MARKET TRACTION

Almost to Escape Velocity?

<u>This Week's Trade Ideas:</u>

(View Webinar*)

Bullish Ideas:

(View Webinar) AA > Alcoa > $43.03 Last. Buy the Sept. 21st 41.5 Calls for $2.90 or less with a close or anticipated close above $43.23 in an up market with expectations for continued strength in the major indices.

(View Webinar) RDN > Radian Group > $20.17 Last. Buy the Sept. 21st 20 Calls for $1.50 or less with a close or anticipated close above $20.26 in an up market with expectations for continued strength in the major indices.

<u>Bullish Mentions</u>:

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

CMCSA remains on the verge of moving higher despite being a frustrating idea from last week ☹**.**
LITE, but it's moved up quite a bit the past 2 days.
ZION and **CFG**, from last week, could add more with a little more push!

Bearish Ideas:

None at this time.

<u>Bearish Mentions:</u>
ETFC.

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 challenging of the All-Time-High in the SPX, that we've long-thought we'd see, then practically saw, then thought could be over for a while, is back! August is working out like August so far, and the next 2 months that follow have been challenging historically.

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%

Can bulls reach escape velocity and keep things going into the midterm elections that are just over 2 months away?

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:

As we expected a few weeks back, *they're* back to ignoring Turkey in favor *China Dreams*, at least for now, and that combined with solid news helped the bull's case last week. Which was fortunate for us, because though we tried, we couldn't turn up solid bear ideas aside from **GT** which failed to trigger and that was a blessing! Because, despite early panic on Wednesday morning, the bulls were able to hold above a line in the web of support that we highlighted, and it has been up, up and away ever since. **GT** did flirt with triggering on last Wednesday's market weakness, but it managed to close above our trigger level and just like the market, it hasn't threatened to move lower since that early scare.

The good news from last week is that we had many more bull names at the ready and since the market became more bullish after Wednesday and remained so, we had the chance to profit in several names.

WMT was most definitely the highlight of the week and we did provide an update or two on it as a result. As longtime readers know, we don't often mention names with earnings releases pending as we view earnings as a crap shoot in most cases. We couldn't help but mention **WMT** as we viewed the technical picture as being a very positive one. We also recognize that some like to trade earnings where we typically do not. Fortunately, the bullish complexion in the stock was not misleading and the earnings release delivered a huge upside move. **WMT** closed the day prior to the release at $90.22 and the day of the release it reached a high of $100.21 thereby making almost a $10.00 pop to the penny. We're not sure who, if anyone, became involved in **WMT,** but hope that some did as it was a very powerful and nearly instant windfall if one took the gift that was given to them and didn't look at the proverbial gift-horse the wrong way. As for the other names on the bull side, we finally can't complain! It's been many weeks since the markets trended for a while and we're happy that it happened again because it proves that if the gang permits stocks to move, we can profit from it!

SBUX and **CMCSA** were our two official bullish ideas and the mentions were Walmart, **WBA, ZION, CFG, PCAR** and **CAH.** We'll cover them and sort of in order…

CMCSA has tried to move up but its 200 SMA has kept it tamped down. It's still close if it can surmount that 200 SMA challenge.

SBUX has moved up nearly $2.00 since last week's deadline but while it did move, it didn't explode higher as we would have liked to see. **WBA** also moved up about $2.00 but it too didn't explode northwardly. **ZION** and **CFG** both moved up *OK'ly*, but neither exploded as hoped as they couldn't get above resistance levels that would unleash more run potential.

CAH also moved up but it too failed to rumble higher and is being persuaded to hold itself below $52.00 thus not allowing it to attack a much higher resistance level that's north of here.

PCAR however, was a very solid performer running up nearly $4.00 to just under our resistance target.

Last week, like the week before has things trending even more on the right direction. We got some movement that helped two weeks back and last week we got even more. It wasn't the explosive kind we seek aside from the Walmart earnings blastoff. Hopefully the markets will finally rip out of this and we'll get sustained trending movement for a while.

The low-volatility environment finally blinked but in case we see more of it in the future, please see ***Options Academy***.

Market Overview

Once again, support of a kind held, and the Gang forgot all about INTERNATIONAL TURMOIL! At least for the time being. AND…they're back in LOVE with Retail. In fact, it's pure passion at this point!

We've got to believe that they're feeling better about the consumer if this is how they're behaving in **XRT** and that could bode well for the 2nd Half's GDP which would seemingly bode well for the major indices. The Nasdaq appears to be playing possum:

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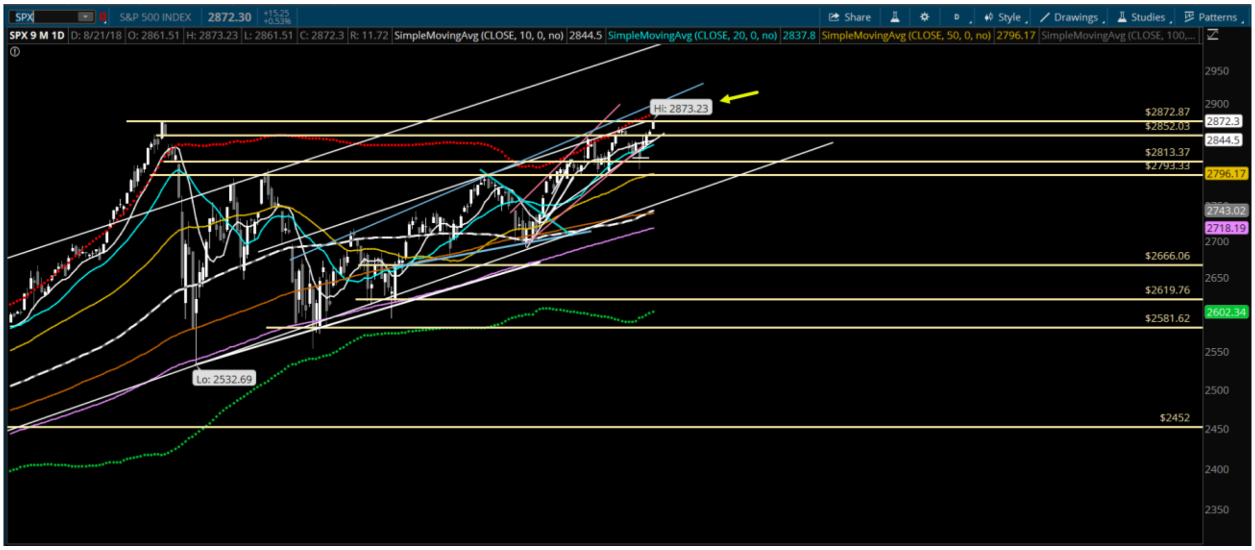
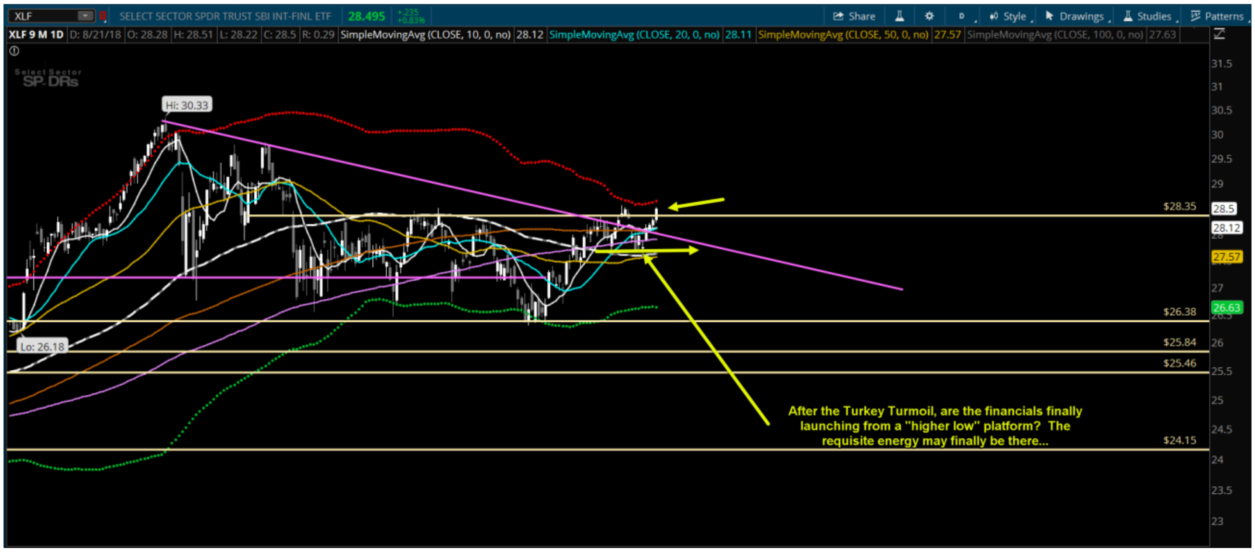
But the DOW is attempting a break out:

While the S&P 500 has **<u>FINALLY MADE A NEW ALL-TIME-HIGH</u>**:

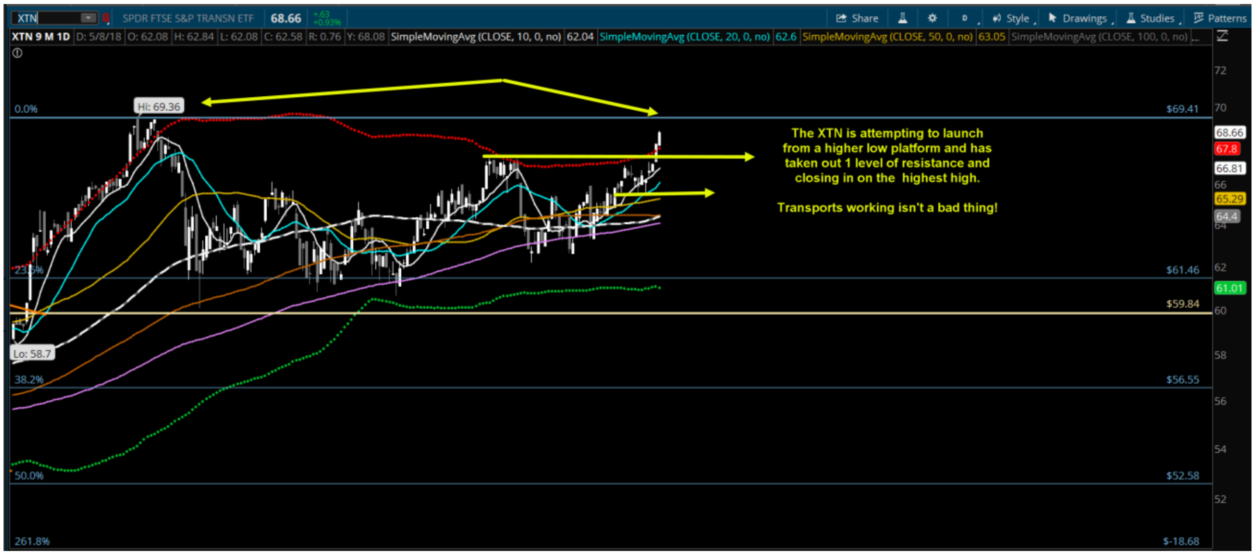


Let's now check in on a few key areas of the market that have begun to fare better with Turkey now off the news menu…

First, the Financials, an area we've attempted to be bullish on more than a few times of late:



They look much better and so does another key area, the Transports:

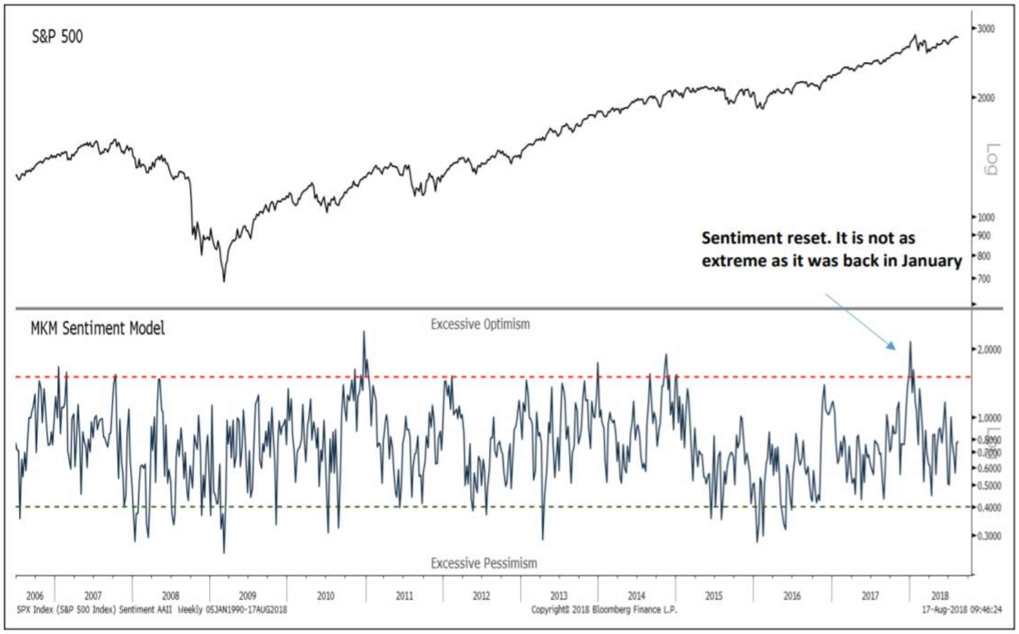


With the DOW working again and the Transports working again:

Chart 10: Dow Theory - Dow Industrials (top) & Dow Transports (bottom)

Source: BofA Merrill Lynch Global Research, Bloomberg

That's likely to be interpreted bullishly and received well! AND, things aren't overly frothy yet, and it is not even close:



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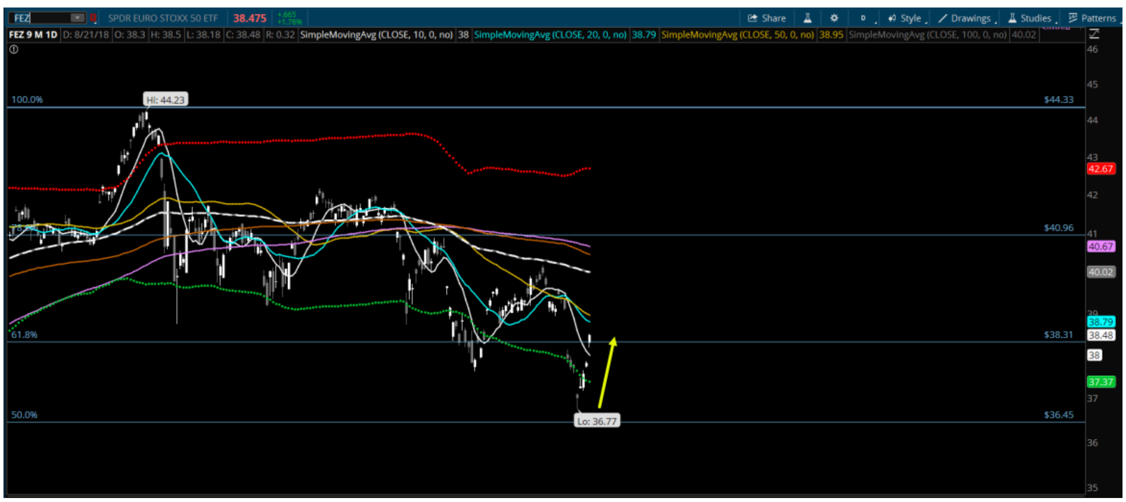
But we're not done yet:

AND, even Europe and China are looking better so for now, the party seems to be reviving:



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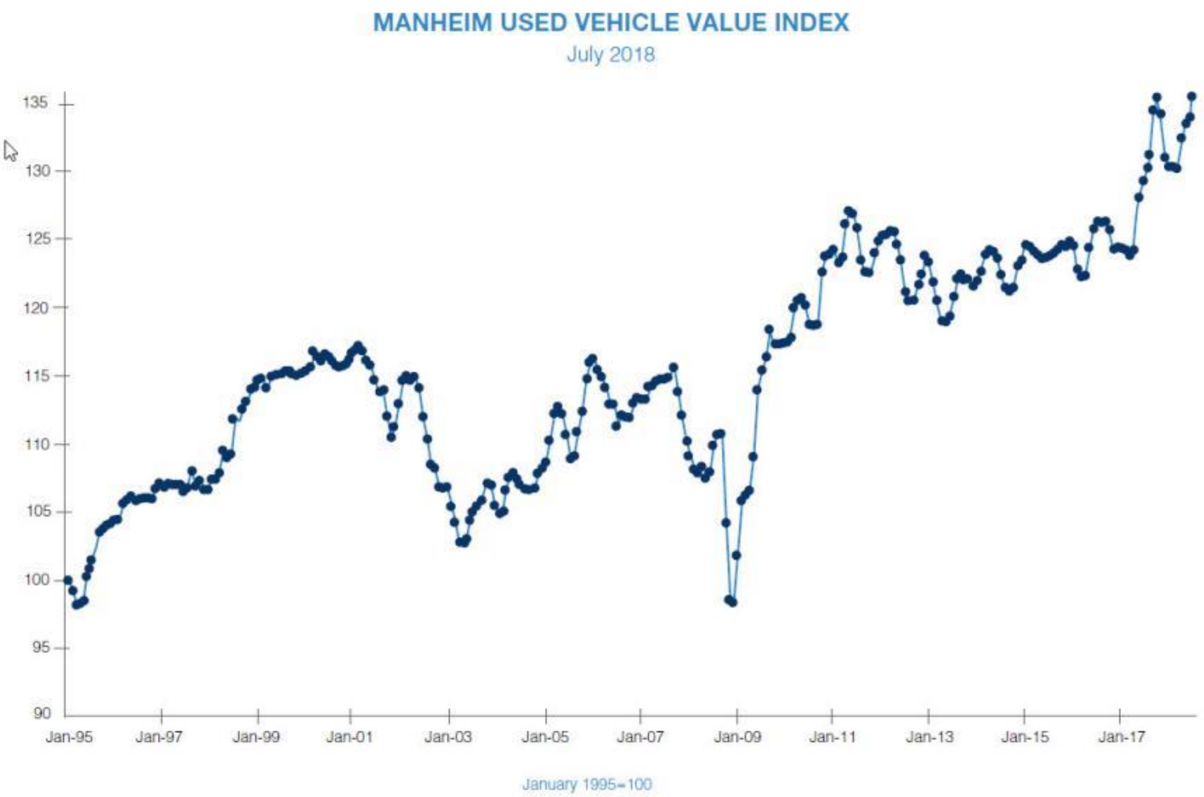
The conclusion at this point must be that August is trying to act very August-like and we're about to see a real breakout or a false one. We have to treat it as real until it isn't!

Additionally, if you'd like to peek at an offbeat indicator, check this rather bullish information out:

https://www.zerohedge.com/news/2018-08-20/used-car-prices-hit-all-time-high



The calendar, as is often the case, is a little lighter this week after a fairly-heavy week last week. We must favor the FED minutes on Wednesday and FED Chairman Powell speaking on Friday as the biggest news items on the calendar. As we asked last week: *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?* The shift to new information seems to be on, at least for now…

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This Week's Economic Calendar

TIME (ET)	REPORT	PERIOD	ACTUAL	MEDIAN FORECAST	PREVIOUS
MONDAY, AUG. 20					
	None scheduled				
TUESDAY, AUG. 21					
	None scheduled				
WEDNESDAY, AUG. 22					
10 am	Existing home sales	July		5.40 mln	5.38 mln
2 pm	FOMC minutes	7/31-8/1			
THURSDAY, AUG. 23					
8:30 am	Weekly jobless claims	8/18		215,000	212,000
9:45 am	Markit manufacturing PMI (flash)	Aug.		--	55.3
9:45 am	Markit services PMI (flash)	Aug.		--	56.0
10 am	New home sales	July		640,000	631,000
FRIDAY, AUG. 24					
8:30 am	Durable goods orders	July		-1.0%	0.8%
8:30 am	Core capital goods orders	July		--	0.2%
10 am	Jerome Powell speaks				

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Below the Radar – Special Late Summer Prep for the Fall Edition!

This week won't be as scary as last week, and it will also be a more balanced…

Mainly because the *Media is Gonna Media*, we're including this link regarding the *historicalness* of this bull market;

https://www.msn.com/en-us/money/markets/why-the-longest-market-rally-in-history-might-be-bull/ar-BBMdqHo?li=BBnbfcL&ocid=SK216DHP

It's literally on the eve of becoming the longest ever but that depends on how and who's looking at it. We're not caught up in all the arguments but it's a mildly interesting read and we note it because when the media puts on their celebratory regalia, the fallout a few months later can be severe!

Now that that's been addressed, let's get into it.

We've done our fair share of bellyaching over the past month or so and even at other times, but we may have been justified to complain 😊:

https://www.marketwatch.com/story/dows-200-point-tumble-puts-it-at-risk-of-the-longest-stint-in-correction-territory-in-nearly-60-years-2018-08-15

The Dow Jones Industrial Average notched a dubious distinction on Wednesday, as U.S. equity benchmarks fell firmly lower, and extended it on Thursday despite a powerful rally.

The blue-chip benchmark failed to move 10% above the closing low hit earlier in the year, and has now spent the longest period in correction territory — 132 trading sessions (as of Thursday's close) — since the 223 sessions in 1961, according to Dow Jones Market Data.

*MarketWatch's Ryan Vlastelica has noted that **such protracted stock-market corrections are extremely unusual**. According to Dow Jones data, the average correction for the Dow has lasted a little over 50 trading sessions since the inception of the 122-year-old equity gauge. The past five corrections, on average, have lasted fewer than 40 trading days. (It's worth noting that the averages don't also include drops that pushed the Dow into bear-market territory, defined as a drop of at least 20% from a recent peak.)*

***Stocks have mostly moved in fits and starts this year**, with the Dow, particularly, facing stiff headwinds as worries about trade wars between the U.S. and China and other major developed economies have continued to dog the benchmark, which comprises some of the biggest companies in the world, many of which are notably vulnerable to trade tensions.*

At least we have proof, good proof, that it wasn't our imagination!

While we see the major indices on the verge of attempting bullish breakouts, another story we came across reminded us to once again always be respectful of risk:

https://www.marketwatch.com/story/the-stock-markets-latest-sell-signal-has-happened-only-5-other-times-since-1895-2018-08-21

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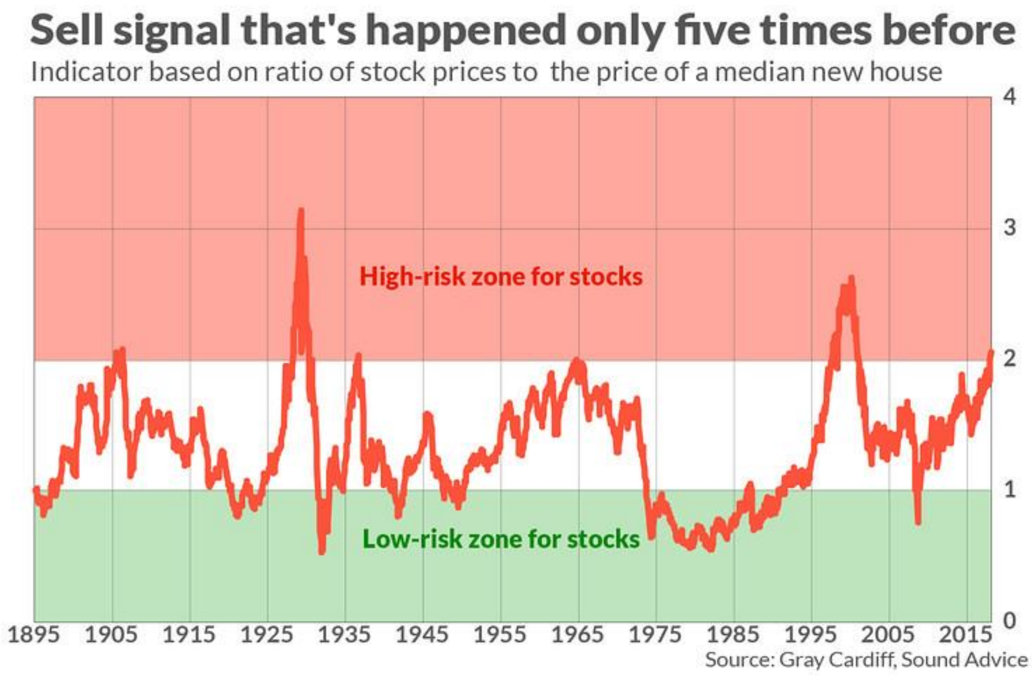
Would you be interested in an indicator with more 100 years of history, an excellent record at calling multi-generational tops in the U.S. stock market, and which has just flashed only its sixth sell signal since 1895?

*Of course you would. That's because most of the indicators with solid long-term records — such as the Cyclically-Adjusted Price Earnings Ratio, or CAPE, **made famous by Yale University professor and Nobel laureate Robert Shiller** — have been in "sell" mode for so long that many have stopped paying attention.*

*The "Sound Advice Risk Indicator" is a different story. This indicator, the brainchild of Gray Cardiff, editor of the **Sound Advice newsletter**, is derived from the ratio of the S&P 500 **SPX, +0.47%** to the median price of a new U.S. house. For the first time since the late 1990s, and for only the sixth time since 1895, this indicator has risen above the 2.0 level that represents **a major sell signal for equities.** (See accompanying chart.)*



The investment rationale underlying this indicator, according to Cardiff, is that it "measures the struggle for capital" between the two major asset classes that compete for capital at the riskier end of the spectrum — stocks and real estate. When the indicator rises above 2.0, he argues, it means that the stock market has absorbed "a larger proportion of available investment capital than economic conditions can justify" and, therefore, it is in "imminent danger of falling."

Now, we'll break to swing back to the positive side to keep this even keel.

https://www.marketwatch.com/story/this-historic-bull-market-could-run-at-least-another-year-2018-08-21

Sam Stovall's take, to be found above, is worth the read to appreciate that we can't fight with something that could work for a bit longer.

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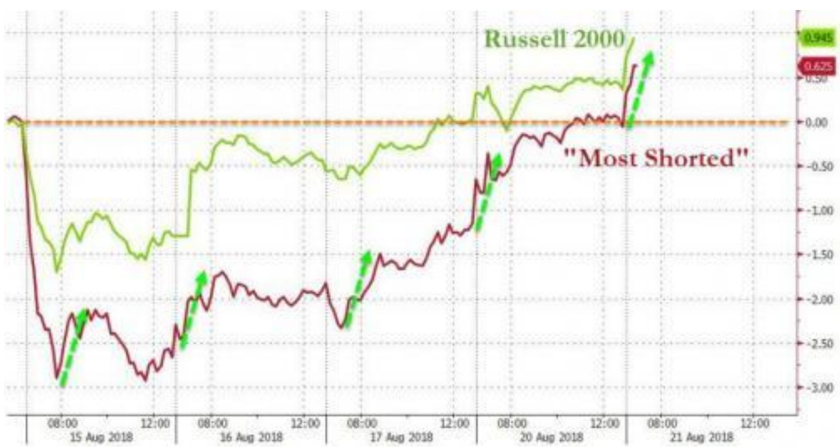
And now, back to scary! Keep in mind that *bad stuff* can occur for quite a while in front of bull market tops!

https://www.zerohedge.com/news/2018-08-21/us-foreclosures-rise-first-time-36-months

The surprising reversal in the US housing sector comes at a time when the US economy is reportedly firing on all four cylinders, with the stock market at all time highs and not long after the Department of Commerce revised income and spending data to "discover" that US households had actually saved twice as much as previously expected. Which begs the question: is the rise in interest rates a sufficiently adverse development to offset all the other favorable trends in the economy, or is something more sinister - and unknown - taking place in the US economy.

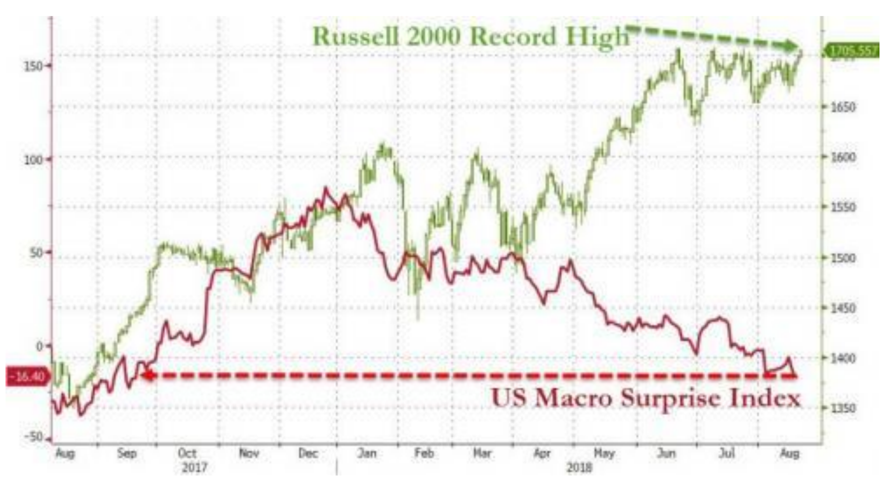
We also found a piece covering the “game within the game” that argues that hedge funds have been rocked by recent market developments and are getting crushed in a short squeeze as stock prices have rapidly begun to run higher:

https://www.zerohedge.com/news/2018-08-21/hedge-funds-rocked-relentless-short-squeeze



Ummm, think there’s a correlation there?

We’ve seen these many times before and once the short squeeze lighter fluid burns off, there better be improving fundamentals or stocks will *woosh* right back down! Other things could cause stocks to *woosh* right back down as well:



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With the US MSI continuing to work lower as domestic stocks work higher, that lends credence to the short squeeze argument and stirs more risk into the mix. It's never that easy!

And it may get much more difficult if China Trade Deal Dreams are Dashed!

If we finally see a breakout, let's hope it's not a false one that's based upon a short squeeze!

Bank and Roll like fiends!

Options Academy

As promised last week, here's **Approach #3**! The often overlooked but truly *powerhouse* strategy known as the **Diagonal Spread**.

Batten down the figurative hatches because this week is a looonnnggg one! Maybe the longest **OA** EVER! We headed back to the spring to mine a write-up we did on **Covered Calls** which laid the groundwork for coverage of the **Diagonal Spread** the following week. We decided that this exercise should be done longform and thus it is very wordy! However, we plan to follow up next week with graphics etc. while delivering the goods as to why the **Diagonal Spread** is by far our "favorite" true strategy. Most, including us at times, classify going long call or long put as a strategy. It's splitting hairs but we've always viewed them as alternative investment vehicles vs. long stock/short stock. They're our top strategy and especially so for shorter-term trading but the **Diagonal** isn't very far behind at all!

Let's tackle the far inferior **Covered Call** strategy first so that the *pure awesomeness* of the **Diagonal** can be best appreciated.

The Covered Call – A Dividend Crusher

We're heading into MSFT to get things started. In our example, MSFT is currently trading at $96.95 and we can sell the *30 Day Out* the slightly OTM June 97.5 calls for $1.85. (There are other ways to do this, but this one will work for us for now.) We selected that call as it brings in nice chunk of premium in just about 1 month (31 days). That will provide us with easy extrapolation for a full year (12 months). We can be more aggressive sellers by selling only 1 or 2 weeks out in time, but we're keeping it simple as the concept is more important than the mechanics at this point. We'll look at 3 outcomes of the many that are possible:

A: The stock *sits still*, and we collect the full $1.85.

B: The stock rises to $97.50 where it closes on expiration day.

C: The stock drops $1.85 from where we bought it and closes there on expiration day.

Let's work out Scenario A. We buy 100 shares for the current price of $96.95 and sell 1 June 15th 97.5 call for $1.85 and the stock closes on expiration day exactly where we bought it at $96.95. In this scenario, we make nothing on our stock position but make $1.85 by selling the call. Our return for the month is: $1.85 / $96.95 = 1.9%. That's pretty-darn good all things considered (interest rates!). Let's project that out over 12 months but without any fancy compounding math. 1.9% x 12 months = 22.8% annual return! (simplified). That's very good and we're doing it on what's considered a very safe stock which is a very important part of the process. It's hard to knock this outcome.

Now, Scenario B. It's pretty much the same but better than A. In this case, we keep the full $1.85 of premium on the call but add $0.55 of profit due to the stock rising. Thus, we make $1.85 + $0.55 = $2.40 for the month. $2.40 / $96.95 = 2.47%. Even better than A above! Over a year above: 2.47% per month x 12 months = 29.64%

And finally, Scenario C. The stock drops $1.85 from where we bought in to $95.10. We lose a $185.00 on the shares but make $185.00 (in the real world) via the sale of the call which offsets our loss in the stock. Thus, we lose nothing! We have about a 0% return using this simple math approach but normally, had we not *written* a call, we'd have lost about 2% ($96.95 x 2% lower = A loss of $1.93.)

A Note before we move on: Because we receive a credit on the sale of the call, our basis is not $96.95 in these scenarios but a $1.85 lower: $95.10. Thus, our performance was even better, but we wanted to keep it very simple.

Now, back to it, albeit briefly. We covered the covered call this week under 3 scenarios. There are many other possible outcomes, but these are 3 key ones we can use to compare this approach to a superior approach next week. Remember, we're not big on covered calls, so we'll compare and contrast this to the other approach next week.

Before we conclude, we want to note that MSFT pays a $0.42 dividend each quarter for a total of $1.68 in dividends for the year. The stark contrast should be obvious. In ONE month, if we write the proper call, we can make more in premium collection than capturing an entire year's dividend stream. That's very powerful. Granted, there's risk to be taken and there are tradeoffs, but there's risk in owning stocks and trying to collect dividends as well.

The Diagonal Spread – Follow Up after the Covered Call

We'll use slightly different prices but the same start date we used last week in MSFT. MSFT closed up at $97.32, that's just a little higher than our Covered Call simulation last week. We're going to adjust for that, but it really doesn't change much. This week, instead of buying shares of MSFT, we're going to buy an outer-month deep ITM call to serve as a proxy for shares. There are many ways to go about selecting this "anchor call", but for now, we're going to keep it simple and move out to just after the Summer and into a September contract. We'll then select the 4-Month-Out (120 Days Out) 80 calls which we can buy for $18.15. This will serve as our replacement for 100 shares of the underlying MSFT stock as it effectively allows us to control 100 shares for several months and serves to cover the risk we'll entail when we sell our premium collection call next. Please note that this call purchase creates a $98.15 breakeven point* on this leg alone. Once again, let's lay out our 3 scenarios:

We can sell the very slightly OTM *30 Days Out* 97.5 calls for $1.97. (There are other ways to do this, but this one will work for us for now.) We selected that call as it brings in nice chunk of premium in just about 1 month (31 days). That will provide us with easy extrapolation for a full year (12 months). We can be more aggressive sellers by selling only 1 or 2 weeks out in time, but we're keeping it simple as the concept is more important than the mechanics at this point. We'll look at 3 outcomes of the many that are possible:

Scenario A: The stock *sits still*, and we collect the full $1.97 but it's not as straightforward as last week! Last week we utilized shares of stock to write this call against. Shares have no decay since it has not time value! It simply exists in perpetuity*. Options, though, do have decay associated with them, obviously. So, we have to account for that here on the one we own. There are other assumptions we're making as well but we're keeping this simple! So, for now, we must note that if MSFT sits at $97.32 on June 15th, our Sept. 80 call will have lost $0.59 due to decay. Thus, dollar wise, we're not up the full $1.97 but rather $1.38. Thus, on our $18.15 stock proxy call, we'd make $1.38 on that for the month: $1.38 / $18.15 = 7.6%! That's very, very darn-great compared to the covered call's 1.9% from last week! Now, let's project that out over 12 months but without any fancy compounding math. 7.6% x 12 months =

91.2% annual return! (simplified), vs. last week's 22.8%! We're crushing the covered call and once again we're doing it on what's considered a very safe stock which is a very important part of the process. It's much, much harder to knock this outcome and now much easier to knock last week's similar scenario, which, actually, looked pretty-good for a minute or two there!

Scenario B: The stock rises to $97.50 where it closes on expiration day. In this outcome, we net $1.55 because the stock is up a little and we're net long delta. We'll take it! Thus, $1.55 / $18.15 = $8.5% for the month! This is an ideal outcome which is similar but better than A. In this case, we keep the full $1.97 of premium on the short call but and lose less on our anchor call due to the stock price rising. Thus, we make $1.55 for the month. $1.55 / $18.15 = 8.5% per month x 12 months = 102% annually! Woohoo!

Scenario C: The stock drops $1.97 from where we bought it and closes there on expiration day. $97.23 - $1.97 = $95.26. Naturally, we keep the $1.97 but we'd lose on decay and on delta in our outer-month call for a total loss on it of $2.33 on it. Thus, we'd lose $0.36 to that point. NOW, had we owned the stock instead, we'd have lost $1.97 on our shares which would perfectly be offset by the $1.97 of short call income and thus our net would be $0.00 (Otherwise known as Kent Dorfman's GPA 😉) On this one, we'd lose a little more even though we had lower delta with our ITM call than stock. This is due to decay over 31 days.

As we noted last week, because we receive a credit on the sale of the short June call, our basis is lower than the $18.15 we paid for our anchor call in these scenarios, it's actually $16.18. Again, our performance was even better, but we wanted to keep it very simple and so we're leaving that alone.

Moving on…there are many other scenarios that can play out but to keep it consistent we kept the same 3 as last week. In scenarios A and B, we dramatically improved our return percentage. If we committed the same amount of capital as we would have in the buy write/covered call scenario, we could have traded 4X as large and thus quadrupled our already far superior returns. In short, there's a lot to think about but it is very clear that a **Diagonal Spread** is far superior approach to the **Covered Call** even considering scenario C's slightly worse loss.

NEXT WEEK WE WILL DISCUSS DIAGONAL SPREAD AGAIN BUT FOCUS ON PRACTICAL AND THEORETICAL ASPECTS TO ROUND OUT MATTERS.

BELOW you'll find the other approaches and the past few weeks of OA so a full read or a re-read can be easily had and referenced.

Approach #1 – The Slightly ITM

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 "*slightlys", 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 *slightlys*…

Slightlys 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???

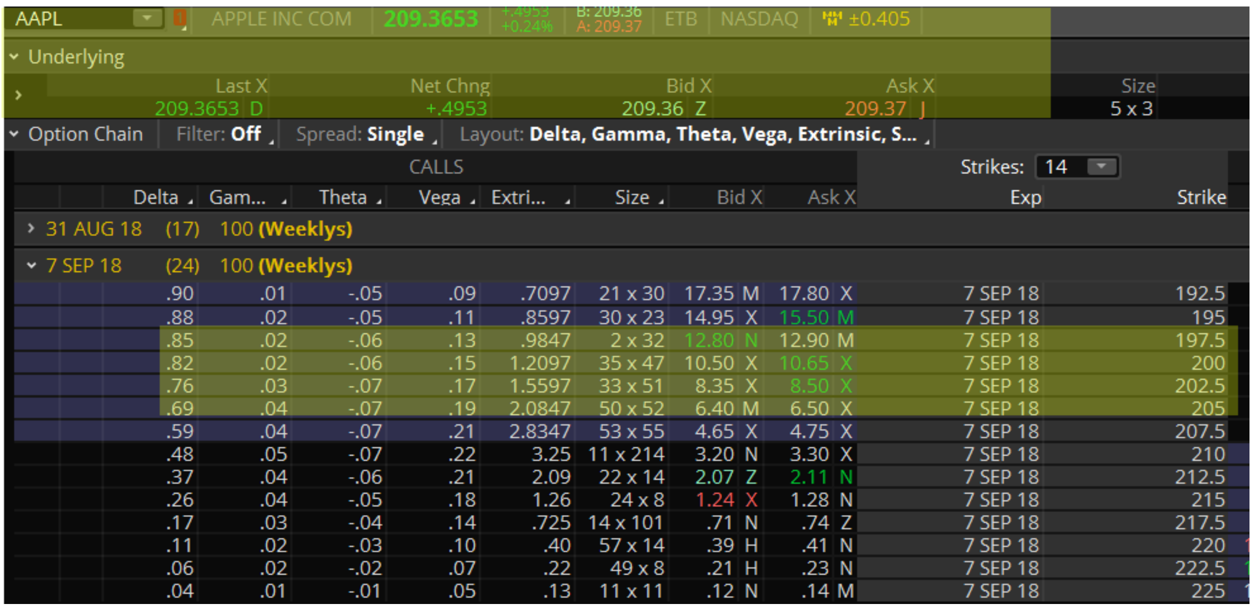
Here's the thing, frequently, *slightlys* can cost ¼ to ½ or less than SROs which means that we only have about a quarter to half of the capital at risk! This is the main reason why they are intriguing to us especially when swing trading because, as the past several months have proven, conditions can 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 *slightlys* 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 *slightlys*. With *slightlys* 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 *slightlys* are in the 65 to 75 delta range. And now for the P's and C's:

Pros First:



AAPL | APPLE INC COM | 209.3653 | +.4953 +0.24% | 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 | Strikes: 14

31 AUG 18 (17) 100 (Weeklys)

7 SEP 18 (24) 100 (Weeklys)

Delta	Gam...	Theta	Vega	Extri...	Size	Bid X	Ask X	Exp	Strike
.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

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.

Now 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 Cal**l webinar 😊.

Reprint of Past Week's OA

Approach #2 – The Short Vertical Spread

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

MARKET TRACTION

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 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.

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.

Finally, here's a reprint from a few weeks back for perspective on the past few weeks.

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…

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 **<u>something incredible</u>**: **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 Cal**l webinar. 😉