

MARKET TRACTION

How Much Longer will it take to Untangle this Market?

This Week's Trade Ideas:

(View Webinar*)

Bullish Ideas:

(View Webinar) **SBUX > Starbucks Corp > \$52.59** Last. Buy the Sept. 14th 51 Calls for \$2.35 or less with a close or anticipated close above \$52.85 in an up market with expectations for continued strength in the major indices.

(View Webinar) **CMCSA > Comcast Corp > \$35.39** Last. Buy the Sept. 14th 34.5 Calls for \$1.80 or less with a close or anticipated close above \$35.92 in an up market with expectations for continued strength in the major indices.

Bullish Mentions:

Based upon closing prices and all assume an up market with expectations for continued strength in the major indices.

WMT has positive qualities but earnings are due out imminently!

WBA has big potential if it can fight through 2 nearby resistance levels.

ZION has nice potential if it can fight through 2 nearby resistance levels.

CAH, very nice reversal potential but risky as well.

CFG has reversal potential but options leave a lot to be desired.

PCAR, possibly reversing trend.

Bearish Ideas:

(View Webinar) **GT > Goodyear Tire & Rubber Co. > \$23.56** Last. Buy the Sept. 7th 24 Puts for \$1.00 or less with a close or anticipated close below \$23.30 in a down market with expectations for continued weakness in the major indices.

Bearish Mentions:

None at this time.

We strongly suggest viewing this week's **Morning Call** webinar for full details with respect to these idea(s), last week's and options education.

Special Note:

Remaining nimble is a focus in the newsletter and in our **Morning Call** webinar and will be so.

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Outlook:

The market is technically-tangled, and choppiness is all we have as a result.

Technicals:

Will be discussed in-depth in the **Morning Call** webinar.

Fundamentals:

These trade idea(s) and mentions are technically-driven.

(Editor's note: These trade ideas may be updated periodically, in keeping with market conditions. It is intended solely for educational purposes.)

Recap of Last Week:

Another Summertime Snooze. Our bulls were **USB** as an idea, mainly to keep things safe, and these as mentions: **GILD, GS, PNC, FSLR. USB**. Depending on if and how folks handled it, the USB idea could have been taken, not taken, stopped out on, or still held! We updated on it noting that we couldn't fault folks for trying to get into it despite last Wednesday's unimpressive market action. Had they, they would have had to deal with the Turkey Tantrum and possibly would have had to exit below \$52.80 if using our more conservative stop. Those that became involved and allowed more breathing room may still be in and those that passed, well, they passed on it. We logged it at \$53.30 last week and as we write it is near \$53.13. What can we say? It's hung in there well despite weakness in the **SPX** and **XLF**. All other bullish names never had a chance when Turkey's turmoil suddenly became selloff stimuli. That's too bad but that's the way it goes in listless summertime trading and especially so in non-trending markets.

MAR and **HLT** were both and all our bear names for the week. **HLT** fell almost \$3.00 from where we logged it to yesterday's low, or about 3.50%. **MAR** fell about \$4.50 from where we logged it to the low or about 3.75%. Both of those drops were nice percentage-wise since they transpired in only 5 trading days or so. We're happy with that but we didn't get the "*bottom falling out*" we so desperately seek. We noted in yesterday's update that they were both short-term oversold and both have bounced quite strongly since that update when out. The bounces also coincided with the **SPX** finding support at our support line provided in that update and a few SMAs.

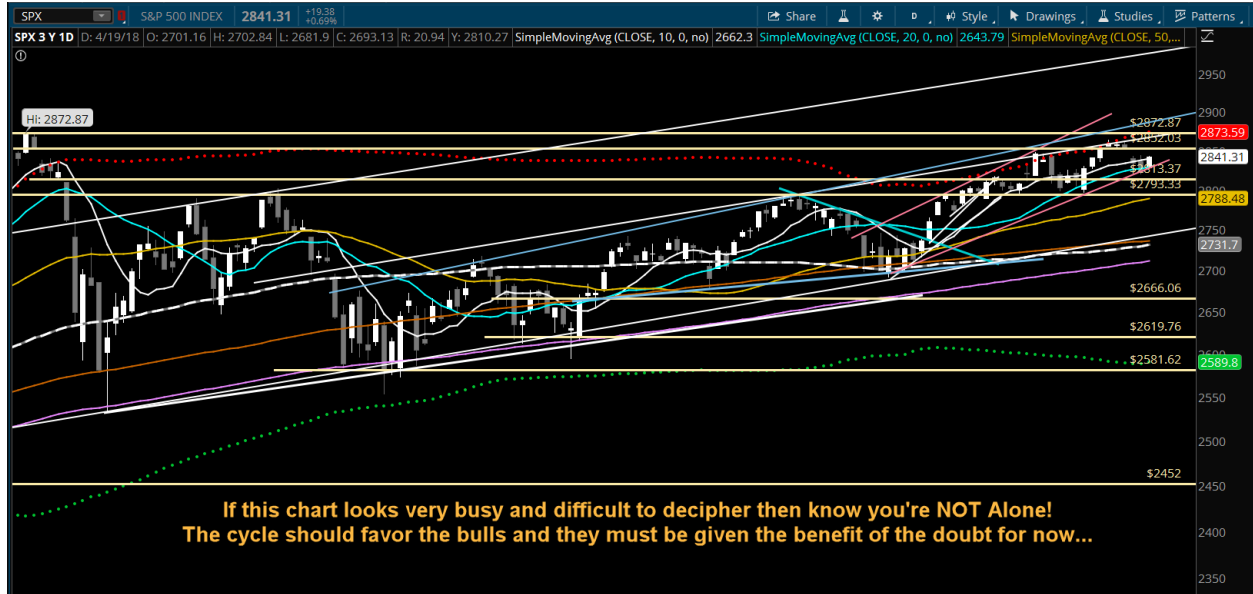
In reflection, it wasn't a bad week as at least a few things happened but it did prove that the *Summer* is still in full force. Aside from the big name/high risk names, not a lot is going on and that can only last for so long. We're looking forward to the brisk air of the fall more so than ever!

Once again and as promised, due to this low volatility environment persisting in so many stocks, we're introducing other strategies that readers can employ to profit should they choose to do so. See **Options Academy**.

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Market Overview

We're keeping it simple this week because there's too much congestion and uncertainty for us to make a strong case. Put another way, we can't wait for THIS summer to end! The tangled web of various forms of support and resistance are killing sustained movement right where it stands!

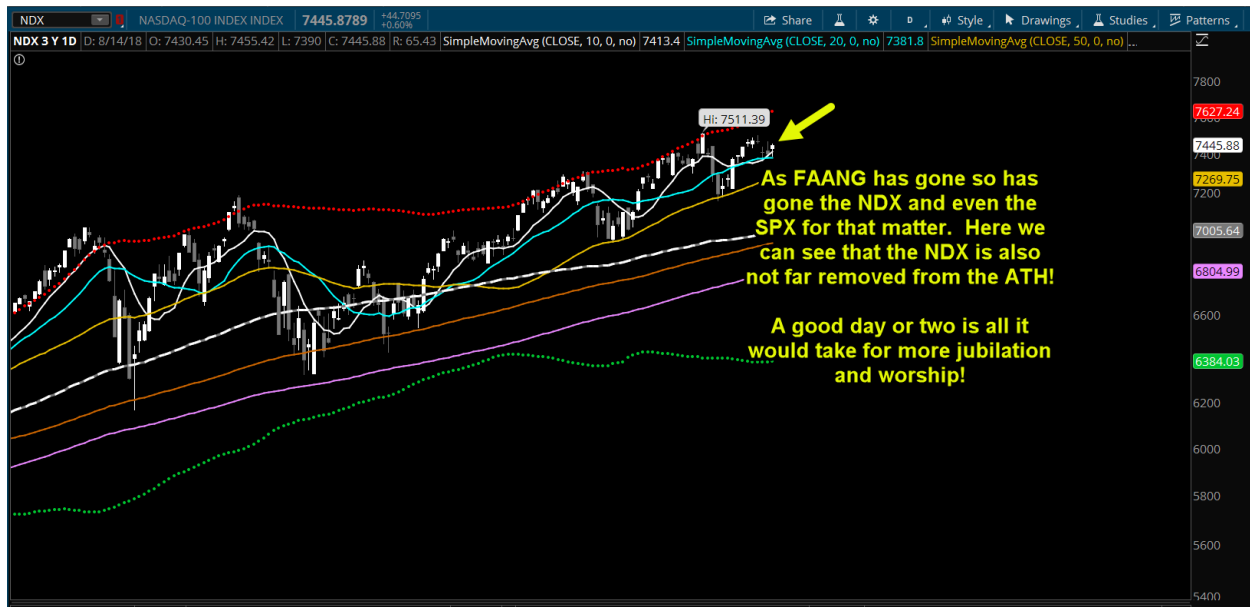


The SPX, which we labeled as short-term overbought last week, pulled back on Turkey, Turkey, Turkey, and found support where we would have expected it to do so. After that news-driven rest, the bulls should be on the verge of resetting and forgetting! Just as they have with nearly every other issue that's developed over the last 9 years! We'll soon see if August is going to fulfill its historically bullish promise (see **BTR**).

The FAANG love affair remains obsessive and dangerous but remain it does:



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Much of the rest of the world continues to deteriorate. But who cares? Not this market!



At least not yet...

We're getting the sense that the early fall months are setting up to be very interesting. We believe that risks should be respected once again, mainly because valuations are a real concern coupled with the fact that there are many warning signs flaring up that continue to be ignored by most. This is not a crash prediction to be very clear. The narrowness of the leadership in this market and the shrugging off of nearly everything isn't a recipe for another 9 years of bullishness, in fact, those factors can often appear in later stages. Given the option, we're rather be respectful of risk and pleasantly surprised than oblivious and regretful.

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Finally...

The calendar is a little fuller this week vs. last week's light fare. Wednesday is the big day with many reports set to hit the tape, but Thursday and Friday also will have a little to add to the mix. Will the Turkey Tantrum linger and overwhelm the calendar, or will the markets focus on new information and allow Turkey to recede as they've done with similar issues over the past decade?

This Week's Economic Calendar

TIME (ET)	REPORT	PERIOD	ACTUAL	MEDIAN FORECAST	PREVIOUS
MONDAY, AUG. 13					
11 am	<u>Survey of consumer expectations</u>	July			--
TUESDAY, AUG. 14					
6 am	<u>NFIB small business index</u>	July	107.9	--	107.2
8:30 am	<u>Import price index</u>	July	0.1%	--	-0.1%
11 am	<u>Household debt</u>	Q2	3.5%	--	3.8%
WEDNESDAY, AUG. 15					
8:30 am	Retail sales	July		0.1%	0.5%
8:30 am	Retail sales ex-autos	July		0.3%	0.4%
8:30 am	Empire state index	Aug.		--	22.6
8:30 am	Productivity	Q2		2.4%	0.4%
8:30 am	Unit labor costs	Q2		-0.1%	2.9%
9:15 am	Industrial production	July		0.3%	0.6%
9:15 am	Capacity utilization	July		78.2%	78.0%
10 am	Home builders' index	Aug.		--	68
10 am	Business inventories	June		--	0.4%
THURSDAY, AUG. 16					
8:30 am	Weekly jobless claims	8/11		215,000	213,000
8:30 am	Housing starts	July		1.271 mln	1.173mln
8:30 am	Building permits	July		--	1.273mln
8:30 am	Philly Fed index	Aug.		--	25.7
FRIDAY, AUG. 17					
10 am	Consumer sentiment	Aug.		98.5	97.9
10 am	Leading economic indicators	July		--	0.5%
10 am	Advance report on services	Q2		--	--

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Below the Radar – Special Late Summer Scare Fest Edition!

A few notably **scary** items cropped up over the past week, and here they are...

<http://www.crossingwallstreet.com/archives/2018/08/the-eight-best-predictors-of-the-stock-market.html>

Here's us cutting to the chase for you!:

The blog's indicator is based on the percentage of household financial assets—stocks, bonds and cash—that is allocated to stocks. This proportion tends to be highest at market tops and lowest at market bottoms.

According to data collected by Ned Davis Research from the Federal Reserve, this percentage currently looks to be at 56.3%, more than 10 percentage points higher than its historical average of 45.3%. At the top of the bull market in 2007, it stood at 56.8%.

Ned Davis, the eponymous founder of Ned Davis Research, calls the indicator's record "remarkable." I can confirm that its record is superior to seven other well-known valuation indicators analyzed by my firm, Hulbert Ratings.

That gets us started with yet another reason to respect the risk side of the equation at this stage.

As for Hulbert, here's a related blurb with respect to his offerings:

Mark Hulbert recently penned a very good article discussing the ["Eight Best Predictors Of The Stock Market,"](#) to wit:

"The stock market's return over the next decade is likely to be well below historical norms.

That is the unanimous conclusion of eight stock-market indicators with what I consider the most impressive track records over the past six decades. The only real difference between them is the extent of their bearishness.

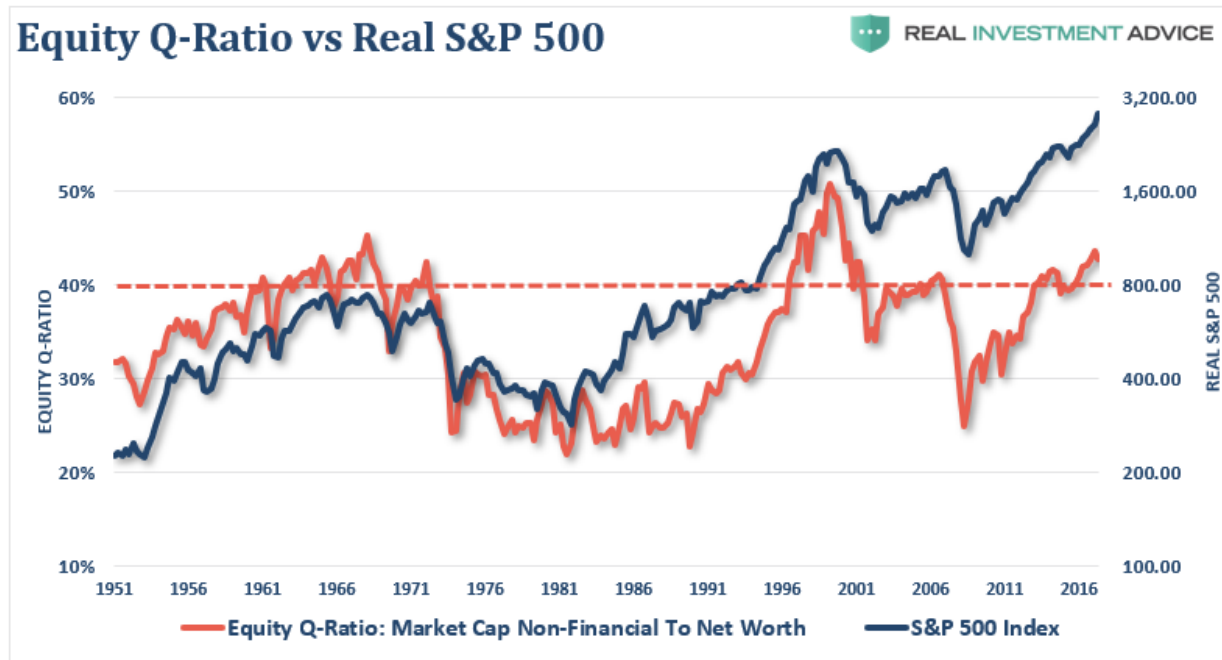
To illustrate the bearish story told by each of these indicators, consider the projected 10-year returns to which these indicators' current levels translate. The most bearish projection of any of them was that the S&P 500 would produce a 10-year total return of 3.9 percentage points annualized below inflation. The most bullish was 3.6 points above inflation.

The most accurate of the indicators I studied was created by the anonymous author of the blog [Philosophical Economics](#). It is now as bearish as it was right before the 2008 financial crisis, projecting an inflation-adjusted S&P 500 total

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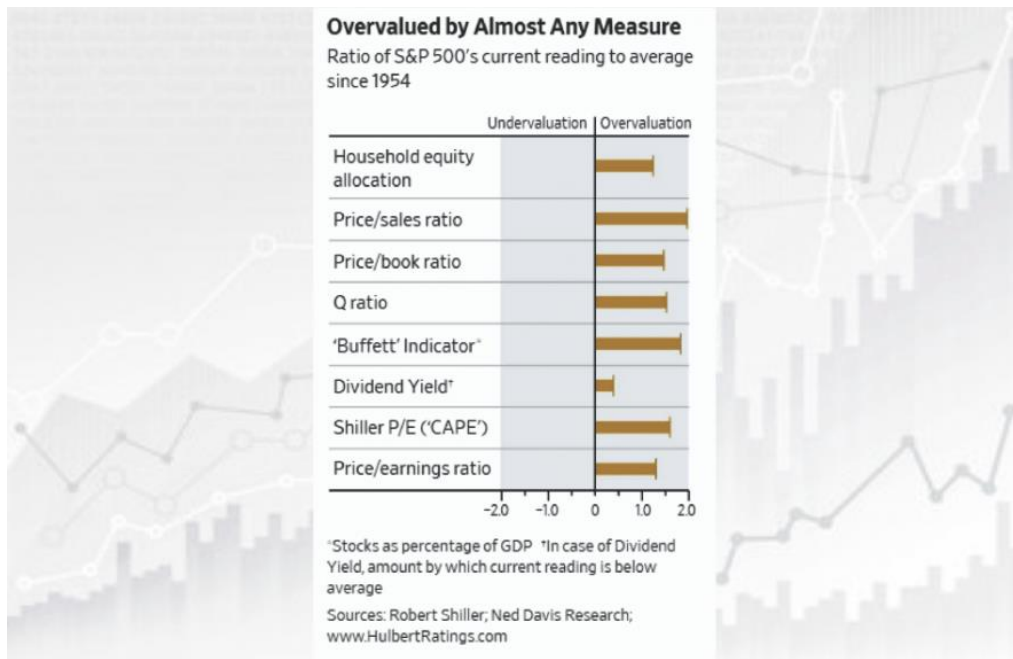
return of just 0.8 percentage point above inflation. Ten-year Treasuries can promise you that return with far less risk."

Here's a graphic to support the above:



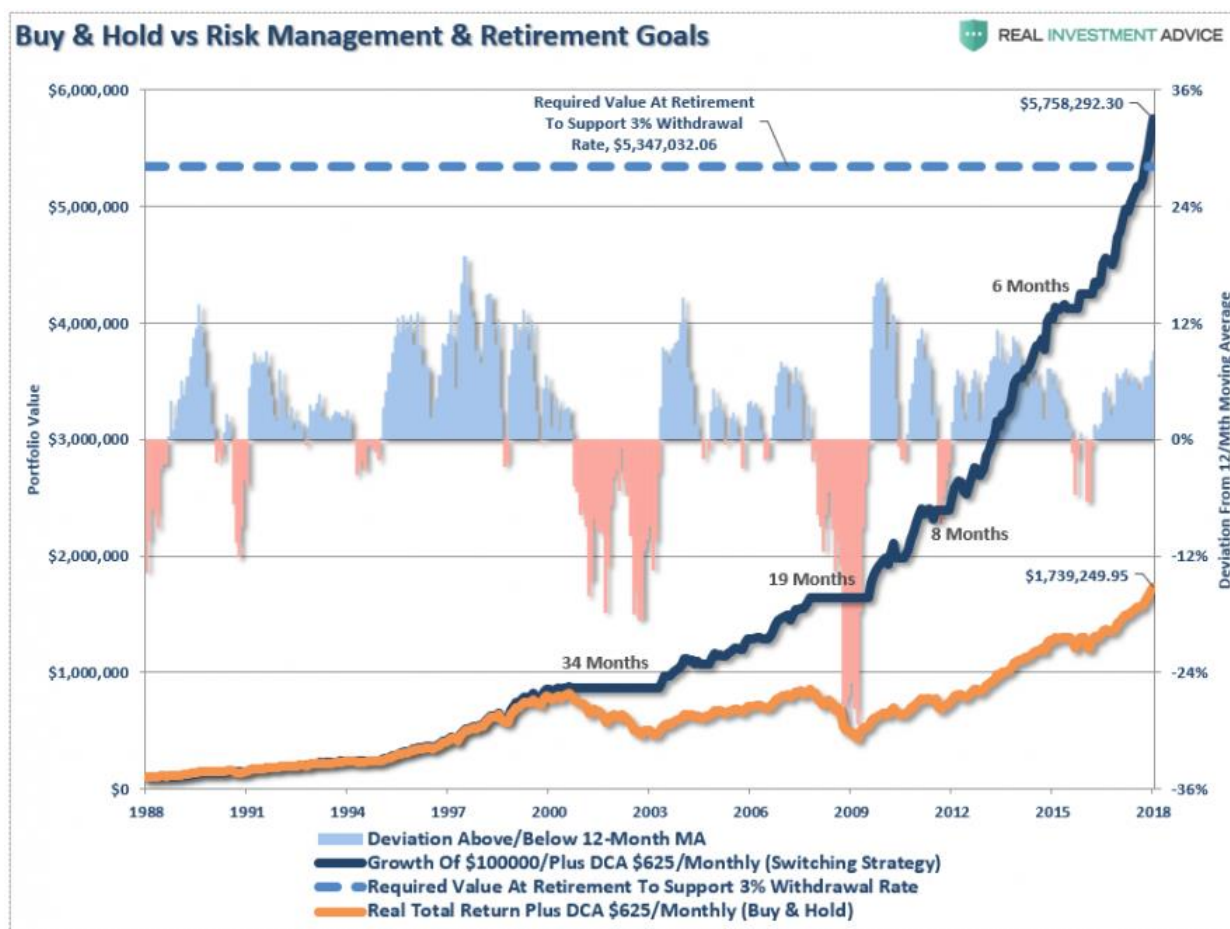
It's very easy to see how *scarily stretched* the S&P 500 is vs. the Q Ratio.

How about the other 7? They are, you guessed it, very *scary*!:



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Finally, here's why Wall St.'s beloved "buy and hold" is something investors should be **wary to scared** of to say the least. Why suffer if it can be avoided? Why not "build from higher levels"?



We're going to interrupt the proceedings here momentarily to bring you this extremely **spooky** message from John Hussman that we couldn't weave into **BTR** last week.

<https://www.marketwatch.com/story/this-prophet-of-doom-predicts-stock-market-will-plunge-more-than-50-2018-07-30>

Hussman's claim to fame includes forecasting the market collapses of 2000 and 2007-2008. Since then, however, he's also become **known as a permabear** for his repeated calls for sharp stock market declines and his oft-repeated mantra of "overbought, overvalued, overbullish" as the bull market continues into its ninth year by some measures.

Hussman says he's learned from and [addressed past errors](#).

In his most recent call, he argued that measured "from their highs of early-2018, we presently estimate that the completion of the current cycle will result in market losses on the order of -64% for the S&P 500 index, -57% for the Nasdaq-100 Index, -68% for the Russell 2000 index, and nearly -69% for the Dow Jones Industrial Average."

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Near and dear to our **black hearts** is the graphic below that found its way into the Hussman piece:

Exhibit 3: 10 stocks have contributed more than 100% of S&P 500's YTD return
as of June 28, 2018

Ticker	Company	Cons. 2019E sales growth	Total return	Mkt cap weight	% of SPX Return
AMZN	Amazon.com Inc.	23 %	45 %	2.1 %	36 %
MSFT	Microsoft Corp.	10	16	2.9	18
AAPL	Apple Inc.	4	10	3.8	15
NFLX	Netflix Inc.	24	106	0.4	15
FB	Facebook Inc.	27	11	1.9	8
GOOGL	Alphabet Inc.	18	7	2.8	7
MA	Mastercard Inc.	12	31	0.6	7
V	Visa Inc.	11	17	0.9	6
ADBE	Adobe Systems Inc.	19	37	0.4	5
NVDA	NVIDIA Corp.	14	25	0.5	5
Top 10 contributors		16 %	20 %	16 %	122 %
S&P 500		5	3	100	100

Source: FactSet, Goldman Sachs Global Investment Research

This demonstrates, yet again, just how narrow 2018's performance has been and how the story would be much, much different were it not for the **dangerous and pervasive obsession with FAANG**.

The final blurb from Hussman:

But Hussman, who projected in March 2000 that the Nasdaq would plunge 83% (it ended dropping more than 77% from its March 2000 high to its September 2002 low), emphasized that these growth names are not overvalued to the extent that the hotshot stocks were 18 years ago.

Hopefully, by this point, everyone's respect for downside risk has returned to healthy levels. If not, we've got one more **section of scary** to turn the trick.

<https://www.marketwatch.com/story/ behold-the-scariest-chart-for-the-stock-market-2018-08-08>

A lot has changed since the stock market crash of 2000. Apple Inc. has gone from being just another computer brand to becoming the most valuable company in the world, Amazon.com Inc. went from being an e-book retailer to a byword for online shopping and Tesla's Elon Musk has risen from obscurity to Twitter stardom.

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Yet some things never change and Doug Ramsey, chief investment officer at Leuthold Group, has been on a mini-campaign highlighting the parallels between 2000 and 2018.

Among the numerous similarities is the elevated valuation of the S&P 500 then and now, which Ramsey illustrates in a chart that he has dubbed as the “scariest chart in our database.”



“Recall that the initial visit to present levels was followed by the S&P 500’s first-ever negative total return decade,” he said in a recent blog post.

As for the ***double the scare*** graphic, take a peek:



“Overvaluation in 2000 was highly concentrated; today it is pervasive, with the median S&P 500 Price/Sales ratio of 2.63 times more than double the 1.23 times prevailing in February 2000.

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No **Scare Fest** would be complete without **EERIE Parallels!** And so, we conjured them up:

"In the earlier case, a volatile five-month upswing that began in mid-April ultimately fell just a half-percent short of the March 24th high by early September. This year, a similarly choppy, six-month rebound has taken the S&P 500 to within 1% of its January 26th high," Ramsey said.



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Do not lose sight of the performance that follows breezy July and August! The next two months can be challenging for markets!

Month	Average DJIA gain since 1896
January	+0.9%
February	-0.3%
March	+0.8%
April	+1.2%
May	0%
June	+0.2%
July	+1.4%
August	+1.3%
September	-1.2%
October	+0.2%
November	+0.9%
December	+1.4%

And with rates rising and economic activity surprising counter to index movement...



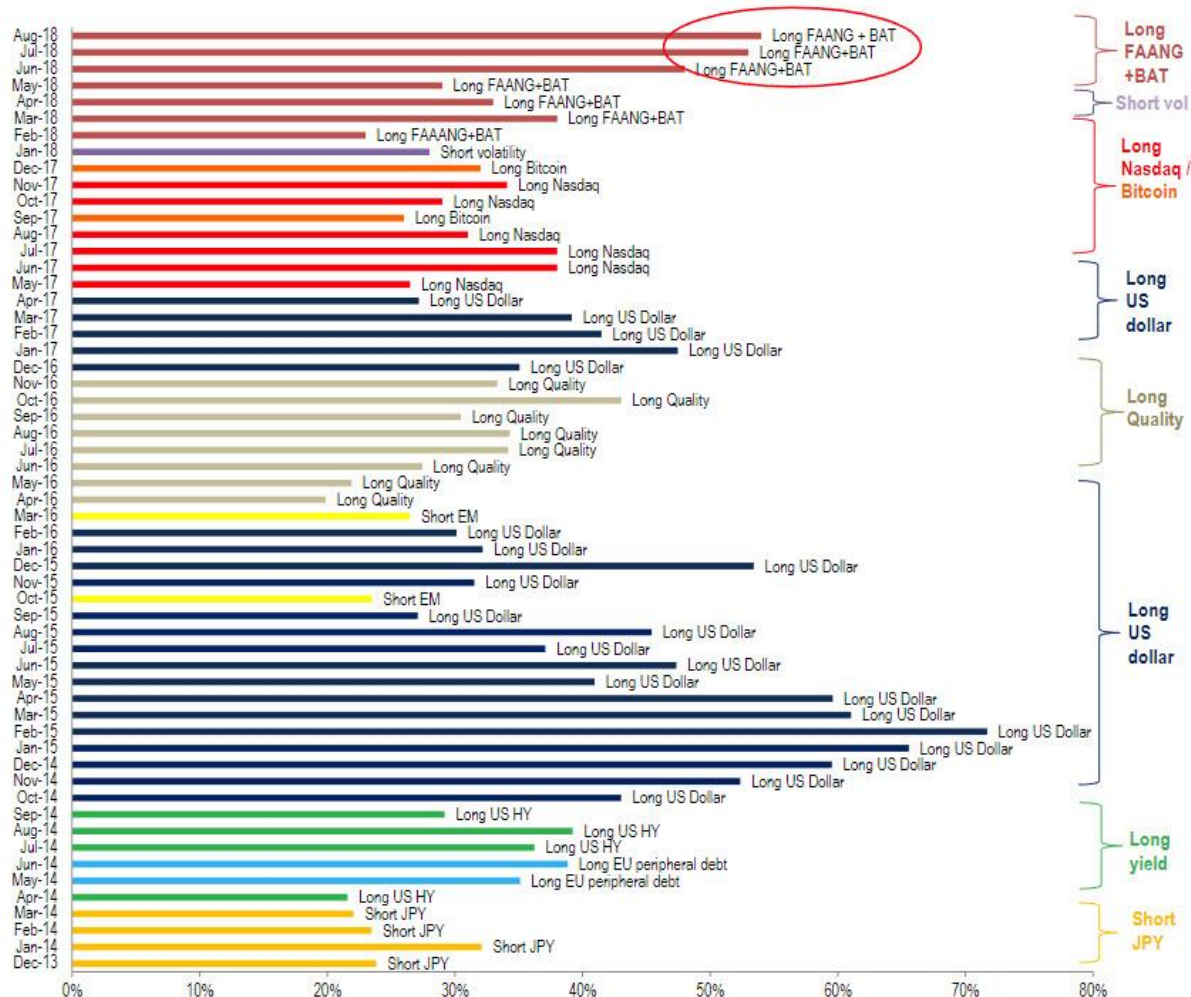
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And finally, let's not forget about those contrarians! Here's a lot of what you need to know about exuberance and a potentially deadly love affair!:

<https://www.zerohedge.com/news/2018-08-14/bullishness-us-stocks-hits-3-year-high-faang-lovefest-continues>

They just can't get enough of the last few names that are working when most of those names are near record highs after running up for 9 years!!!

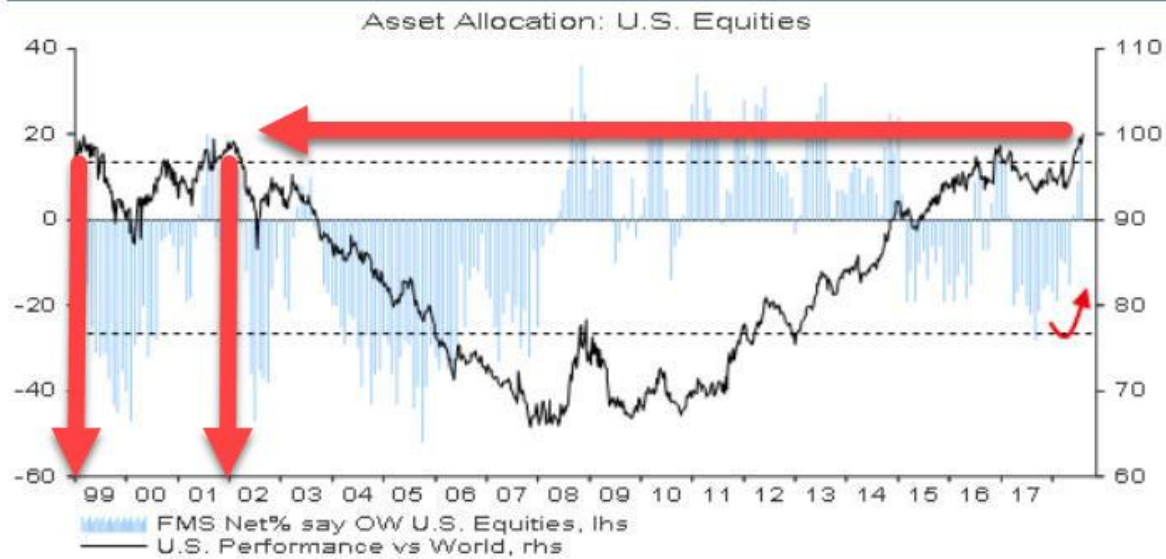
Exhibit 3: Evolution of Global FMS "most crowded trade"



Source: BofA Merrill Lynch Global Fund Manager Survey

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Exhibit 4: Net % AA Say they are overweight US Equities



Source: BofA Merrill Lynch Global Fund Manager Survey

Beware as autumn approaches!

Bank and Roll like fiends!

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Options Academy

As promised last week, this week we're following up as planned:

*Next week we'll likely **cover the straightforward long call/long put approach we prefer** and from there we plan to wrap up with a "hybrid" concept that may help folks to add another arrow to their trading quivers.*

In doing so, we're going to *borrow* from an **OA** that we published several months back.

Last week, just to make things interesting, we covered **Approach #2** since it's "*new*" as an approach for this newsletter. Now we'll cover the very-familiar-to-long-time-readers **Approach #1** thus leaving **Approach #3** for next week. Got it? Good!

Approach #1

This week we hope to better explain what drives us to select the slightly-in-the-money options we typically default to in our trades. These types of options normally fall in the 65 to 75 delta range and deliver for us what we prefer: **lower risk and very respectable reward**. Read on!

Many folks that are new to options investing seem to be seeking a blueprint or a series of guidelines that they can use to apply the proper strategy, while using the right options to employ said strategy. This is only natural as they're operating in new territory that's much more nuanced than shares of stock, futures trading or mutual funds, and it certainly takes time spent *in the trenches* too before most people begin to feel comfortable. Quality options education programs normally steer new-to-options investors into using stock replacement options (SROs) and *with good reason*. This type of options selection is probably the most likely to keep an investor comfortable. That is, by using deep in-the-money options with high deltas and low theta, an investor will not be very far from stock-type performance, which is what they're already accustomed to experiencing. Remember, shares of stock have ZERO THETA and payoff penny for penny/dollar for dollar as they're 100 DELTA. Thus, a level of comfort can be found more quickly while using options as an investment vehicle if we select very high delta options as they payoff much like shares of stock and have relatively low theta since they have low extrinsic values. This stock-to-ITM-options conversion process normally goes smoothly. It's the NEXT step that seems to throw the proverbial *monkey wrench* into the mix...

We've made it clear that our preference is to use "*slightly*", or *moderately ITM options*. Students have often wondered why we'd choose to leave the positive qualities of stock replacement options (SROs) behind since, well, they've recently become very comfortable with those types of options. The questioning is only natural and once they've heard the reasons as to why the switch, they're then ready to take the next step themselves. Let's get into the details courtesy of good old *compare and contrast*.

What do stock replacement options (SROs) bring to the table for us?

Recall, that we get stock-like performance via high delta, low theta (low extrinsic value), in addition to much lower cost vs. stock ownership and we have an embedded "protective put" or "protective call" depending on if we buy a call or put respectively. That's quite a bit of very good stuff which is what makes options such as fantastic investment vehicle. Why would and why did we leave these benefits recently? Well, we didn't leave them entirely! Let's cover the *slightly*...

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*Slightly*s have lower deltas and higher thetas (greater than deep ITMs extrinsic value). This results in less initial payout on delta and greater theta each day. Again, many may be wondering: WHY???

Here's the thing, frequently, *slightly*s can cost ¼ to ½ or less than SROs which means that we only have about a quarter to half of the capital at risk! This is the main reason why they are intriguing to us especially when swing trading because, as the past several months have proven, conditions can become choppy. Additionally, their deltas may not be all that much less than those of SROs and if our expectations pan out, the high gamma that they offer will have us enjoying SRO type performance in very little time BUT for a fraction of the initial capital outlay (dollar risk)! That's pretty good stuff too! And, if our forecast doesn't work out or a news event undermines us, we won't lose nearly as much since we have only a fraction of capital at risk vs. SRO players and even more starkly vs. stock players. Remember, the entry and exit parts of the trade cycle are often the most-risky times!

To summarize, our focus that favors *slightly*s invites a little more in the way of theta risk with lower deltas, but it dramatically lowers our proceeds at risk in a market that we haven't felt as comfortable, say **2017 comfortable** with in for a while. Thus, we were able to continue to participate in a market has us concerned instead of sitting on the sidelines altogether.

Another way to understand the benefits is to consider this: Stock and futures operators managed to move the DOW around by over 1000 pts in 1 full session plus 1 opening earlier this year! If we'd been holding deep ITM (SRO) options during those extreme volatility phases, we'd have potentially paper-lost a much more significant portion of our ITM value than anything we've been exposed to at any time with our *slightly*s. With *slightly*s this temporary paper (intraday) loss would have been a far lesser loss yet we would still have been in the game in a significant way if our forecasts had played out, as they largely have but with much less stress!

Stock replacement options are typically described as being 80 to 85 delta options. That delta range delivers the very positive characteristics we discussed above and going deeper ITM than that range delivers decreasing marginal returns for each additional dollar that's spent. As a contrast, our *slightly*s are in the 65 to 75 delta range. And now for the P's and C's:

Pros

AAPL		APPLE INC COM		209.3653	+0.405	B: 209.36	A: 209.37	ETB	NASDAQ	±0.405		
Underlying												
		Last X	Net Chng		Bid X		Ask X		Size			
		209.3653 D	+4953		209.36 Z		209.37 J		5 x 3			
Option Chain		Filter: Off	Spread: Single		Layout: Delta, Gamma, Theta, Vega, Extrinsic, S...							
CALLS												
		Delta	Gam...	Theta	Vega	Extri...	Size	Bid X	Ask X	Exp	Strike	
31 AUG 18 (17) 100 (Weeklys)												
7 SEP 18 (24) 100 (Weeklys)												
		.90	.01	-.05	.09	.7097	21 x 30	17.35 M	17.80 X	7 SEP 18	192.5	
		.88	.02	-.05	.11	.8597	30 x 23	14.95 X	15.50 M	7 SEP 18	195	
		.85	.02	-.06	.13	.9847	2 x 32	12.80 N	12.90 M	7 SEP 18	197.5	
		.82	.02	-.06	.15	1.2097	35 x 47	10.50 X	10.65 X	7 SEP 18	200	
		.76	.03	-.07	.17	1.5597	33 x 51	8.35 X	8.50 X	7 SEP 18	202.5	
		.69	.04	-.07	.19	2.0847	50 x 52	6.40 M	6.50 X	7 SEP 18	205	
		.59	.04	-.07	.21	2.8347	53 x 55	4.65 X	4.75 X	7 SEP 18	207.5	
		.48	.05	-.07	.22	3.25	11 x 214	3.20 N	3.30 X	7 SEP 18	210	
		.37	.04	-.06	.21	2.09	22 x 14	2.07 Z	2.11 N	7 SEP 18	212.5	
		.26	.04	-.05	.18	1.26	24 x 8	1.24 X	1.28 N	7 SEP 18	215	
		.17	.03	-.04	.14	.725	14 x 101	.71 N	.74 Z	7 SEP 18	217.5	
		.11	.02	-.03	.10	.40	57 x 14	.39 H	.41 N	7 SEP 18	220	
		.06	.02	-.02	.07	.22	49 x 8	.21 H	.23 N	7 SEP 18	222.5	
		.04	.01	-.01	.05	.13	11 x 11	.12 N	.14 M	7 SEP 18	225	

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Compare the 69-delta call in Apple above to the 85-delta call. On the BIDs, the price of the 85-delta call is double that of the 69. So...for the same amount of capital at risk, we can control not 100 but 200 shares if we choose to do so. If not and we go 1 contract vs. 1 contract, we play the game for half the cost of the 85-delta player. Our theta isn't much greater, but our GAMMA is, and if we're fortunate with a good entry, we'll be getting high 70's/low 80's payoff in just a few bucks of movement. If the entry timing is poor, we lose less as we realize that we need to cut our losses and live to trade another day. Especially in markets that are increasingly noisier, very news-driven (day to day opaque) and during times which could be late cycle, with interest rates rising, we're much more comfortable playing the directional trading game with half the capital at risk vs. deep ITMs because we're still *rock stars* if things work out well and we lose much less if things move against us.

Cons

We make less in dollar terms if the trade works out well.

We have lower theta/extrinsic value levels to be concerned with during the life of the trade.

Summary

Going deeper ITM with stock replacement options (85-delta) is a smart move. It truly is a no-brainer vs. tying up much more capital via stock purchase. Why spend much more to not make much more and in doing so leave yourself unhedged with less flexibility, capital and less diversification? Going slightly ITM is, in our view, a refinement on that approach. It's all about getting the eternally sought-after "best bang for the buck" and in 2018's market/swing trading environment, we believe that the 70-delta range delivers just that and much more peace of mind to attempt to navigate the market's unending vicissitudes.

If you have questions, ask away in this week's **Morning Call** webinar ☺.

Reprint of Last Week's OA

Approach #2

Now, we'll go a little bit deeper into selecting good options strikes but also strategies! That's right, we're branching out as was noted last week! We're going to rework our plans, and instead of moving directly into why it works well to consider ITM options between 65 to 85 delta, depending on your goals and time horizon, we're going to weave in a discussion on using OTM spreads to help us profit. Why? Because this Summer has been FAR more boring and absent of sustained movement than we expected. With the *mélange* of background news, we've been observing for months, we believed that the *FED meetings* and the *Earnings Season* were likely to deliver some sustained movement for most stocks. That hasn't been the case as the SPX has remained bottled up for quite a bit of the past month or so. The most recent several days have delivered some movement but prior to the closing of last week, we hadn't made much progress for weeks. That's left us frustrated despite knowing that it is part of the grand scheme of things and that we can't have good trending action *ALL* the time... and we can add to

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that the we were bullish on the SPX for over a month with respect to our outlook, but haven't gotten follow-through from many our bullish stocks selections.

Thus, we've decided to outline 3 ways to approach directional trading while utilizing options. Now there are many, many ways in which that can be done to be clear. Our preferred way, a simple long call or long put strategy, obviously depending upon our directional bias, will only be profitable if movement develops to at least some extent and in agreement with our forecasts. We've written quite a bit about that and our options selection process and we will return to the simple long call/long put approach in the next week or two but, to illuminate on where we're going, we've decided to introduce the "*short vertical spread*" approach. It has its pros and cons and we're going to cover them now from the bull side. The bear side is virtually the same but naturally the opposite in terms of direction.

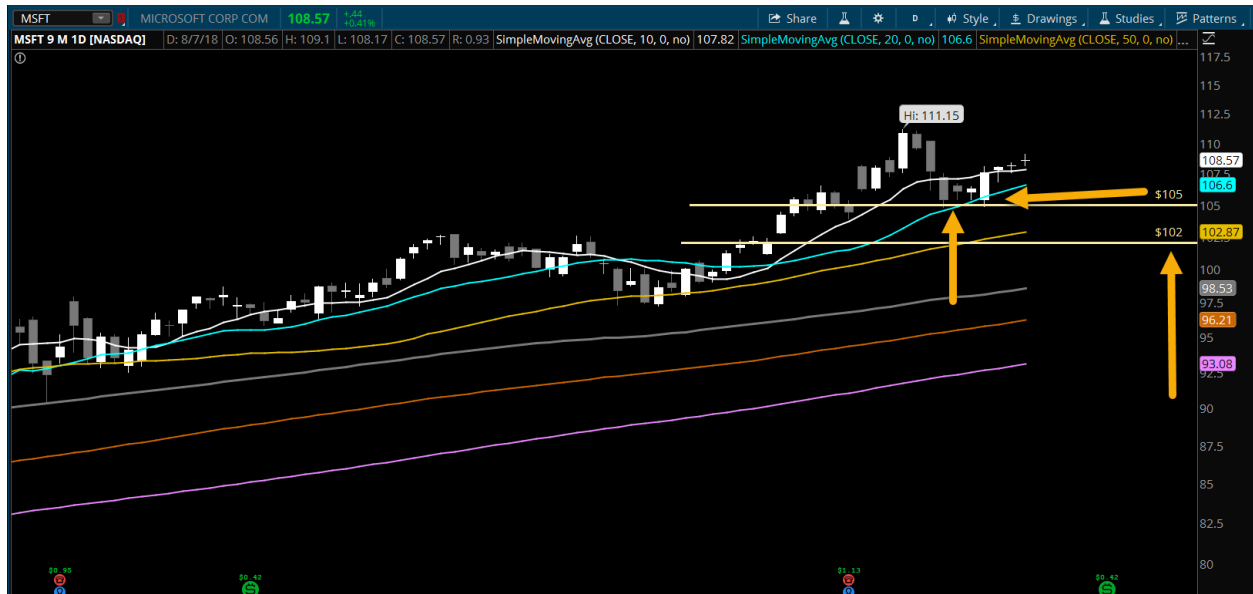
First, a visual!:



We'll use MSFT as our example stock and let's assume that we believe it is about to move up bullishly and it triggers but let's also go further. Let's assume that we expect MSFT to remain on the "*road*" it's on. If we believe that MSFT is to stay on that *road*, then we must believe that MSFT will NOT make the hard-right turn and veer off into the **RED X**. Can we make money if MSFT's stock price AVOIDS that area? Why **YES**, yes we can! Just another awesome thing about options, we can profit if stock prices AVOID chart areas too. So...instead of reaching for our trusty ITM calls, we're going to SELL an OTM Put Spread. In other words, if we believe that MSFT is moving higher, we believe that OTM puts will effectively decline in value and potentially become worthless. That would be EXACTLY what we want as sellers of an OTM put spread. We want to sell one option to profit from as it loses its value but buy another at a lower price to protect ourselves against unlimited loss potential. Thus, we sell one from which to make money and buy one against it to insure ourselves. Our hope is that both values decline to ZERO at expiration and we keep the PREMIUM we sold the spread for initially. It's a strange thing to buy something and hope it will be worthless but that's exactly what we want to see. We "sell now" hoping

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to “buy back later” for a lower price or even better to not have to buy back later because the spread is worthless. We simply keep the premium we sold the spread for at inception.



(Keep the above graphic in mind as you read below 😊)

So, let's get into the nitty-gritty. We've identified the \$105 level as the first nearby support level. Thus, we can sell that put strike because we want to bring in the most premium we can while selling at a perceived-to-be-safe technical level. MSFT shouldn't be able to easily plummet through \$105 due to the support that appears to be there.

Additionally, we then want to buy our insurance/protection in a put strike no lower than the next support level down to limit losses. That would be \$102. We'll now add in some real-world prices if we sell about 1 month out in time as a general starting point with MSFT near \$108.80:

The Short Put Spread:

Sold 1 Sept. 7th 105.00 Put for \$0.80 to collect premium/make money.

Bought 1 Sept. 7th 102.00 Put for \$0.40 to insure ourselves against practically unlimited losses.

Net: We bring in \$0.40 in premium (Extrinsic Value).

Expectations: MSFT moves up and the spread's value declines as the OTM puts become further OTM and thus Worth-LESS on their way to becoming entirely worthless! That's our hope.

CONS First:

We can only make \$0.40 or \$40.00 in the real world! That's not a windfall!

We can't easily morph this into an unlimited upside bullish position either.

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Additionally, we need to wait for the decay process to work in our favor which is not a very direct way to profits!

We can lose far more than we can make if this blows up in our faces! The Max Value of Spread is \$3.00. The difference between the strike prices ($\$105.00 - \$102.00 = \$3.00$). If we had to close this down for MAX LOSS, we'd have to pay \$3.00 to get it back after selling it for \$0.40. We'd take a \$2.60 loss!

We only make a little due to having the probabilities in our favor (see below).

Now PROS:

We're not asking the stock price to do much. All we want is for it to AVOID an area. That means that many other outcomes allow us to win! Goes up a lot, fine, we win! Goes up nicely, fine, we win! Sits still, fine. And so on.

With the stock near \$108.60, we can even have the stock drop 2% in price and still be safe and win fully!

We're starting out where the stock needs to be, above \$105.00. That gives us cushion to begin to adjust if need be and the stock unexpectedly sells off.

The delta of our short put, the \$105 strike, is only .23. The options pricing model believes that it only has a 23% chance of the option finishing ITM. Naturally, we can infer and flip that to see that it believes there's a 77% chance that the option expires worthless! That suggests that we have a high probability of winning and roughly should see our short put expire worthless, from 3 out of 4 to 4 out of 5 times over the course of time.

We don't have much work to do if MSFT stays above \$105, our short strike price. As long as it does, we count on the *Sun to Rise in the East* and as long as that happens with MSFT remaining above \$105, we're good!

Summary: We delved into this short vertical because we want readers to have another approach at the ready. The very nice thing about spreads of this type is that they'll profit if the recent stale environment persists while our long call/long put approach definitely needs movement to sustain for nice profits. If folks prefer one approach to another, now they'll have the basic mechanics to initiate trades in other ways to capture profits in the future.

Naturally, there are many variations on short vertical spreads, but the approach outlined above is rooted strongly within the chart's price structure and is sound with respect to options theory and application.

As a reminder, don't forget about the Decay Curve! We can't cover all possibilities but let's note that selling say the final 2 weeks of option's life is more lucrative than selling monthly when done so over time.

Next week we'll likely cover the straightforward long call/long put approach we prefer and from there we plan to wrap up with a "hybrid" concept that may help folks to add another arrow to their trading quivers.

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Finally, a **reprint** from a few weeks back for perspective on recent **OA's**.

Last week's **OA** centering on avoiding the "**3 Biggest Mistakes**" most new-to-options players make inspired us to follow up with a refresher on something very basic, but very powerful, that many of us take for granted. That being, the **Stock Replacement** strategy. We'll get into more details soon but let's not skip over the "nutshell" that makes this simple but fantastic:

We can have virtually all the upside potential a stock can offer but with far less downside risk and far less capital at risk. (Yes, we can flip it around if we'd prefer to a bear.)

That's just our beginning but the simple power of options as an investment/trading vehicle is unmatched and nothing else we're aware of even comes close! However, by refining our selection process when using them, and focusing on genuine "stock replacement" calls, we further enhance our approach in many ways, some of which we'll lay the groundwork to cover now!

First though, a requisite detour through options basics and options pricing fundamentals is in order.

"ITM" – in-the-money options are comprised of two building blocks:

1. Intrinsic Value
2. Extrinsic Value

We can write many words, or we can do this exercise to better understand these building blocks:

Current Stock Price = \$91.00

ITM \$85.00 Strike Price Call Option Price = \$7.00

Current Stock Price – Strike Price = INTRINSIC VALUE

\$91.00 – \$85.00 Strike Price = \$6.00 Intrinsic Value

ITM \$85.00 Price Call Option Price = \$7.00 - \$6.00 Intrinsic Value = \$1.00 EXTRINSIC VALUE

All non-option-based investors are putting up \$9100.00 to own 100 shares of this example stock.

WE, as options players (and since options are quoted on a per share basis just as stock shares) are required to put up \$700.00 to CONTROL (not own) 100 shares of the example stock.

Why 100 shares?

That's a standardized options contract deliverable number of shares except for in special situations.

Why \$700.00 in cost?

That's the options price of \$7.00 (as quoted) x the 100 shares in the standardized contract = \$700.00.

Hopefully, now we can see that \$600.00 of our option cost, the intrinsic portion, is merely us paying for a "stub" of the stock price that we seek to control shares of for a certain time. Put another way, we're putting up a small portion of the share price because that's already built into the option's value as it is IN THE MONEY! That \$6.00 of the option's cost, as quoted, is "equity" that's already a part of the option's value. What remains beyond that, the \$1.00 (as quoted in the markets) or \$100.00 (in the real world) is, by definition, extrinsic value which is also known as **time value**, which is very important to understand...

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The time value portion that we purchase is charged to us for many reasons in theory, but we can think of it as paying to participate in the potential the stock price offers over a certain period of time COMBINED with something incredible: **Leverage**. Our willingness to pony up that extra \$1.00 per share, SAVES us from having to put up all the extra money that's necessary to own the shares the way most Toms, Richards, and Harrys are still doing. It also does something else AMAZING for us by virtue of the fact that it prevents us from losing any more than what we've paid. If the stock price plummets below \$85.00, we as buyers/owners of the call option, are under NO OBLIGATION to take delivery of the shares. It is our right to take delivery of 100 shares if we'd like to, but we'd have no interest in buying shares at \$85.00 as the contract stipulates, if we could buy them say at \$75.00 because the share price has dropped by that considerable amount. Thus, it PROTECTS us below \$85.00 if we experience a good deal of adverse movement and limits our loss to \$700.00 whereas the stock player would experience a \$1600.00 so-called *paper loss* at the time as the stock price fell \$16.00 from \$91.00 to \$75.00.

Now, to be sure, we'd certainly experience some financial pain if the stock price dropped below our \$85.00 strike price in this example, but while the pain may linger, it would NOT INTENSIFY the way it would for the stock investor as \$85.00 gave way to \$80.00. then \$75.00. and so on, as is typical when cascade selling manifests itself. The shares-based trader has practically unlimited losses compared to the *smart* options investor. However, there is a negative aspect to this that we must cover...

TIME VALUE, which is that extra portion we're paying for, will fully dissipate as time passes and the option contract runs OUT OF TIME. That extra portion of extrinsic value that we purchase, can be thought of as rent we pay. day by day. to use that call option as our preferred vehicle. If we *ride it* all the way until it expires, we'd naturally pay the full amount of time value to have rented it. BUT, let's keep in mind that we're not required to hold the option contract all the way until it expires. We can EXIT the contract any time we'd like prior to the contract expiring and being permanently retired. Thus, we can rent day by day if we'd like and once we're no longer in need of the contract's services, we move on from it. That doesn't sound very threatening and it shouldn't as there's great flexibility in options. Much more so that most imagine. Folks tend to hear terms like "contract" and "expiration date" and begin to assume that their "married" to the situation once they enter it. That's simply not the case at all. We can exit options contract right after we've entered them, assuming the markets are still open.

Unfortunately, there's more to it than that and we'll need to use more time and more space than we originally planned next week in **OA** to thoroughly describe why it's not as easy as *picking an option, any old option*, to be consistently successful in investing. There's a smart place to position ourselves and we'll not only find it but fully explain why it is where it is and why that's the case.

If you have questions, please ask away in our next **Morning Call** webinar. ☺