

Option Trading

Rules To Trade By

Revised and Updated Fall 2012

1. ***"The first rule of investing is don't lose money. The second rule is don't forget Rule No. 1."***
Warren Buffet
2. Analyze each trade BEFORE engaging in the trade to determine and comprehend:
 - a. Expiration conditions: When will it expire, what price it will expire, valuation at expiration?
 - b. Exercise conditions: Why would the trade be exercised? When would the trade be exercised? What is the valuation when the trade is exercised? Consider exercise of trade at expiration and prior to expiration.
 - c. Determine Buy To Close (BTC) conditions: When to BTC? Why BTC? Valuation of potential Roll Up or Roll Out conditions.
3. Each trade will be similar but slightly different so analysis must address these core component and take into consideration the specific nature of the trade.
4. If the COOL Tools, charts, and analyst guidelines coincide with personal fundamental analysis, make the trade. If not, move on.

Covered Options

- ***Conservative Options should ONLY be used to augment existing quality growth or value positions and NOT be used to recover losses or to replace long term, fundamental investing.***
- If your analysis of the stock is a buy, then buy the stock; if it is a sell, then sell the stock.
- Always review prospective trades using the COOL Tools Spreadsheets to evaluate the potential trade:
 - > 20% APR
 - > \$100 Net Premium!
 - Maximize number of contracts per trade to lowers costs, reduces contract premium
 - < 2% commission target for each trade
 - Consider closing out the position when current premium drops < 10%
 - Use front month or weekly contracts to take advantage of wasting asset (time premium).
 - Do NOT write options across Earnings dates or similar events (elections, political strife)
 - Pay attention to data entry – red means stop and wait for another opportunity!
 - **It is a game of walks and singles... move the line!**

Covered Calls (CC)

- Stock price has moved UP for a while
- Stock is UP on the day
- Market is UP on the day
- Volatility is UP (higher volatility = generally higher option premiums)
- Bearish technical indicators

Cash Secured Puts (CSP)

- Stock price has moved DOWN for a while
- Stock is DOWN on the day
- Market is DOWN on the day
- Volatility is UP (higher volatility = generally higher option premiums)
- Bullish technical indicators

Option Type	Stock Trend	Stock Price	Market Price	Volatility	Technicals
CC	UP	UP	UP	UP	BEARISH
CSP	DOWN	DOWN	DOWN	UP	BULLISH

Covered Options for Index ETFs

- Use “trading ranges” to repeatedly sell CC and CSP to collect premiums as the ETF trades within the range.
- Use Simple Moving Average (SMA) and Bollinger Bands (BB) to analyze prospective trading range for ETF. Verify movement with at least one other technical indicator:
- Limit exposure to one week out to take advantage of time decay.
- Catch the ETF at or near a bottom and follow it up. If the ETF is near the upper BB, walk the dog and wait for it to trend down.

CSP

- Market has moved DOWN for several days
- Market is DOWN for the day
- Close to a perceived trading bottom (close to or below lower BB)
- Volatility is UP
- Use same rules (>20%, >\$100, <2%, one week out, red warnings = wait)
- Look to buy to close (BTC) contract if premium drops <10%
- Repeat
- If CSP is put to you, then

CC

- Market has moved UP for several days
- Market is UP on the day
- Close to a perceived trading top (close to or above upper BB)
- Volatility is UP
- Use same rules (>20%, >\$100, <2%, one week out, red warnings = wait)
- Look to buy to close (BTC) contract if premium drops <10%
- Repeat
- If CC is put to you, then look to CSP or use cash for a quality stock.

Option Type	Stock Trend	Stock Price	BB	Volatility	Technicals
CSP	DOWN	DOWN	LOWER	UP	BULLISH
CC	UP	UP	UPPER	UP	BEARISH