Money & Markets
PRECISION PROFITS

Trading Spreads:

Collect Low-Risk Income in Any Market Environment

By Michael Carr

I understand the problem.

You want income. Low interest rates destroyed traditional income investments.

So, you pursued alternative income strategies and bought income stocks. Then you realized that 3% dividend yield wasn't enough to offset the 20% decline in the stock's price.

You added real estate investment trusts (REITs) to your portfolio. Then you got a tax form telling you that part of your dividend was actually a nontaxable return of capital. Unless you're a CPA, you might not have known what this meant. Basically, that part of the dividend wasn't taxable income for that year. Instead, it lowered your taxable basis in the REIT and will be taxed later, when you sell.

No one warned you that REITs could complicate your taxes, and now you're annoyed.

For a moment, you thought about buying an investment property. Many people do that, and they like their returns. But others find the returns never match expectations since unexpected maintenance or other expenses reduce income.

Plus, there's tax complications.

Although you learned a few things that didn't solve your problem, you still didn't have a solution for income. You kept searching. After reviewing preferred stocks, various types of notes and other assets, you still didn't have a solution.

At this point, like many investors, you looked at options for income. Selling puts seemed like a good idea. At first it was. You had steady income. But then you suffered a big loss. That single loss wiped out three months or more of income.

This happened to many investors who ever tried selling options for income.

Fortunately, I believe there's a better way to generate income.

Before I explain exactly how it works, we need to first take a look at a popular income strategy that ours is based on.

Why It's Dangerous to Just Sell Puts

Put options increase in value when prices fall. If you buy a put, you can profit in a down market.

Because they rise when prices fall, puts decline in value when prices rise. If you bought that put, you will lose money if the underlying stock rises.

Now remember, there are two sides to every trade. If you buy a put, someone has to sell it to you. That person makes money if you lose money on the trade.

Since stocks go up more than they go down, some investors think that selling puts seems to be more profitable than buying them. Traders believe put selling is a high probability trading strategy. They claim it has a win rate of 75%.

Years ago, I tracked down the source of that claim. It was a study using data from 1997 to 1999. But it didn't look at stocks.

That study looked at options on futures contracts. It found that 76.5% of options on futures held to expiration expired worthless. I'm surprised the number is so low.

Only contracts open on the expiration date were included in the study. Winners or losers closed before that day were excluded. I went through exchange data and found just 5.5% of all contracts traded during those three years expired worthless.

So, the data shows you can't expect a contract to expire worthless. Yet, this is the foundational belief of many traders who use this strategy.

Their lack of research often results in an unexpected loss. Since they believe they will win an overwhelming amount of the time, some ignore the risks. Then there is a market selloff and the loss on a single position becomes large. In fact, it becomes large enough to wipe out several months' worth of income.

I suffered three losses in that time. Those losses wiped out more than six months' worth of gains.

My research, based on a list of previous black swan events showed that there was no way to avoid occasional large losses with a put selling strategy.

There were ways to reduce that risk. A different strategy is needed.

Cutting Risks With Spreads

A spread requires entering orders for multiple options contracts at one time.

For example, we can sell a put for income and buy a different put to limit risk. These trades fix the problem with a traditional put-selling strategy.

We still receive income immediately. This met one of my goals. It also limits risk, which attains my primary goal. An additional benefit of spreads is that these trades require a small amount of capital. My recommendations will always require less than $500 in capital. Usually it's less than $250, and sometimes less than $100. Put selling, on the other hand, often requires thousands of dollars of capital to open a trade.

Now, there is a potential downside to this strategy. Because they require low amounts of capital, they generate smaller amounts of income, often less than $50 per contract. We will overcome this shortcoming by placing these trades more often.

You may see an income trade alert every week. They are always short-term trades and will sometimes be open less than a week. Other trades will be open a few weeks. I'm a short-term trader, so my recommendations will never be open for months.

Let's look at an example.

On June 27, I recommended to our internal team a trade in BioNTech (Nasdaq: BNTX). The instructions were to sell a put with an exercise price of $134 that expired on July 1. This meant that we would profit if BNTX ended the week above $134. The stock was at about $143 that day, but BNTX is volatile. It could easily fall $9 before the option expired.

To limit the risk, I recommended buying a put with an exercise price of $131 that also expired on July 1. This gave us the option to sell BNTX at $131. If the stock fell sharply, this option limited our risk since we were 100% protected below $131.

For this position, I recommended entering the trade for a credit of at least $0.40.

Now, it's possible to open a credit or debit spread. A debit spread requires a cash outlay to open the position. A credit spread results in immediate income. I always recommend credit spreads.

When you open the position, your broker allows you to open the trade as a spread. By doing this, there is no risk of a large loss. At expiration, one contract offsets the other.

In this case, at expiration, BNTX was at $157.50. Both options expired worthless, and we kept the credit received when we opened the trade. I was able to enter at $0.44. Five contracts generated an income of $220.

My broker required a margin deposit for the trade based on the difference between the exercise prices of the options less than the credit received. The difference between the exercise prices was $3, and the credit received was $0.44. That totals $2.56. Each contract covers 100 shares, so the total margin required was $256. That was also the maximum risk of the trade. No matter what happened, it was impossible to lose more than $256 per contract.

You can look at the gain in one of two ways. It was a 100% gain since I kept the credit. Or it was a 17% gain on the margin deposit of $256. That's an excellent return considering the trade was open just five days.

If I could make a similar trade every week, the income would be substantial in a year. In one month, I actually made three trades like that.

A trade in the SPDR S&P 500 ETF Trust (NYSE: SPY) was opened on June 13 and closed two days later. The credit on the trade was $30 per contract. The risk was $170.

On June 7, I opened a trade in Affirm Holdings Inc. (Nasdaq: AFRM). The credit was $31 per contract and the risk was just $69.

For the month, that was income of $105 per contract. Risk was $495 for all of the contracts. Since all contracts expired before the next trade was opened, this required a small capital commitment.

Realistically, $500 would allow me to trade this strategy. In June, that would have allowed me to generate $321 in income. With $5,000 committed to this strategy, the income would have $3,210. Over the course of a year, the potential return on capital is more than 100%.

My Rules

To collect income in any market environment, I follow a strict set of rules.

Find the right stock. To benefit from a spread, we want a stock that is moving in the same direction as the broad market.

That means we will want a stock that's moving. Some of my recommendations will be on stocks that have just released news and made a large move after that announcement. Others will be based on a change in the trend of the stock's underlying volatility. Some will be based on momentum.

All of my recommendations will be in active, liquid stocks. Liquid stocks are those that are easily traded. I only look at stocks that are components of major market averages. I know we can open positions in these stocks because they are included in index exchange-traded funds (ETFs). We may also trade ETFs that track major market indexes.

Market makers will always be willing to take our trades in stocks like this because of some technical market structure factors.

Find the right options. Here we are simply looking for trades that offer significant income, low margins and a high probability of success.

You're probably thinking: "This is too good to be true. What's the catch?"

Well, frankly, the risk is you.

There will be some losses with these trades. Committing too much capital to these trades can lead to large losses. If you committed too much capital to the trade, a loss can become an issue. Fortunately, this problem is easy to avoid.

The best way to prevent that is to decide how much money you'll allocate to this strategy. Divide

that by five, the maximum number of positions I will have open at any one time. Then make trades with that amount.
As your account balance grows, or shrinks, review your allocation. Have a plan for that. Maybe you will review the allocations after you balance increases 10%. Then, you'll take half the profits out of the account and take future positions based on your new capital allocation.

That's just one example. There are countless ways to decide how much capital to allocate to spreads. But don't risk more than you can afford to lose and don't overtrade. If you avoid that, you can have fun trading.

Regards,

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