless, option un-friendly brokerages often require margin on both spreads.)

This is the beauty of the Iron Condor. So long as Apple - currently trading at \$604.30 in this example - stays between \$695 and \$510 at expiration in less than a month, we bank the net premiums on both the Bear Call Spread and the Bull Put Spread, a total of  $\$45 + \$36 = \$81$ . That, boys and girls, is an 8.1% return in one month on the single \$1,000 margin. And, yes, this is in line with what we are seeking every month.

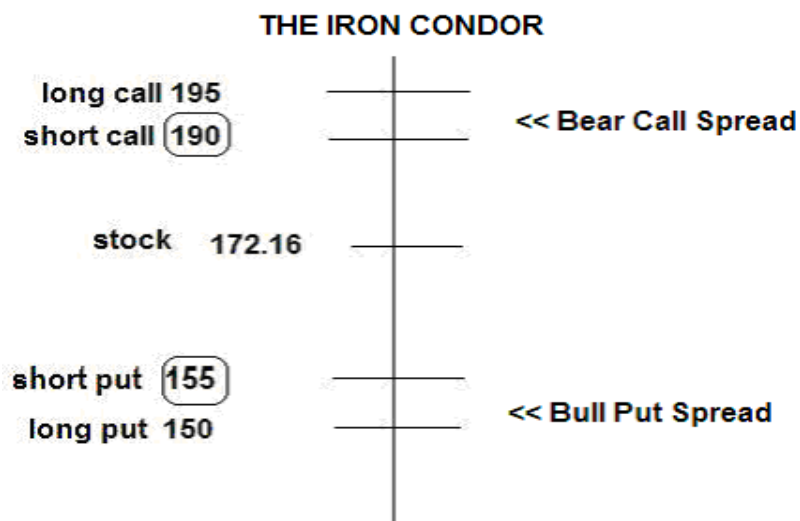
Note: It is very important that your options account be housed at a brokerage firm that is options-friendly with respect to Iron Condors, etc. (There is a "white paper" article that reviews brokerage firm considerations and recommendations at [www.SaferTrader.com/options-friendly-brokerage](http://www.SaferTrader.com/options-friendly-brokerage).)

Below is a graphic representation of the Iron Condor. This is just an illustration; as you will see when we get to "Entry Criteria," the Strike Prices shown in this example do NOT actually meet our entry rules.

## The Monthly Income Machine

Keep in mind that the Iron Condor is usually established by “legging into” the two spreads. Typically, the bull put spread and the bear call spread that comprise an Iron Condor will not *both* meet all the entry criteria at the same time and allow establishing the Iron Condor with a single order (a 1-step Iron Condor).

Usually, both of the necessary spreads do not offer at least the minimum required net premium at the same moment in time. Instead, you might put on the bear call spread one day, and then later – after the market goes down a bit – the bull put spread premium at the correct distance from the underlying might now conform to the minimum premium as well as the rest of the entry requirements. When it does, if you place a bull put spread order at that time that is filled, you then have the Iron Condor in place (a 2-step Iron Condor).



When establishing an Iron Condor, whether in 1 or 2 steps, both spreads must independently meet all the entry requirements.

Important: Note, above, that the short leg of a credit spread (whether a Bear Call Spread or a Bull Put Spread) is always the closest Strike Price to the price of the underlying stock, ETF, or index.

## ***Two Critical Steps on the Road to Recurring Profits:***

It comes down to this:

1. Rigorous adherence to the Entry Criteria "The Monthly Income Machine" uses in selecting Bear Call Credit Spreads, Bull Put Credit Spreads, and whenever possible the Iron Condors wherein both a Call and Put spread are established in the same underlying for the same option month.
2. Managing the positions, if needed, prior to expiration.

# *Chapter 7*

## ENTRY CRITERIA FOR MONTHLY INCOME MACHINE POSITIONS

### ***THE ENTRY CRITERIA - Selecting the Credit Spreads***

These are the nuts and bolts of the "Machine." As with any machine, each part is needed for smooth operation.

#### 1. Stocks, ETFs or Indices?

Any of the three classes of underlyings can conform and each has its entry criteria. Since an individual stock is normally more volatile than an index or ETF based on a basket of stocks, we like our stock-based credit spreads to be a little further away from the underlying stock than an index or ETF spread is from their underlyings.

In other words, index and ETF basket credit spreads generally are typically less subject to dramatically large percentage moves or overnight "gaps" (which could work against us) than are individual stocks, i.e. they are usually less volatile.

This is because individual stocks can spike powerfully up or down on such things as a surprise in an earnings report, a rumor or announcement of a take-over offer, a development involving a competitor, or one involving the market as a whole.

While market indices like the S&P (SPX), the Nasdaq (NDX), and the Russell 2000 (RUT) can move sharply on news developments that impact the entire market, such moves are usually smaller, percentage-wise, than those that occur when a major stock-specific development takes place.

An individual stock can rocket up 30% or more in one day on a surprisingly good earnings report or takeover bid. Similarly, a substantial earnings “miss” can cause a stock to plummet.

Indices, which are comprised of multiple stocks, could theoretically experience such gigantic percentage moves in one day, but that would be very rare. (The largest percentage move I am aware of for a major index occurred on October 19, 1987 – Black Monday – when the Dow fell 22.61%.)

Another significant index matter: there is a tax benefit (in a non-retirement account) to income earned that results from index trades as opposed to individual stock trades. Under Section 1256, the IRS gives favorable tax treatment to contracts that are “non-equity options,” a category that includes index options.

The IRS recognizes broad based stock index options to be non-equity options and thus profits and losses on them can be treated as 60% long-term and 40% short term, even if they are held for less than a year.

The significance of this rule is that long-term capital gains or losses enjoy *lower marginal tax rates*. You should discuss this with your accountant to confirm that this is favorable in your situation.

### 2. Option Month of Credit Spread

The "Machine" is based upon employing either the **current** option month or the **next** expiration month option chain. These months will have a substantial amount of time value built into the premium of out-of-the-money options we use, and time decay of the premium works powerfully in our favor.

Credit spreads could be done using weekly-expiration options, but “The Monthly Income Machine” technique does not employ these very short-term options with less than 6 trading days remaining until expiration. Weekly options can be used if entered with more than 6

trading days remaining before expiration, but the disadvantage of using them rather than the monthly option expiring at about the same time is that the weeklies are generally less actively traded and thus may be carrying a wider bid-ask spread.

This is because by the time an option has only a week's life left before expiration, much of the "time value" associated with the premium is long gone. Capturing the extrinsic value (time value) built into out-of-the-money option premium is critical to the way – and why - the "Machine" works. Note that although some very active options appear on the option chain as "available" several weeks before weekly option expiration day, these usually have relatively little activity at that time and thus can be very difficult to trade with rational premiums and/or decent order fills.

Please note that our objection to weekly options – when there is a week or less remaining until expiration - refers to their use with credit spreads. There are situations where a weekly option may make sense. Such a situation could be when an event is known to be coming – an example would be an earnings report – within the time frame covered by a particular weekly option. If the investor wanted to speculate with an outright option purchase (not a credit spread) on the outcome of the event whose timing is known, a weekly option might make sense. This is because if *buying* an out of the money option outright, it's an advantage to have little time value built in that must be paid for.

### 3. Stock Disqualifiers

We eliminate stocks from Credit Spread consideration immediately on the basis of:

- *Price of the Stock*

"The Monthly Income Machine" entry rule for individual stock, ETF, or Index credit spreads is: ***the underlying must be trading at \$50 or more***. This is because options on lower priced stocks generally will not provide sufficient Premium at the Strike Price distance from the market that we require.



We particularly like stocks trading at \$100 or more, because the Strike Prices we will want to use will often provide spread Premiums well above our *minimum* entry criteria amount (\$0.25).

- *Lack of Trading Volume/Open Interest*

A stock that is only thinly traded will generally display both poor Option Volume and minimal Open Interest. This is manifest in wide bid-ask spreads that can be terrible for either entering or exiting a position at a fair price. **Low volume and open interest** mean the option is not very liquid, which could be a problem both when entering a position or exiting from it via a stop loss order.

We generally want to see the short option Strike Price we are considering to have an open interest of 250+ contracts, when there are between 25 and 10 *trading* days (non-holiday weekdays) until expiry. This should be viewed as an *optional* consideration, not an entry “rule.” It’s not a rule because Open Interest is not a stable indicator; it varies widely depending on how much time remains to expiration and how far the Strike Price is from the underlying.

Average Daily Volume of the Underlying, however, is much more stable as an indicator of overall liquidity. Our entry rule (and this one is a rule) is that average daily volume of the underlying must be 1,000,000/day or more for stocks, ETFs and Indices.

- *Lack of Volatility*

A stock with a history of relatively **little volatility** (i.e., stock trades in a narrow range for extended periods of time and is often referred to as a “low beta” security) will offer **unsatisfactory premiums** at the distance from the underlying Strike Prices we will want to use. Accordingly, no separate entry

criterion (other than the confirmation afforded by the Delta entry requirement) is needed re: volatility. The Delta requirement inherently includes the impact of Implied Volatility (IV).

- *Earnings Report Prior to Expiration*

***A stock underlying is immediately disqualified from consideration for Credit Spreads if there will be an earnings report prior to expiration day.***

Your options-friendly brokerage firm will show the date of the next earnings report when you pull up a quote on the stock. Violent moves following surprises in earnings reports occur frequently. We have no interest in violent moves.

Although not an earnings report, I would recommend (not a “rule”) that one avoid retail stocks if Black Friday or CyberMonday occur prior to expiration. This is because credit card and market research agencies often release preliminary sales data for retailers before the day is even over!

Markets can react to these data as they would to pleasant or unpleasant surprises in an earnings report.

- *Actual or Rumored Takeover Offer Has Occurred*

Stocks will rarely offer sufficient Premiums at the Strike Prices we want to use if there is already a ***take-over offer on the table to acquire the stock***. There are also additional risks of sudden strong moves based on offer turndowns, revisions, withdrawals, etc. If there is a take-over issue involving the stock, it is disqualified.

When you look at a quote on a stock, there is usually a place to “click” to see recent news developments on the stock.

### 4. Trade-off between Premium and “Distance”

When you analyze and select credit spreads, there is always a trade-off between the premium you collect, and the distance your spread Strike Prices are from the underlying stock, ETF, or index.

The further away a Strike Price is from the “market” (the current price of the underlying), the less the premium will be, all other things being equal.

This is because buyers correctly assume the underlying is less likely to reach that more distant Strike Price before expiration, and therefore are willing to pay less premium than for a Strike Price closer to the market.

“The Monthly Income Machine” is adamantly in favor of establishing the greatest possible distance from the price of the underlying, consistent with our minimum premium goal, rather than trying to capture the greatest possible premium.

The old Wall Street adage applies: “bulls make money, bears make money, pigs get slaughtered.”

### 5. How Far To Be From the Market (the Distance criterion)

#### A. Individual Stock credit spreads:

The "Machine" rule is that the Strike Price of the short leg of the spread (the one closest to the current price of the underlying) should be at least *15% above the current price of the underlying stock if it's a Bear Call Spread, and at least the same 15% below the current price of the underlying if it's a Bull Put Spread.* (Exception: See “C” below)

### B. Index and ETF credit spreads:

Here the rule is the *Strike Price must be at least 12% above the current price of the ETF or index for Bear Call Spreads, and 12% below for Bull Put Spreads. (Exception: See “C” below)*

There is no guarantee that the underlying will not reach the short (closest) Strike Price prior to expiration day, but I have found that the options will cooperate and expire worthless approximately 85% of the time using this rule along with the other "Monthly Income Machine" entry criteria and considerations.

### C. Distance Rule When Close to Expiration (10 *trading* days or less):

Bearing in mind that a conforming "Machine" trade must meet ALL the entry criteria rules, a moderate relaxation of the distance rule may be considered when we are approaching expiration.

The entry distance requirement with less than 10 trading days remaining to expiration is reduced to 11-12% for stock spreads, and 9-10% for index. (No less please; remember that I will be looking over your shoulder!)

## 6. Validating the Distance - Delta

As a further confirmation that our spread Strike Prices are sufficiently far from the current underlying, given the current volatility, time decay situation, and underlying price, we check the current “Delta” for the *short* leg of the spread. (Your options-friendly brokerage firm website should provide a table of current Delta values for all option strike prices.)

You will recall from the discussion of the “Greeks” in Chapter 4 that Delta is an estimate of how much the price of an option will change as a result of a \$1 change in the price of the underlying stock, ETF, or index.

***Delta can also be used as an estimate of the mathematical probability that an option will expire “in the money”*** (above the strike price of a Call option or below the strike price of a Put option).

I recommend that the Delta value for the short Strike Price of a spread be *.08 or lower*, which means there is only an 8% probability that the underlying will be “in the money” at expiration.

This is an entry “rule.”

Personally, I like it even better when the Delta is .06 or lower. Obviously, the lower the better.

### 7. Validating the Distance – Support and Resistance

Our entry rule for Distance from the underlying, and the use of Delta, help provide a position where the mathematical indications suggest our spread should behave nicely and expire worthless in about a month. Still, things can - and will - occasionally go wrong.

When that happens, we will take steps – called “managing the trade” – to minimize or even overcome the impending loss on the trade. This subject, the MRA (Maximum Risk Amount) is discussed in detail in the next chapter.

However, we can both increase the likelihood of a successful trade at the outset, and lay the groundwork for later managing the trade if it becomes necessary, by looking at chart support and resistance levels *before* placing our order.

As the names imply, “support” refers to a price level where previous declines have stopped and then reversed, and “resistance” refers to a price level where previous rallies have stalled and then reversed.

Ideally, we want to place the Strike Prices of our conforming Bear Call Spreads *above recent resistance levels*, and our conforming Bull Put Spreads *below recent support levels*.

If the underlying penetrates the support or resistance level associated with our credit spread, that may provide us with a signal that the underlying has now established a trend going the wrong way, and represent a rationale for exiting from the trade even before our maximum risk amount (MRA) is reached.

These levels are easily seen on a daily price chart. Charts of underlying stocks, ETFs, and indices are available over time frames ranging from minutes to 10-year and longer periods. I generally use the 3-month and 6-month charts, where each bar represents one day, for identifying support/resistance levels when evaluating potential credit spreads.

Consider the price chart on the following page for the RUT 2000 index back in 2009. If we had been considering a Bear Call Spread on the RUT in mid-June of that year, we saw that each time the RUT rose to about 535, it would bounce off that price level and fall back. So we would have liked to have our Bear Call spread Strike Prices as far above the 535 resistance point as possible.

Establishing our conforming bear call spread at Strike Prices above the then 535 resistance level would give us an early indication that the market had "changed" in a way unfavorable to our Bear Call position if the RUT price broke significantly through that previously well-established resistance point. That might induce us to take some corrective action rather than hoping the breakout was a "false" one and simply waiting for expiration. In point of fact, the breakout above resistance was very real and the RUT continued trending higher.

Similarly, if we had been looking at the following RUT Support and Resistance chart in terms of considering a Bull Put Spread later in August, we see clear support at 550. If we were considering a Bull Put spread at that time, we would have liked to have entered our conforming Put Strike Prices as far below 550 as possible. That way, a significant downside penetration of that 550 support would alert us to a potential problem with our Bull Put spread, since a clearly bearish chart development would have occurred.

Consequently, if we were considering several different credit spreads based on underlying stocks or indices, and several potential credit spreads met all of our Price, Distance, Premium and other Entry Criteria, all other things being equal we would probably favor a credit spread whose Strike Prices could conveniently be located above a major resistance level or below a major support level.

REMINDER: It is always the *short* Strike Price – the part of the spread closest to the underlying stock, ETF, or index price – that we care about. The long Strike Price is just along for the ride to provide protection and a lower margin requirement as explained on page 36.



### 8. Minimum Acceptable Spread Premium

Certainly we want as much premium as we can get. Realistically, though, at the distance from the market we demand for the short member of the spread as discussed above, I require at least \$0.25, and hopefully closer to a \$0.50 Premium. If I cannot get at least \$0.25 premium (\$0.25 x 100 underlying shares = \$25.00/spread), I don't enter the order. Note that *every*

spread must meet at least the minimum premium requirement. Therefore, a conforming Iron Condor has two credit spreads, each of which must offer at least a \$0.25 net premium (and each must also meet the distance-from-the-underlying criterion) when established.

Fundamentally, premium - the price for buying or selling an option or an option spread - is nothing more than buyers and sellers agreeing on how much that right to buy or sell is worth. Whether we are buyers or sellers we are, of course, operating with imperfect knowledge as to the future outcome of the transaction.

However we do know what factors are most important in determining whether our potential credit spread will expire worthless (as we wish it to) and thus deliver the spread's net premium to us as banked income.

The key factors affecting the final outcome, and what premium buyers and sellers arrive at, are: (1) how far the price of the underlying is from our (short) Strike Price, (2) how much and in what direction investors believe the news/rumor "headlines" acting on the general market and on our stock or index will drive prices, (3) how volatile will the price action be along the way, and (4) how much *time* remains before expiration.

We can't control the "headlines," but we can - and do - evaluate the strike price's **volatility** (delta), **distance** from the underlying, the **net premium** available, and the **time** remaining until expiration when we decide on a credit spread position.

### A. "Multiple Choice" Distance vs. Premium

If the RUT 610/620 bear call spread we were discussing is 12% above the underlying RUT index, and has a net premium of \$0.48, that would meet our distance and our minimum premium requirements. The next higher Strike Price pair, the 620/630, might have a \$0.35 premium and would therefore also qualify with respect to distance and minimum premium.



## The Monthly Income Machine

It would be up to the individual "Machinist" to decide between the two conforming spreads. For the record, I would opt for the 620/630 to give my spread Strike Prices even more distance from the underlying RUT index and thus greater "safety." A somewhat less conservative investor might prefer taking a little more distance risk in order to snag a bigger premium and he could go with the 610/620 since it also conforms to the Distance entry rule.

### B. Wideness of Your Credit Spread (How Wide Apart Should the "Legs" Be?)

First: the answer. Then we'll discuss the reason for it.

"The Monthly Income Machine" rule for the interval between credit spread strike prices is this:

- (A) If the option chain for the underlying offers strike prices that are \$1, \$2.50, or \$5 apart, we can use a spread where the strike price of the long leg of the spread is up to \$15 from the strike price of the short leg.
  
- (B) If the option chain for the underlying offers strike prices that are \$10 or more apart, we can use a spread where the strike price of the long leg of the spread is up to \$30 from the strike price of the short leg.

Now we will consider the rationale for the entry requirement concerning the interval between the long legs of the spread. The minimum acceptable Strike Price of the short leg is "fixed" by the distance-from-the-underlying entry requirement, but we may have choices to make with respect to establishing the Strike Price of the *long* leg.

Those choices (assuming they conform to minimum net premium and all other "entry requirements") are among adjacent strike price legs, or legs wider apart up

to the maximum described in (A) and (B), above.

The further away the long leg is from the short leg of the spread, the greater will be the premium available.

But the trade-off is that the further away the long leg is from the short leg of the spread, the less rapidly the long leg will gain to help offset loss in the short leg when the underlying is moving in an unfavorable direction.

Since we want the *net* spread premium to decline to zero (both legs of the spread expire worthless), any increase in net spread premium once our order has been filled is counter to our wishes. And the wider apart the legs of the spread are, the more significant is the widening of the spread premium during an adverse underlying move.

Remember, too, that as the legs are further and further apart, the margin requirement gets larger and larger which materially affects our rate of return on margin employed.

Here's an illustration of our "interval between legs of a credit spread" rule:

XYZ stock at 60

[From the current month XYZ Option Chain Table]

<u>Call Strike Price</u>	<u>Premium</u>
65	0.95
70	0.50
75	0.15
80	0.06
85	0.01
90	0.01

The preceding table provides easily arrived at conclusions -

- a. The short 65 does not meet the 15% distance from underlying rule for the short leg, so it's off the table.
- b. The 70 Strike Price does meet the 15% distance rule, so it's the first possible short leg of a conforming credit spread.
- c. Thus, the 70/75 spread also conforms to the minimum premium rule (\$0.35 net premium for the 70/75 is above the entry criterion \$0.25 net premium requirement).
- d. The 75 Strike Price as a possible short leg more than meets the minimum 15% distance requirement, but the 75/80 spread does not meet the \$0.25 minimum premium requirement, so it's a non-starter. The 75/85 and the 75/90 likewise fail the minimum premium test, so a short leg of 75 won't work.
- e. Our short leg of the credit spread must therefore be the 70 Strike Price.

Now you will note that while the short 70/75 spread delivers \$0.35 net premium (\$0.50 received for the short leg less \$0.15 paid for the long leg) and meets both rules (distance => than 15%; premium at least \$0.25), the 70/80 *also* meets the entry criteria... and delivers a bigger net premium to boot.

## The Monthly Income Machine

The reason for the bigger net premium, of course, is that with the wider 70/80 spread we would pay less - only \$0.06 - for our protective long 80 Strike Price option.

The 70/85 provides an even greater net premium because the long leg would only cost us \$0.01, and it too meets the distance between legs criterion (up to \$15 between strike price legs when available strike prices are \$5 apart).

Bottom line, we can decide on the long leg of the spread based on how we view the trade-off between premium and safety... how conservative we are in weighing reward against risk.

For me, the 70/85 would not be acceptable (even though it met the entry rules) because the extra risk and extra margin for the small premium increase compared to the 70/80 would not interest me.

Finally, let's look at a different example where the option chain for ABC stock only has available strike prices that are \$10 apart.

ABC stock is trading at \$60

Option Chain:

<u>Call Strike Price</u>	<u>Premium</u>
70	0.62
80	0.35
90	0.15
100	0.01

The 70/80 has strike price legs \$10 apart and a net premium of \$0.27, thereby meeting the distance and net premium and criteria.

The 70/90 and the 70/100 also meet the minimum \$0.25 premium and the \$30 maximum interval between strike price legs of the spread.

The problem with the 70/100 is that the long leg is so far from the underlying that the market is only assigning a value of a penny to it. That long 100 leg will provide practically no net premium protection, or reasonable margin, for the spread because it will not rise in value nearly as fast as the 70 short leg, hence the spread net premium will widen very considerably and very fast in the event of an adverse move. Consequently, I would not consider the 70/100 favorably.

Given the above hypothetical data, only the 70/80 and 70/90 are in the running for conforming "Machine" entry. The choice between those two is a function of your degree of conservativeness. Comparing the two, we know that the 70/80 gives somewhat less premium income, somewhat more safety during an adverse move in the underlying, and a more favorable (lower) margin requirement. The 70/90 conforms as well, but offers considerably more net premium, somewhat higher risk and margin requirement. But either would be rational, conforming choices.

### ***Summary of Entry Criteria, Step-By-Step***

I've listed the entry criteria ("The Monthly Income Machine" trade entry rules) in the order in which I check them each month when investigating potential credit spread trades. You can check the criteria in whatever order you find efficient, but please make sure every criterion is met before you conclude that the trade you are contemplating is a conforming one.

1. Earnings Report: There must be no earnings report due prior to expiration (not applicable to "basket" EFTs and indices).

## The Monthly Income Machine

2. Merger: There must be no take-over activity rumored or "on the table" involving the underlying stock.
3. Time Remaining to Expiration: Option can be a "current month" option or one expiring the following month.

The "sweet spot" for entering a trade for the current option month is when there are 10 to 6 trading days until expiration; this often offers an attractive balance between amount of premium and "wait time" to expiration.

In periods of unusually low overall market volatility, it can be more difficult to identify potential current month trade candidates that offer the minimum necessary premium at the "Machine" entry requirement distance-from-the-underlying. It is perfectly acceptable - i.e. within the rules - to go out to the next expiration month to find sufficient premium at the right distance from the market.

The downside to this is that your monthly *rate* of return potential may be lower because it will take longer to realize your profit on longer-duration trades. It is also obviously true that if you are in a trade longer, there is more time for something untoward to occur.

The upside of establishing the spread with more time to go is that because there is more "time," there will be more premium... perhaps enough to offset the effect on monthly rate of return of the longer trade duration.

4. Current Price: The underlying stock, ETF or index must trade at \$50 or more.

Among the \$50+ candidates, the most promising - those that represent the "usual suspects" - are the stocks with significant volatility and investor interest. Without moderate-high underlying price and decent volatility, we would not have useful premiums.

Note: To obtain a copy of my own current list of "usual suspects" for stock credit spreads, contact Customer Service at [info@SaferTrader.com](mailto:info@SaferTrader.com).

5. Liquidity:

Rule: "Average Daily Volume" of the underlying must be at least 1,000,000/day.

Optional: Like to see "Open Interest" for the options to be above 250, but that is often not feasible when the option is far from the underlying and/or the option month has just recently begun.

No matter what number of Open Interest contracts exist at the time, I would not be comfortable if my order would result in my Strike Price options representing more than 10% of that Strike Price's total Open Interest.

6. Distance From Underlying:

*(a) For STOCK underlying credit spreads:*

The Strike Price of the short member of the **Bear Call** credit spread (the leg closest to the underlying stock price) must be at least 15% *above* the current price of the underlying stock.

Similarly, the Strike Price of the short member of the **Bull Put** credit spread (again, the leg closest to the underlying stock price) must be at least 15% *below* the current price of the underlying stock.

Note: When there are 10 or fewer trading days remaining until expiration (includes the "sweet spot"), you can reduce distance from underlying stock requirement from 15% down to 11-12%.

*(b) For ETF and INDEX underlying credit spreads:*

The Strike Price of the short member of the Bear Call credit spread (the leg closest to the underlying index price) must be at least 12% *above* the current price of the underlying ETF or index.

Similarly, the Strike Price of the short member of the Bull Put credit spread (the leg closest to the underlying index price) must be at least 12% *below* the current price of the underlying.

Note: When there are 10 or fewer trading days remaining until expiration, you can reduce distance from underlying ETF/index requirement from 12% down to 9-10%.

Important: Remember that once you establish what the Strike Price of the *short* member of the credit spread must be to meet the "distance" and premium criteria, you can then select the *long* member of the credit spread, up to the maximum entry criteria rule for strike price spread interval, based on the trade-off between net spread premium vs. safety during an adverse move.

7. Maximum Spread Width (interval between strike prices of long and short leg of spread):

Our maximum Strike Price spread interval rule is:

for option chains with strike prices \$1, \$2.50, or \$5 apart, difference between long and short leg of spread can be up to \$15.

for option chains with strike prices \$10 or more apart, difference between long and short leg of spread can be up to \$30, although more conservative investors may wish to limit the distance between long and short leg to a more narrow interval.



## The Monthly Income Machine

8. Net Premium: The net premium received on the spread meeting the preceding requirements should be at least \$0.25 (of course, more is better!).
9. Delta: The Delta value for the short member of the credit spread must be .08 or lower (meaning an estimated 92% probability that the underlying will not reach that Strike Price by expiration day).
10. Chart: Although not an absolute “entry requirement,” I *always* look at the 3-month and 6 month charts of any underlying I am considering for a credit spread.

I greatly favor a situation that allows me to establish the *short* Strike Price of my bear call spread *above a resistance level*, and *below a support level* if it is a bull put spread.

I can then use the breaching of that support or resistance as a signal to either exit from the position or to employ an adjustment technique (explained in the next section) because such breakouts suggest my spread's short Strike Price is, or may soon be, threatened.

I also look at a stock's chart to see at a glance if it is currently in a strong trend, or is more or less “range-bound.” I prefer not to establish a bull put spread in a sharply falling market, or a bear call spread in an explosively rising one, unless I have very strong indicators that the market in question is very much oversold or overbought.

Note: There are several widely used overbought/oversold indicators; the one I use frequently (with an additional filter) is discussed in detail in the SaferTrader “white paper” located at: <http://SaferTrader.com/overbought-oversold-markets-how-to-recognize-and-profit-from-them/>.

11. The “Conforming Credit Spreads Service” Subscription (optional):

Everything needed to successfully use “The Monthly Income Machine” program is explained step-by-step in this book, supplemented by the ongoing series of “white paper” article alerts, access to the members-only Forum, and one-on-one coaching by

the author if you ever have any questions.

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However, for investors who wish to have a provisional list of fully-conforming “Machine” trade candidates *routinely delivered to them* for further consideration, SaferTrader offers a separate, optional, subscription service at about the proverbial “cost of a cup of coffee a day.” Again, the investor can arrive at exactly the same list of “conformings” doing his own screening as outlined in the book, but the Service does offer a substantial saving of time in identifying and choosing trade candidates for further evaluation.

The Screener was developed for our community by our Technical Director Dr. H. Shane Chang. He is a research scientist whose Ph.D. in computer engineering and analytical interests previously led him to major research project positions with both Harvard Medical School and MIT.

The “Conforming Credit Spreads Service” is available only to current, registered owners of “The Monthly Income Machine.” Because the conforming trade candidates provided by the service after Friday’s close must be confirmed by the user before placing orders (once trading begins again on Monday, prices, etc. can change), it is essential that subscribers fully understand and be able to implement the “Machine” entry criteria and trade management details as spelled out in the book.

Note: If you wish to review more information about the Service, or obtain a sample copy of a current report, contact Customer Service ([info@SaferTrader.com](mailto:info@SaferTrader.com)) or go to <http://SaferTrader.com/screening-service-sales-page>.

# *Chapter 8*

## MANAGING AND ADJUSTING POSITIONS IF TRADE IS THREATENED

### ***MANAGING AND ADJUSTING POSITIONS***

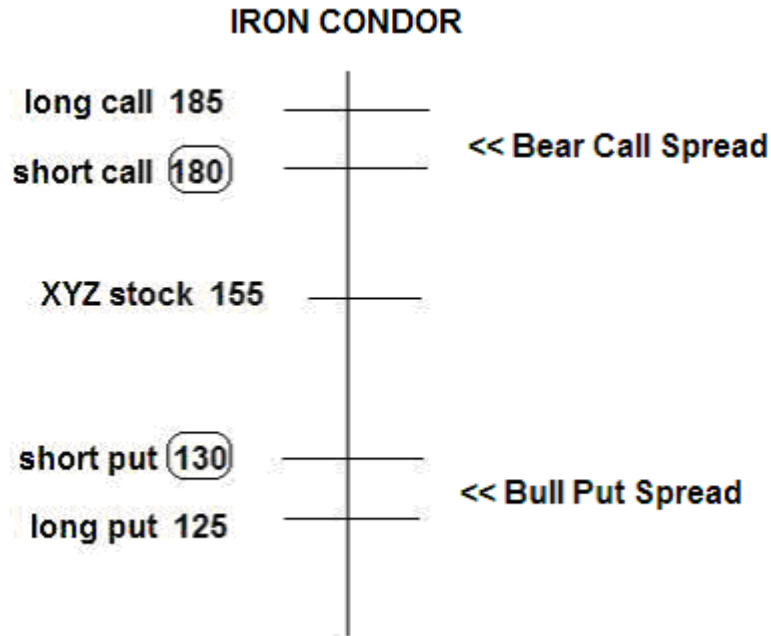
Clearly, the purpose of "The Monthly Income Machine" is to seek a reasonable Premium, over a very short time period (usually one or two months), and to do so with a high degree of reliability.

Following the exact entry rules of "The Monthly Income Machine," it is reasonable to assume that approximately 80% of the time you will capture this premium income on each credit spread or Iron Condor.

Typically, the underlying stock, ETF or index will bounce around, the inexorable power of time decay will work its magic for us, and the underlying will not reach our credit spread's short Strike Price prior to expiration day. Accordingly, our credit spread or Iron Condor will expire worthless and, as we hoped, we will bank our entire premium income for the trade.

But, approximately 2 times out of 10 the underlying will not cooperate and we MUST make adjustments in our positions. We must do our best to NEVER allow a losing trade to be large and thereby undo all the good work of our successful trades.

Let's refer back to an earlier graphic of an Iron Condor position, this time on XYZ stock trading at 155.



Assume that these two related credit spreads (an Iron Condor) each met all the “Entry Criteria”, having received a \$0.45 premium on the September 180/185 bear call spread and a \$0.40 premium on the September 130/125 bull put spread. If XYZ stock remains between 130 and 180 at expiration on the third Friday of September, we bank the total \$0.85 premium. That means we would earn \$85 ( $\$0.85 \times 100$  potential shares an option represents) on our \$500 margin, for a 17% rate of return on margin employed in one month.

Everything starts out fine. Then a problem arises when XYZ announces a new whiz-bang product and the stock starts moving strongly upward and threatens our Bear Call Spread even though it started out a full 15% above the then-current price of XYZ.

We may need to adjust our position or simply exit from the Bear Call Spread with a relatively small loss if the stock continues to move even higher. (Note that the other half of our Iron Condor, the Bull Put Spread, would actually be in great shape if this very strong rally occurred.) But in no case would we want to suffer a large loss on *either* component of our Iron Condor.

## The Monthly Income Machine

Our best-case scenario results if the stock ultimately finishes below 180, the short Strike Price of our Bear Call Spread, and we do bank the \$0.45 premium we collected for it at the outset. Our worst-case scenario would occur if we – insanely – stood by and allowed the stock to climb all the way to above the higher, long Call Strike Price (185) at expiration.

Then the maximum possible loss would occur. Since the Strike Prices are \$5 apart, that loss is \$5, minus the \$0.45 premium we received = \$4.55. Obviously, we would not ever want to risk \$4.55 to make \$0.45, so we need to do our best to make sure that outcome, or anything close to that, does not occur.

Fortunately, we have a number of techniques for dealing with a credit spread if we are threatened by a powerful move against us by the underlying stock, ETF or index.

The first, and most important, consideration is: “what is the maximum amount we allow a position to move against us before we make an adjustment?” In other words, what is our Maximum Risk Amount (MRA)?

That we *do* set a MRA on every trade is a “rule.” *What* the MRA should be, however, is up to each investor to decide based on his objectives and risk tolerance.

A *suggested* MRA follows next.

### Maximum Risk Amount (MRA)

While this could vary depending on the investor’s risk tolerance, my risk tolerance is low, and my MRA on a credit spread is:

A **loss** of 1.5 to 2 times the premium I initially collected on the trade is the maximum amount I am willing to risk on any spread position.

## The Monthly Income Machine

For our example, let's use the value of MRA = 2 times premium received.

In the XYZ example, I received a premium of \$0.45 on the threatened Bear Call Spread of my Iron Condor. 2.0 times my original premium is \$0.90. Therefore, if the rise in XYZ stock pushes the Bear Call Spread to a premium of \$1.35, I exit the threatened spread with a \$0.90 loss (paid \$1.35 to exit from the spread, minus \$0.45 I collected on the spread as up-front premium = \$0.90 loss... which I'd defined as my MRA).

So, in this example, I would place a "stop order" to exit from my credit spread if the premium widened to \$1.35. Note: a stop order is always placed on the net premium of the spread, not on the individual long and short legs of the spread.

When setting the protective stop based on your MRA, please keep in mind that there is a difference between the maximum loss risk that is acceptable to you (your MRA), and the price at which the stop is placed. In the above example, the investor is willing to risk a loss of \$0.90 (his 2.0 times premium received MRA), but the stop is placed at a net premium of \$1.35 in order that the loss calculation also account for the premium received when the trade was established.

A handy shortcut for determining where to place the stop on a spread if using a 2 X initial premium MRA, is to set the **stop** at 3 X initial premium.

Returning to our example, I leave my Bull Put Spread alone, since this net spread premium will have moved even further down in my favor toward zero as the stock rose. The \$0.90 loss on the Bear Call Spread I exited is not ruinous.

I still have my increasingly likely potential \$0.40 profit on the Put spread I'm keeping, and I could make back the net loss on the entire Iron Condor (\$.90 bear call spread loss and \$.40 bull put spread profit = \$0.50 Condor loss) on my next trade or two.

## The Monthly Income Machine

The purpose of having a MRA on every credit spread, and sticking to it, is to assure that when a loser comes along – and it will – our account and long-term profit are not jeopardized by a large loss.

Using 1.5 or 2.0 times original premium received as the MRA strikes a reasonable balance between risking too much on a trade, and not allowing the spread enough “breathing room” to work as the underlying stock, ETF, or index moves around.

These numbers were not pulled out of a hat; there is a mathematical basis to them.

Consider this: if we experience 8 out of 10 trades as winners (this is our actual estimated outcome), and we gain only the minimum entry criterion premium profit (\$0.25) on each, we gain \$2.00 on those 8 trades. If on the 2 out of 10 losing trades in our hypothetical, we lose 2.0 X premium received, we will lose \$0.50 on each loser, or a total of \$1.00.

That works out to an account profit over the 10 trades of \$1.00 (\$2.00 total profit from 8 winners - \$1.00 total loss from 2 losers). In other words, the account value grows.

Before leaving the “adjustment” involving simply exiting from the position and accepting the pre-determined MRA loss on the trade, we’ll take a moment to define how we “exit,” i.e., close out, the transaction.

It’s simply doing the opposite of what we did when we entered the trade originally, and thereby offsetting the position.

Since we entered the Bear Call Spread with the order:

- Sell to open 1 XYZ September 180 Call

- Buy to open 1 XYZ September 185 Call

- ... day order

- ...at a net credit of \$0.45

To offset this trade (exit from it), we could enter a “stop” to buy back the 180 Call and sell the 185 Call with this order:

Buy to close 1 XYZ September 180 Call

Sell to close 1 XYZ September 185 Call

STOP

... at a net debit of \$1.35

... day order

If the stop price of \$1.35 were reached, our order would be filled “at the market,” and we would then have no XYZ Calls left. We have taken our \$0.90 loss (our MRA) on the Bear Call Spread leg of our Iron Condor. Note: Conventional stop orders, when the trigger price is reached or exceeded, are filled “at the market” – meaning the best price the brokerage firm can get for you at that moment. The “fill” might be somewhat above or below the actual trigger price, but the investor will be “out” if his stop point is reached.

However, we also have other choices.

### 1. Early Profit Exit Prior to MRA

An investor might choose to exit from a then-profitable spread prior to expiration because he wishes to free up margin for another spread opportunity.

He might also simply decide that he has a nice potential profit right now, and rather than risk a later adverse move that could turn the trade into a loss, he might prefer to exit from the spread early at some immediate profit, rather than risk waiting for expiration and the maximum profit that would be achieved if the spread expires worthless on expiration day.

### 2. The Roll

The roll represents a powerful trade adjustment technique that, when the situation warrants, can substantially reduce the over-all loss on a single credit spread or Iron Condor, and in fact



may turn a potentially losing trade into a profitable one.

A roll up or a roll down is simply first *exiting* from a threatened credit spread and *then establishing another one* at higher Strike Prices (if a Bear Call Spread) or at lower Strike Prices (if a Bull Put Spread), so long as the new spread meets the usual entry criteria.

If the required net premium is available at our required distance, the roll up might be done in the same option month as the threatened spread. At the lower end of acceptable minimum time remaining, however, it may be quite difficult to obtain sufficient premium at the necessary Strike Price distance. However, the roll can usually be established at the desired Strike Prices at a greater net premium using the *next* expiration month.

In this example, the sharp rise in XYZ stock increased the net premium on our 180/185 Bear Call Spread to the stop loss trigger price of \$1.35, causing us to exit the trade. But it also increased the premium on those Strike Prices ABOVE our previous 180/185 Strikes.

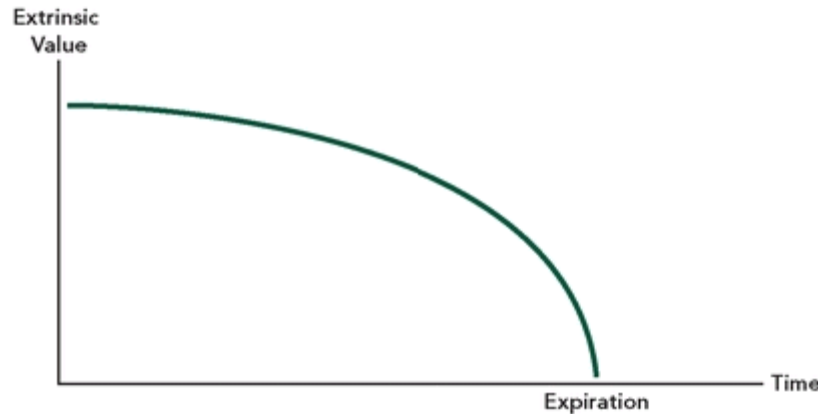
Therefore, after we exit the XYZ Bear Call Credit Spread because our MRA has been reached, we could employ “The Roll Up.”

As noted, when there are 10 or fewer trading days left before expiration, we may be able to use the option chain for the current month with the “sweet spot” lesser distance requirement. Using this reduced distance-from-the-underlying entry requirement as discussed earlier, and the usual minimum premium criterion, we can look to roll up into another Bear Call Credit Spread with higher Strike Prices. We might employ, for example, the 190-195 credit spread which is trading at a \$0.50 net premium after the move higher in the underlying.

Alternatively, we might want to (or have to) go out to the next option month and take advantage of the even larger premium that having more time-remaining affords us. If successful this time, we will be able to reduce or even completely offset the loss on the original trade.

## The Monthly Income Machine

As discussed earlier, we are always dealing with out-of-the-money options, so all of the premium in the option is "extrinsic," i.e. the option's entire value is based on the amount of time remaining till expiration. That extrinsic time value declines at an ever increasing *rate* as we approach expiration. The decay rate, as seen in the illustration below, occurs especially rapidly during the last two weeks prior to expiration.



Therefore, again as noted earlier, for credit spreads based on an underlying stock with 10 days or less left until expiration, I can reduce my short Strike Price distance requirement to 11-12% from the underlying, rather than the usual 15%. Similarly, I can reduce my ETF or index option distance requirement to 9-10%.

When I am rolling into a new spread in the *same expiration month*, I need no additional margin to enter this trade because I still have the now profitable, much safer Put Credit Spread part of my Iron Condor still working; in effect I am simply re-establishing an Iron Condor with a new Bear Call Spread component.

So, in the previous example, I then place my new credit spread order to Sell the 190 Call and Buy the 195 Call at a net premium credit of \$0.50 or more.

As long as XYZ remains below 190, I will bank this \$0.50 premium. Now let's look at our Adjusted Iron Condor arithmetic at expiration:

Original Call Credit Spread	0.90 loss
Rolled Call Credit Spread	0.50 gain
<u>Original Put Credit Spread</u>	<u>0.40 gain</u>
Adjusted Iron Condor	0.00 break-even

Just remember that the roll into a spread of the same expiration month is used *only* when there is enough time-related premium to produce a trade at an acceptably safe distance from the underlying. Incidentally, if there is sufficient net premium (at least \$0.25) with less than 6 remaining trading days at the required distance, I would be somewhat suspicious as to *why* there was so much premium under large distance/near expiration conditions. Does somebody know something?!

And, of course, you can do exactly the same thing as described for a CALL spread if the PUT credit spread leg of your Iron Condor is the one in trouble. You would exit from your PUT spread, and then roll into a new PUT Credit Spread with Strike Prices below your original ones to re-establish the Iron Condor.

In some situations it is possible to do a roll that retains one of your initial strike prices.

Assuming there is sufficient time remaining in the current option month, we might wish to roll our threatened 180/185 call spread into a 185/190 call spread rather than the 190/195 roll discussed previously. Of course, doing so would provide more premium (and is somewhat more aggressive) since the new 180/185 spread is closer to the current market than the new 190/195 would be.

To do this roll, you would:

- Buy back your 1 short 180 call,
- Sell 2 185 calls (1 to offset your existing long, and 1 to establish a new short position at 185),
- Buy 1 190 call to establish the long position to go with your new short 185 call.

You end up “out” of your original 180/185 call spread, and rolled into a new 185/190 call spread.

Finally, if there isn't enough time left in the current expiration month to meet the minimum net premium rule, you can establish your roll-out spread for the *following month's* expiration period. There you will find that the premium available will be substantially higher than the premiums available for the current month close-to-expiration options of the same Strike Price.

This is the case, of course, because next month's options have more time value.

To do this “roll,” you simply exit from this month's spread that reached your MRA, and establish a new conforming spread in the next month.

### 3. Early Adjustment Trigger – Violation of Support or Resistance

Recall that in the “Entry Criteria” section we discussed the desirability of placing the Short Strike of your Bear Call credit spread above resistance, or below support with a Bull Put Spread. These levels are easily identified by looking at 3-month and 6-month or longer period charts of the underlying (page 54).

One purpose in pre-identifying support and resistance levels is to provide us with a “trigger” for possible early exit, or early exit with roll, when important price levels of the underlying are breached and you are nearing, but haven't yet reached, your MRA (Maximum Risk Amount).

### 4. Early Adjustment Trigger – Rise in Delta

When we enter a credit spread, one of our entry criteria is that the Delta for our short component of the spread (the one whose Strike Price is closest to the market) must be .08 or less (meaning that the estimated probability of the underlying reaching the Strike Price prior to expiration is only 8%).

Once we have established our trade, the delta value of our credit spread's short option continually changes as the price and/or volatility of the underlying changes and as time passes.

If the underlying should be making a fairly strong move in the "wrong" direction and we are uncomfortable with our position, we could use a higher Delta - say of  $\Delta = 0.50$  for example - as an early exit trigger... and simply exit the position with a loss well below MRA, or exit and also employ the Roll.

#### 4. Early Exit - Just Before Expiration Day for Index Options

Often, investors stay with a profitable position through expiration and allow the spread to expire worthless, providing them with the maximum profit on the trade. This is fine when the underlying is far from the short Strike Price of the spread.

NOTE: With Index Options - if the underlying index is even remotely close to the short Strike Price of the index credit spread on the Thursday before expiration, you **MUST** exit from the spread at least by Thursday, the last *trading* day for Index Options, rather than hoping for the best when it actually *expires* the following day.

If one were to remain in the index spread until after the close on Thursday, and the market opened on Friday such that the underlying moved your spread "into-the-money," there is nothing you can do since trading ended the day before.

Bottom line, you should not be in any index positions on expiration Friday unless the Short Strike Price of your spread is so far from the underlying that the premium is almost non-existent and is almost certain to disappear completely on expiration day.

# *Chapter 9*

## ADDITIONAL CONSIDERATIONS ...AND THEY ARE IMPORTANT!

Up to this point, everything we discussed is geared to understanding the “Why” and the specific “How-To-Rules” entry and trade management considerations associated with “The Monthly Income Machine.”

Now I’d like to go over some additional considerations that you as an investor may want to employ in establishing and managing your credit spreads and Iron Condors. Rather than “rules,” these are techniques that you may want to use depending on your degree of conservativeness, your available capital, and, of course, your income target.

But keep in mind as you read this final section – and the Disclaimers that follow – if there is one paramount “rule,” that rule is to never intentionally allow a losing position to exceed your Maximum Risk Amount (MRA).

We are dealing with a strategy geared to producing reliable monthly income based on relatively small profits on each position, so we must not allow what we bank from a series of winners using “The Monthly Income Machine” to be jeopardized by one large loss.

### A. "Weekly" Options

All "Machine" trades involve the use of monthly expiration options. As mentioned earlier, the increasingly available "weekly" options have a place in the conservative investor's world. But in my judgment, that place is usually not in credit spread.

## The Monthly Income Machine

The reason is this: The major advantage "Machinists" have with their credit spreads is that time decay - an inherent element of all options - works for them and against the outright options buyer.

Furthermore, time decay of the premium value of an out-of-the-money option is not linear. The rate of decay accelerates markedly toward the end of an option's life - especially during the week before expiration.

Since we are selling credit spreads, it is accurate to say that we are essentially selling time. You will recall that in all our discussions of using "The Monthly Income Machine," we point out that it is usually quite difficult to identify a spread candidate that meets the net premium rule at "safe" distances, when very little time remains.

That said, although weekly options are not suitable for new credit spread positions when there is only a very short time remaining prior to expiration, because most of the benefit of time decay is gone, the absence of time premium represents an *advantage* to an investor *who happens to want to buy an option outright* under a particular circumstance.

The bottom line on weeklies: They are fine for speculating on a known upcoming event by BUYING options outright or BUYING debit spreads because the premiums will be relatively low so close to expiration.

Conversely, weeklies are NOT FINE during the final week before expiration for credit spreads because the premiums are too low at reasonably "safe" distances since time decay has greatly reduced the premium relative to distance.

Although weekly options with more than a week or two left before expiration can be used with credit spreads, they generally will offer less liquidity than the corresponding monthly option and thus are more likely to sustain less attractive fills when orders are triggered.

### B. Number of Spreads

You are well advised to “paper trade” the "Machine" for a while to experience entering, exiting when necessary, and adjusting positions. For the sake of simplicity, the examples in this book involve a single credit spread or Iron Condor.

But, realistically, the \$25 - \$100 or so income from a successful trade using a single credit spread with a \$0.25 to \$1.00 premium hardly qualifies as significant monthly income.

Depending on your account size, and income objectives, you will undoubtedly do multiple, identical spread contracts for an underlying each month, employing exactly the same rules and controls you would for a single spread.

When doing more than one contract of your credit spread, you will also be able to take advantage, if and when you wish to, of several additional techniques like the "ladder entry" discussed in section "D" below.

Finally, a few words about “diversification.” There is absolutely nothing wrong with intentionally diversifying a credit spread portfolio among various underlyings and between put spreads and call spreads (so long as all spreads meet all the “Machine” entry requirements, of course!), but diversification need not be looked upon as having the same degree of urgency as with outright long or short positions.

This is because credit spreads are essentially non-directional in nature (up to a point). We do not really care whether the underlying is trending upward or downward so long as it doesn't go too far in the adverse direction. Personally, I consider diversifying credit spreads as possibly desirable, but not a deal killer if not done.

If one chooses to build diversification into his credit spread “portfolio,” I feel it most useful for credit spreads with stocks as the underlying.



## The Monthly Income Machine

For the purpose of guarding against a surprise market-wide development, one might also look favorably on diversifying by favoring a series of conforming spreads that include both bull put spreads and bear call spreads so long as all spreads used are conforming ones.

### C. Number of Spreads vs. Margin Available

Recall that for Credit spreads, when the Strike Prices are \$5 apart, the margin requirement is \$500, and when they are \$10 apart, the margin requirement is \$1,000.

But realistically you actually need a bit more than that in your account to place the trade.

On the SPX (S&P 500 Index) for example, the margin requirement for a spread with strike prices \$5 apart is \$500/spread because that is the theoretical maximum possible loss on one such spread, but there is also transaction cost (commission), so you need a bit more than \$500 in your account to place a single credit spread trade, or the two credit spreads of an Iron Condor trade.

Also, in the event that a spread were temporarily going against you, the "paper loss" would be reflected in a lowered account value, but you would still need sufficient available funds to meet the margin requirement for your position.

Therefore, if you were doing 10 SPX spreads with strike prices \$5 apart, you would need to have a little more than \$5,000 in your account, and so forth. Whether you plan to trade 10 spreads at a time or not, I would not recommend having a "The Monthly Income Machine" account with less than about \$6,000 in available margin.

That's the arithmetic. Although you could theoretically employ all the money in your account as margin at any one time, that would be too aggressive a posture for me.

## The Monthly Income Machine

As a practical matter, I personally “ earmark ” (remember: we are not “ spending ” margin; it just has to be in the account), a maximum of 50-75% of my available margin for credit spreads and Iron Condors each month.

You may elect to employ more or less of your margin, depending on your comfort level with the program and with the trades you are considering.

### D. Ladder Entry

One of the excellent techniques we can use with multiple spread positions is the “ladder entry.” It represents a kind of averaging-in approach.

Assume we intend to end up with 6 ABC Bull Put Spreads. Instead of entering all 6 at once, using for example the 110/105 Bull Put Spread strike prices, we might initially only do 3 of them.

Perhaps early in the life of the trade, the market moves lower, but not enough to worry us that it is likely to reach too close to our short Put Strike Price. Now we could do the other 3 110/105 spreads at an even more attractive net premium, or at more attractive (lower) Strike Prices.

Suppose, instead, the underlying makes a sharp early move down, and we are concerned that it is getting within shouting distance of our MRA.

Then we would forgo the other 3 spreads and, in fact, now only have the original 3 to deal with in terms of exiting with a loss, rolling, etc.

Lastly, suppose the market moves *up* early in our spread’s life, and we are very confident that the original 3 Bull Put spreads we have on are going to be winners.

We could simply add the additional 3 spreads at the same Strike Prices as originally (although the premium will be smaller now because the underlying has moved away from those Strike Prices

...or we could add the additional 3 spreads at *higher* Strike Prices and thus more premium.

In short, laddering gives the investor additional flexibility in establishing multiple credit spread positions.

### E. Timing Your Entry

Consider this: markets rarely go up day after day, or down day after day, even when there is a strong trend underway. This is obvious when looking at the chart of any underlying stock, ETF or index. The underlying may go up three days in a row, and then have a down day or two due to profit taking, news that affects the entire market, etc.

If I am interested in establishing, for example, a XYZ Bear Call Spread that does not happen to offer the benefit of being near a major resistance level, I would prefer to enter my order *after* XYZ has been going up for several days in a row. Then I would enter my credit spread order using, of course, strike prices that meet all of our entry criteria.

### F. "Legging" Into An Iron Condor

Most option-friendly brokerage firms allow you to enter your Iron Condor orders as a single order (a 1-step Iron Condor). We usually do not have this 1-step opportunity, needing instead to "leg into" the Bear Call Spread and Bull Put Spread parts of the Condor at different times in order to meet the premium and distance requirement on each spread.

Suppose, for example, we are planning to do 10 Iron Condors on the Russell 2000 (symbol: RUT), when the underlying RUT is at 770.

## The Monthly Income Machine

Using the Entry Criteria, we see that the net premium on the Bear Call Spread that meets our criteria is \$0.25, i.e., we can sell the 860 Call and buy the 870 Call for a \$0.25 net premium.

At the same time, we see that the premium on the Bull Put Spread that meets the entry criteria is \$0.30. In this example, we could sell the 670 Put and buy the 660 Put and collect a net premium of \$0.30.

We *could* enter our order on the entire Iron Condor, seeking a total \$0.55 net premium (\$0.25 + \$0.30) as follows:

- Sell to open 10 Oct 860 Calls
- Buy to open 10 Oct 870 Calls
- Sell to open 10 Oct 670 Puts
- Buy to open 10 Oct 660 Puts
- ... day order
- ... net premium of \$0.55

I refer to the above scenario – entering both the bull put spread and the bear call spread of an Iron Condor at the same time – as a 1-step Iron Condor. Except with very active/volatile underlyings, it is usually not possible to establish an Iron Condor in the current expiration month as a 1-step Iron Condor. One or the other of the two spreads need for the Condor will often not provide sufficient premium. Remember: BOTH spreads of an Iron Condor must EACH fully conform individually to all the entry rules.

Since each spread of the Iron Condor must offer at least \$0.25 premium to qualify, an Iron Condor must provide at least \$0.50 premium in total... but we cannot have a Condor where one spread provides \$0.35 and the other only \$0.15 – even though the total is \$0.50.

It would be fine to enter that spread with the \$0.35 premium now, and hope to establish the other spread later based on price movement in the underlying bringing that spread premium up to at least \$0.25.

That would represent a “2-step Iron Condor,” wherein we could “leg into” the Iron Condor, i.e., establish half of the Iron Condor now, and the other half later. *This is the most common method of establishing an Iron Condor.*

For example, let’s assume that the underlying RUT had been down for each of the past 3 days, and we decided to now enter only the Bull Put Spread at the \$0.30 premium available on the 670/660 Put credit spread.

A couple of days later, we find that the underlying RUT has bounced up somewhat and is now at 781, \$11 higher than when we had entered the Bull Put Spread. At this point, we are “ahead” on our existing Put spread, because the rise in the underlying – and the passage of some time – have reduced the net premium on our existing spread... which is what we want, of course. In other words, our Bull Put spread is now even further away from the underlying price than when we established it.

Furthermore, because the underlying RUT has risen \$11, we might now be able to do our Bear Call Spread at higher Strike Prices (of course, at the required distance from the underlying) and still collect a minimum \$0.25 premium. In this example we might find that instead of the 860/870 spread, the 870/880 now meets all of our entry criteria, and thus we could enter our Bear Call Spread order accordingly.

Now we have our complete Iron Condor, but are better off than we would have been had we established the entire Iron Condor at the outset with a single order. The distance apart between the Call Spread and the Put Spread is greater, and we already are ahead on the Put Spread.

### G. Protecting Your Credit Spread From the Unexpected

Obviously, the various entry criteria concerning distance, premium, absence of earnings reports, delta, and relative liquidity are all focused on identifying spread candidates with a high

probability of success. Limiting risk once in the spread position is the key trade management responsibility and using a MRA (maximum risk amount) is a key to limiting risk on each position.

But there can be occasions, albeit infrequently, when the underlying makes an overnight or sudden intraday mega move in the wrong direction and blows right through our MRA stop loss order and can result in a bigger losing trade than the MRA called for. Of course, the theoretical maximum loss based on the interval between the strike prices would stop the bleeding, but we could still be well beyond the risk we identified as our risk “limit” at the outset of the trade.

Is there a solution for preventing a so-called “black swan” event? No, there is no perfect defense against a giant adverse move that leaps past our stop loss trigger. However, there are steps we can take before an unforeseeable headline event wrecks a conforming spread trade.

### Extra, Extra, Read All About It

#### *Additional “long” option of the spread*

This technique involves adding one or more “extra long” options to a Credit Spread, e.g., we might SELL 10 Strike Price 860 RUT Calls, and BUY 11 or 12 (instead of 10) Strike Price 870 RUT Calls for our Bear Call Spread, or sell 10 Strike Price 670 RUT Puts and buy 11 or 12 Strike Price 660 RUT Puts.

Why buy the extra long option(s)? Because in the case of the Bull Put spread, we might be a little concerned that even though a contemplated Bull Put spread meets all the “entry criteria,” there is something in the news that’s nagging at us. Perhaps we’re hearing that there is saber rattling going on between the Republic of Last Tuesday and the Duchy of Hortense and there’s an outside chance we could be drawn into the fracas. Maybe China suddenly devalues its currency, or North Korea does something terminally stupid.

By adding the extra Puts, if the market does make a sharp move down (which is certainly not what we want with a Bull Put Spread), that extra long Put or Puts can offset some or even all of our loss on the 10 spreads, because it will be gaining in value on its own. Of course, buying the extra Put reduces our net premium somewhat, but we can look upon the expenditure as insurance.

### *Extra unrelated option(s)*

If looking to protect a bull put positions from a “black swan” market collapse, the investor could use an insurance policy made up of some long SPY puts. These would bring separate profits into the account if the market tanked and would thus serve to offset all or some of the loss on conforming put spreads that suffered in the downdraft.

A similar approach can involve purchasing some VIX calls along with the conforming bull put credit spreads. Since the VIX is an instrument that represents a “fear index,” we can expect it to increase in value when the market is falling hard (taking our bull put spreads with it in the general decline) no matter what is causing the fear. Again, the profits from the long VIX calls can offset losses in bull put spreads we have in the market.

As noted, extra long positions established to protect spreads from an extreme, unforeseeable down move is an insurance policy in every sense of the word. We hope nothing happens and our spreads expire worthless giving us our maximum profit, or if a spread goes the wrong way, we are able to exit at or near our pre-determined stop loss point.

But if the worst case, rare, very abrupt move occurs, we’d be very happy that we bought the insurance even though most of the time the insurance we purchased will not be used.

### H. Freeing Up Margin

Here is an excellent move you can make in the following specific situation:

The market has moved strongly in the direction you want and, with at least 2 weeks left until expiration, you see that you could exit from a credit spread (not part of an Iron Condor) at a premium of only 5 or 10 cents.

You might want to do that, even though you are: (1) giving up some of the potential profit you would earn if you waited until the spread expired worthless, and (2) are incurring an extra commission.

The reason you might consider exiting earlier is that the margin requirement disappears when you exit from a spread (not part of an Iron Condor), and you could now put on another spread (employing the appropriate entry criteria) and earn an extra premium from the same margin during the same month.

Obviously, you also remove any possibility, no matter how remote, of having to eventually exit from the original spread at a loss.

### I. Stop Loss and Contingent Stop Loss Orders

The purpose of a stop, or contingent stop, order is to have your position automatically offset (exit from the trade) if the price moves against you and reaches a certain predetermined point.

The order is “resting” in the market and will automatically take you out of the position if the specified price is reached. When you place the order, you indicate if it is to be a “day only order” or a “good till cancelled” one.



## The Monthly Income Machine

You don't have to be there, watching, or take any additional action once the order is placed. Of course, you are free at any time (as long as it has not been filled) to cancel the order, change the trigger price, change from day order to good till cancelled order, or vice versa.

I sometimes prefer to initially place my protective orders as "contingent stop orders," on the underlying stock or index rather than as "stop orders" on the options themselves.

Because options are less liquid than the underlying, their prices tend to bounce around more than that of the underlying. Consequently, a stop loss order placed directly on an option spread might get filled because of unrealistic bid/ask prices even though the price of the underlying doesn't warrant the option moving that much. The risk of such an "unwarranted" fill is greatest during the opening minutes of the trading day.

Instead, you can place a "contingent order," that says – in effect – if the price of the underlying stock or index reaches a specified price, take me out of my option spread.

Keep in mind that when using a contingent stop on your credit spread – based on the movement of the underlying – you are working with an *estimate* of where the option spread premium will be if the underlying reaches the trigger value. The calculation of what option premium is associated with what price of the underlying is subject to change as delta changes and as we near option expiration. Accordingly, the investor needs to recalculate the underlying trigger price when the underlying makes a significant move up or down and as time passes.

This contingent stop based on the price of the underlying is useful if placing good-until-cancelled orders, but it is not as accurate as setting the "day only" MRA stop on the option spread itself.

### J. Option-Friendly Brokerage Firms (a **Critical** issue)

All brokerage firms are not equal, and I am not just talking about such obvious considerations as commission rates.

While most substantial brokerages offer stock, bonds, and options trading support, the level of option support, their option policies, and their options trading platform vary widely.

Options-friendly brokerages do offer especially attractive commissions rates.

They also are more likely to have options experts available to answer telephone or e-mail inquiries.

Predictably, trade/quote/information platforms at options-friendly brokerages are typically exceptionally user-friendly. They provide real-time streaming stock, ETF, Index, and option price quotes, with their associated Greeks and other data, as part of their trading platform.

Perhaps most importantly, brokerages differ on **margin policy**. By far the most important margin policy issue is the “recognition” of Iron Condors. It is a critically important selection criterion in evaluating where to have your account.

As discussed in detail earlier, it is absolutely impossible for an option on an underlying to expire in-the-money on both your Bear Call Spread and Bull Put Spread components of an Iron Condor. The price of the underlying at expiration cannot be in two places at one time. Period.

Therefore, you *should* only have to post margin for one side of the Iron Condor, because only one side can be at risk at expiration.

Despite this, some major brokerages do not recognize this indisputable fact, and their software demands margin for both the bull put and bear call spreads of the Iron Condor... which cuts your potential rate of return in half!

Since you have a choice of several top-notch options-friendly brokerages, you should use one of them for your "Monthly Income Machine" account. You can leave your other accounts where they are if you wish, although the recommended firms also handle stock, bond, mutual fund, etc. trading.

*There are several options-friendly brokerages that I recommend you look into. Please check with Customer Service ([info@SaferTrader.com](mailto:info@SaferTrader.com)) to check if any of them are currently offering any special bonus to members of the SaferTrader community.*

*For a discussion and “naming names” of our list of recommended options-friendly brokerages see the “white paper” <http://safertrader.com/options-friendly-brokerage/>.*

## K. Disclaimers and Disclosure

Please read the author's disclaimer, as well as the following required disclaimers.

### *Author's Disclaimer:*

We emphasize that you should not invest more than you can afford to lose in any investment – including "The Monthly Income Machine;" that there are no guarantees of profit using any method or technique; and that there are particular risks associated with leveraged investment vehicles like options and futures.

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# *Glossary of Option Terms*

## (A) ORGANIZED BY CATEGORY

### **Some very basic terms you may have heard before:**

**Bearish-** an investor view that the stock market, or a stock price, will fall.

**Bullish-** an investor view that the stock market, or a stock price, will rise.

**Neutral-** an investor view that is neither bearish nor bullish.

**Stock Options-** give the holder the right to buy or sell particular shares at a fixed pre-determined price within a fixed period of time. Stock options can be traded in the same way that the underlying stock can be bought and sold.

**Underlying Security-** is the stock or index that an option taker has the right to buy or sell if they choose to exercise.

### **Some terms that relate to the mechanics of stock options:**

**Bear Call Spread-** This strategy is constructed by selling one call option while simultaneously purchasing another call option with a higher strike price. The goal of this strategy is realized when the price of the underlying stays below the lower strike price, which causes that short option to expire worthless, resulting in the investor keeping the premium.

**Bull Put Spread-** This strategy is constructed by selling one put option while simultaneously purchasing another put option with a lower strike price. The goal of this strategy is realized when the price of the underlying stays above the higher strike price, which causes that short option to expire worthless, resulting in the investor keeping the premium.

**Call Options-** give the holder the right to buy the underlying stock or index at a fixed pre-determined price within a certain, fixed period of time.

**Contract Size-** The amount of underlying stock covered by an option contract. In the U.S this is normally 100 shares.

**Expiry (Expiration)-** This is the date at which the option contract expires. This cannot be changed throughout the life of the option, and thereafter the contract is worthless.

**Exercise-** The process of fulfilling the put option contract and buying or selling the shares. This can be done any time up to and including the option expiry date.

**Iron Condor-** This strategy is accomplished by establishing both a Bear Call Spread and a Bull Put Spread with the same expiration date on the same underlying stock or index.

**Margin-** The amount of money the brokerage firm requires be available in your account to take a particular position.

**Premium-** The amount you pay for the option contract. Each stock has set strike prices for trading. Where the strike price is in relation to the current share price influences the amount you pay. Premium is the sum of the option's intrinsic value and its time value.

**Put Options-** give the holder the right to sell the underlying stock or index at a fixed pre-determined price within a certain, fixed period of time.

**Spread Margin-** Is the amount of money you must have available in your account to take a spread position like those employed with the Monthly Income Machine. At options-friendly brokerage firms, the margin requirement represents the maximum theoretical possible loss that could be realized on a spread if the investor remained in a position until the underlying stock or index exceeded the strike prices of both parts of the spread.

When the strike prices are \$5 apart, the margin is \$500; when they are \$10 apart, the margin is \$1,000, etc.

**Strike price-** This is the fixed, pre-determined price at which you can buy or sell the shares. This cannot be changed throughout the life of the option contract.

**Taker-** is a trader or investor who buys an option.

**Writer-** is a trader or investor who sells an option.

### **Some terms that relate to the pricing and values of stock options:**

**At-the-Money-** when an options strike price is the same as the current stock price, it is said to be at-the-money.

**Fair Value-** is used to describe the value of an option as calculated by a mathematical model. Also used to indicate intrinsic value.

**In-the-Money-** A call option is in-the-money when the underlying stock price is higher than the strike price of the call, and a put option is in-the-money when the stock price is below the strike price. The option would have intrinsic value.

**Intrinsic Value-** is the difference between the current stock price and the option's strike price. This is the amount by which an option is in-the-money, and indicates the value of an option if it were to expire right now.

**Out-of-the-Money-** A call option is out-of-the-money when the stock price is below the strike price, and a put option is out-of-the-money when the stock price is higher than the strike price. The option would have no intrinsic value.

**Theoretical Value-** The price of an option as calculated by a mathematical model.

**Time Decay-** Options are made up of time value and intrinsic value. As you get closer to the expiry date, the option value diminishes. This is called time decay. When you buy an option, you are buying time.

**Time Value-** is the difference between an options current value and the intrinsic value.

**Overvalued-** describes a stock trading at a higher price than it logically should.

**Undervalued-** describes a stock that is trading at a lower price than it logically should.

### **Some terms you will run into when talking with a broker or when placing orders online:**

**Ask Price-** is the price at which an option seller (writer) is willing to sell. We buy option contracts and stocks at their ask price.

**Bid Price-** is the price at which an option buyer (taker) is willing to buy.

**Bid/Ask Spread-** is the difference in price between the bid and ask price of an option contract. Option contracts that are heavily traded (liquid) tend to have a tighter Bid/Ask Spread and option contracts that are thinly traded (less liquid) have a wider Bid/Ask Spread.

**Buy To Close-** is an order to close your position. It simply means you are buying back an option contract that you have previously sold short.

**Buy to Open-** is an order in option trading to open a position through buying that option contract. You are said to be long that option.

**Closing Order-** is an order placed to close an open position, whether it be a sell to close or a buy to close order.

**Day Order-** an order that expires at the end of the trading day if it is not filled.

**Day trading-** is the process of making multiple trades that are opened and closed all within the same trading day.



**Discount Broker-** is a brokerage firm that offers low commission rates.

**Early Exercise-** is the exercise of an option contract before its expiry date.

**Full Service Broker-** is a broker you deal directly with to execute all transactions and orders. They come with higher fees, but typically provide more “hand holding.”

**Good Until Canceled Order-** is an order that remains effective until it is cancelled or filled.

**Leg In-** is a technique of establishing part of a position now and the rest of the position later.

**Limit Order-** is an order to buy or sell options at a certain, or limited price.

**Long-** to be long is to own a stock or option.

**Mark-** specifies the broker is to use the midpoint between the bid and ask, rather than the bid or ask itself, in determining price at which an order is to be triggered.

**Market Order-** is an order to buy or sell options at the current market price.

**Naked Short Option or Uncovered Short Option-** is when an investor writes (sells) an option he does not currently own AND he does not own the underlying security. This is an EXTREMELY DANGEROUS position.

**Online Broker-** many brokerage firms offer an online trading platform that allows you to control your orders with the click of a mouse. The fees are usually a fraction of the full service brokers’.

**Options-Friendly Brokerage-** is critical to the maximum profitability of the Monthly Income Machine. Refers to a brokerage firm that offers low commissions, powerful and easy to use

trading platform, cost-free quotes and other real-time data needed for analyzing potential trades. Most importantly, requires margin on only one side of an Iron Condor.

**Position-** used to describe the number and strategy currently open. i.e. if you had bought 12 November \$20 call option contracts on XYZ Company, your position would be “long 12 XYZ Nov \$20 calls.”

**Sell To Close-** is an order to close out an open position through selling that option contract. This really means you are selling an option contract that you own.

**Sell To Open-** is an order to open a position by selling (writing) an option contract to a buyer. You are said to have sold short that option.

**Short-** to be short means to sell (or write) to a buyer an options contract you don't currently own.

**Short Term Options Trading-** to buy and sell stock or index options within a period of time no more than 4 weeks in total.

### **Some things that may affect our decisions when to enter or exit a position:**

**Fundamental Analysis-** is the study of a company's financial structure and results in order to form an opinion as to future share price movements.

**Greeks-** are a set of mathematical criteria used to calculate stock option prices.

**Liquidity-** is the ease at which a purchase or sale can be made. Heavily traded stocks have better liquidity.

**Open Interest-** is the total number of outstanding open contracts in a particular option series. Opening transactions increase the open interest, while a closing transaction reduces it.

**Resistance-** is a term used in technical analysis to recognize a price level, or ceiling, that is higher than the current stock price and where the stock has previously traded and then fallen back.

**Return on Investment-** is the percentage of profit that you make on an investment.

**Reward / Risk Ratio-** is a measure of how risky a position would be. Divide the maximum profit potential by the maximum loss potential, and a ratio of above 1 means that the potential reward is greater than the potential loss.

**Stop Loss-** is a pre-determined price at which you have decided to exit a position once it is hit.

**Stop Order-** is a traditional stop loss where your broker will close a position when a predetermined price is hit.

**Support-** is a term in technical analysis indicating a price level, or floor, lower than the current price of the stock, where demand is thought to exist. This indicates that the stock may stop declining when it reaches this level.

**Technical Analysis-** is the study of price movements in order to form an opinion of future possible price movements. The use of stock or index price charts is a common example of technical analysis.

**Trend-** the direction of a stock or index price movement.

**Volatile-** a stock market or stock price that fluctuates significantly up or down over a short time span is referred to as volatile.

**Volatility-** is a measure of the amount by which an underlying stock is expected to vary or fluctuate in a given period of time.

**Volume-** refers to the number of transactions that took place in a trading day. This indicates the number of buyers and sellers in the market.

**VIX-** stands for Volatility Index and is a measure of market expectations with respect to volatility and whether or not current market sentiment is excessively bullish or bearish.

### **And a few strays:**

**American Style Option-** is an option contract that may be exercised at any time up until and including the expiry date. Most exchange-traded options are American-style.

**Derivatives-** are financial instruments whose value is derived in part from the value and characteristics of another financial instrument. Stock Options are derivatives of the underlying stock

**European Style Option-** is an option that may only be exercised at expiry and not before.

**Hedge-** to protect against potential losses.

**Index-** is a compilation of the prices of companies related in size, type, or other criteria into a single number, such as the S&P 500, the Russell 2000, the Nasdaq, and the Dow Jones.

**Index Option-** is an option whose underlying security is an index. Generally index options are cash-based.

**Leverage-** is the power to achieve greater profit potential with a smaller amount of money. Options offer high leverage.

## The Monthly Income Machine

**Market Maker-** is a member of the exchange whose purpose is to aid in the making of a market, by making bids and offers when there are no public buy or sell orders.

**Realize-** once you have closed an open position you will realize a profit or loss.

# *Glossary of Option Terms*

## (B) ORGANIZED ALPHABETICALLY

**American Style Option-** is an option contract that may be exercised at any time up until and including the expiry date. Most exchange-traded options are American-style.

**Ask Price-** is the price at which an option seller (writer) is willing to sell. We buy option contracts and stocks at their ask price.

**At the Money-** when an options strike price is the same as the current stock price, it is said to be at the money.

**Bear Call Spread-** This strategy is constructed by selling one call option while simultaneously purchasing another call option with a higher strike price. The goal of this strategy is realized when the price of the underlying stays below the lower strike price, which causes that short option to expire worthless, resulting in the investor keeping the premium.

**Bearish-** an investor view that the stock market, or a stock price, will fall.

**Bid/Ask Spread-** is the difference in price between the bid and ask price of an option contract. Option contracts that are heavily traded (liquid) tend to have a tighter Bid/Ask Spread and option contracts that are thinly traded (less liquid) have a wider Bid/Ask Spread.

**Bid Price-** is the price at which an option buyer (taker) is willing to buy.

**Bullish-** an investor view that the stock market, or a stock price, will rise.

**Bull Put Spread-** This strategy is constructed by selling one put option while simultaneously purchasing another put option with a lower strike price. The goal of this strategy is realized

when the price of the underlying stays above the higher strike price, which causes that short option to expire worthless, resulting in the investor keeping the premium.

**Buy To Close-** is an order to close your position. It simply means you are buying back an option contract that you have previously sold short.

**Buy to Open-** is an order in option trading to open a position through buying that option contract. You are said to be long that option.

**Call Options-** give the holder the right to buy the underlying stock or index at a fixed pre-determined price within a certain, fixed period of time.

**Closing Order-** is an order placed to close an open position, whether it be a sell to close or a buy to close order.

**Contract Size-** The amount of underlying stock covered by an option contract. In the U.S this is normally 100 shares..

**Day Order-** an order that expires at the end of the trading day if it is not filled.

**Day trading-** is the process of making multiple trades that are opened and closed all within the same trading day.

**Derivatives-** are financial instruments whose value is derived in part from the value and characteristics of another financial instrument. Stock Options are derivatives of the underlying stock

**Discount Broker-** is a brokerage firm that offers low commission rates.

**Early Exercise-** is the exercise of an option contract before its expiry date.

**European Style Option-** is an option that may only be exercised at expiry and not before.

**Expiry (Expiration)-** This is the date at which the option contract expires. This cannot be changed throughout the life of the option, and thereafter the contract is worthless.

**Exercise-** The process of fulfilling the put option contract and buying or selling the shares. This can be done any time up to and including the option expiry date.

**Fair Value-** is used to describe the value of an option as calculated by a mathematical model. Also used to indicate intrinsic value.

**Full Service Broker-** is a broker you deal directly with to execute all transactions and orders. They come with higher fees, but typically provide more “hand holding.”

**Fundamental Analysis-** is the study of a company’s financial structure and results in order to form an opinion as to future share price movements.

**Good Until Canceled Order-** is an order that remains effective until it is cancelled or filled.

**Greeks-** are a set of mathematical criteria used to calculate stock option prices.

**Hedge-** to protect against potential losses.

**Index-** is a compilation of the prices of several common entities into a single number, such as the S&P 500, the Russell 2000, the Nasdaq, and the Dow Jones.

**Index Option-** is an option whose underlying security is an index. Generally index options are cash-based.



**In the Money-** A call option is in-the-money when the underlying stock price is higher than the strike price of the call, and a put option is in-the-money when the stock price is below the strike price. The option would have intrinsic value.

**Intrinsic Value-** is the difference between the current stock price and the option's strike price. This is the amount by which an option is in-the-money, and indicates the value of an option if it were to expire right now.

**Iron Condor-** This strategy is accomplished by establishing both a Bear Call Spread and a Bull Put Spread with the same expiration date on the same underlying stock or index.

**Leg In-** is a technique of establishing part of a position now and the rest of the position later.

**Leverage-** is the power to achieve greater profit potential with a smaller amount of money. Options offer high leverage.

**Limit Order-** is an order to buy or sell options at a certain, or limited price.

**Liquidity-** is the ease at which a purchase or sale can be made. Heavily traded stocks have better liquidity.

**Long-** to be long is to own a stock or option.

**Margin-** The amount of money the brokerage firm requires be available in your account to take a particular position.

**Mark-** specifies the broker is to use the midpoint between the bid and ask, rather than the bid or ask itself, in determining price at which an order is to be triggered.

**Market Maker-** is a member of the exchange whose purpose is to aid in the making of a market, by making bids and offers when there are no public buy or sell orders.

**Market Order-** is an order to buy or sell options at the current market price.

Limit Order an order to buy or sell options at a certain, or limited price.

**Naked Short Option or Uncovered Short Option-** is when an investor writes (sells) an option he does not currently own AND he does not own the underlying security. This is an EXTREMELY DANGEROUS position.

**Neutral-** an investor view that is neither bearish nor bullish.

**Online Broker-** many brokerage firms offer an online trading platform that allows you to control your orders with the click of a mouse. The fees are usually a fraction of the full service brokers'.

**Open Interest-** is the total number of outstanding open contracts in a particular option series. Opening transactions increase the open interest, while a closing transaction reduces it.

**Options-Friendly Brokerage-** is critical to the maximum profitability of the Monthly Income Machine. Refers to a brokerage firm that offers low commissions, powerful and easy to use trading platform, cost-free quotes and other real-time data needed for analyzing potential trades, knowledgeable and responsive customer service, etc. Most importantly, requires margin on only one side of an Iron Condor.

**Out of the Money-** A call option is out-of-the-money when the stock price is below the strike price, and a put option is out-of-the-money when the stock price is higher than the strike price. The option would have no intrinsic value.

**Overvalued-** describes a stock trading at a higher price than it logically should.

**Position-** used to describe the number and strategy currently open. i.e. if you had bought 12 November \$20 call option contracts on XYZ Company, your position would be "long 12 XYZ Nov \$20 calls."

**Premium-** The amount you pay for the option contract. Each stock has set strike prices for trading. Where the strike price is in relation to the current share price influences the amount you pay. Premium is the sum of the option's intrinsic value and its time value.

**Put Options-** give the holder the right to sell the underlying stock or index at a fixed pre-determined price within a certain, fixed period of time.

**Realize-** once you have closed an open position you will realize a profit or loss.

**Resistance-** is a term used in technical analysis to recognize a price level, or ceiling, that is higher than the current stock price and where the stock has previously traded and then fallen back.

**Return on Investment-** is the percentage of profit that you make on an investment.

**Reward / Risk Ratio-** is a measure of how risky a position would be. Divide the maximum profit potential by the maximum loss potential, and a ratio of above 1 means that the potential reward is greater than the potential loss.

**Sell To Close-** is an order to close out an open position through selling that option contract. This really means you are selling an option contract that you own.

**Sell To Open-** is an order to open a position by selling (writing) an option contract to a buyer. You are said to have sold short that option.

**Short-** to be short means to sell (or write) to a buyer an options contract you don't currently own.

**Short Term Options Trading-** to buy and sell stock or index options within a period of time no more than 4 weeks in total.

**Spread Margin-** Is the amount of money you must have available in your account to take a spread position like those employed with the Monthly Income Machine. At options-friendly brokerage firms, the margin requirement represents the maximum theoretical possible loss that could be realized on a spread if the investor remained in a position until the underlying stock or index exceeded the strike prices of both parts of the spread.

When the strike prices are \$5 apart, the margin is \$500; when they are \$10 apart, the margin is \$1,000, etc.

**Stop Loss-** is a pre-determined price at which you have decided to exit a position once it is hit.

**Stock Options-** give the holder the right to buy or sell particular shares at a fixed pre-determined price within a fixed period of time. Stock options can be traded in the same way that the underlying stock can be bought and sold.

**Stop Order-** is a traditional stop loss where your broker will close a position when a predetermined price is hit.

**Strike price-** This is the fixed, pre-determined price at which you can buy or sell the shares. This cannot be changed throughout the life of the option contract.

**Support-** is a term in technical analysis indicating a price level, or floor, lower than the current price of the stock, where demand is thought to exist. This indicates that the stock may stop declining when it reaches this level.

**Taker-** is a trader or investor who buys an option.

**Technical Analysis-** is the study of price movements in order to form an opinion of future possible price movements. The use of stock or index price charts is a common example of technical analysis.

**Theoretical Value-** The price of an option as calculated by a mathematical model.

**Time Decay-** Options are made up of time value and intrinsic value. As you get closer to the expiry date, the option value diminishes. This is called time decay. When you buy an option, you are buying time.

**Time Value-** is the difference between an options current value and the intrinsic value.

**Trend-** the direction of a stock or index price movement.

**Underlying Security-** is the stock or index that an option taker has the right to buy or sell if they choose to exercise.

**Undervalued-** describes a stock that is trading at a lower price than it logically should.

**VIX-** stands for Volatility Index and is a measure of market expectations with respect to volatility and whether or not current market sentiment is excessively bullish or bearish.

**Volatile-** a stock market or stock price that fluctuates significantly up or down over a short time span is referred to as volatile.

**Volatility-** is a measure of the amount by which an underlying stock is expected to vary or fluctuate in a given period of time.

**Volume-** refers to the number of transactions that took place in a trading day. This indicates the number of buyers and sellers in the market.

**Writer-** is a trader or investor who sells an option.

# *Notes*

