

MARKET TRACTION

Closer to Escape Velocity...

But a Speedbump Remains and the Summer is Winding Down...

This Week's Trade Ideas:

(View Webinar*)

Bullish Ideas:

(View Webinar) ALK > Alaska Air > \$66.80 Last. Buy the Sept. 21st 65 Calls for \$3.70 or less with a close or anticipated close above \$67.70 in an up market with expectations for continued strength in the major indices.

(View Webinar) PCG > Pacific Gas and Electric > \$45.75 Last.

This is a Diagonal Spread!:

Buy the Oct. 19th 42 Calls for \$5.00

Sell the Sept. 7th 46.5 Calls for \$0.90

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.

YUM but today it was up more than we'd like, and the market is overbought.

***TLRD** but earnings are due out in about 2 ½ weeks.

Bearish Ideas:

(View Webinar) KHC > Kraft Heinz Co. > \$59.05 Last. Buy the Sept. 21st 60 Puts for \$1.85 or less with a close or anticipated close below \$58.75 in a down market with expectations for continued strength in the major indices.

Bearish Mentions:

***WMB** but earnings are due out in about 1 week.

PEP and **MDLZ**, view webinar.

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:

We got the July and August the textbook says we should get. What of September? We're short-term overbought and the final week of the Summer of 2018 is about to get very lazy without big news.

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:

Last week continued our streak of good upside movement that we found hard to find in July. Things didn't go *gangbusters* in our favor, but it was better than a *stick in the eye* and did at least give us a chance to make profits.

We had one bearish mention and it had no shot due to the market moving higher nearly every day. **ETFC** was the name and we noted that we'd have to wait to see it crack below support that was nearby in a down market. It didn't really try because there hasn't been any weakness. There, that's out of the way.

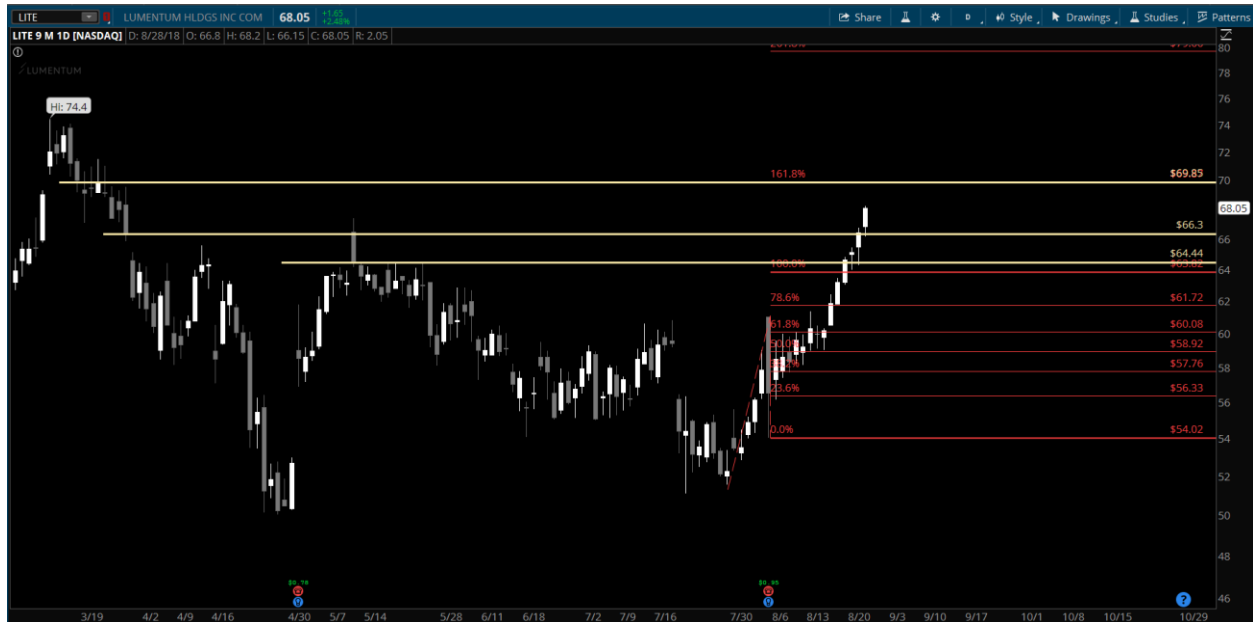
We had two official bulls in **AA** and **RDN**. **RDN** was simply a disappointment. It had the market's wind at its back and didn't do much with it. We updated on it today and noted that if folks were in it and it hadn't worked, that moving on from it wouldn't be the worst idea. **AA** on the other hand, did breakout on Friday and continued to pop into today. It ran through our resistance level/target level 1 as if it weren't there but has subsequently pulled back.

CFG and **ZION** were also bullish mentions. **CFG** has made a better attempt to move higher but **ZION** has remained heavy. Those names remain more frustrating than fruitful.

CMCSA did a little something for us but hasn't followed through enough yet and thus it remains a little frustrating. It didn't make it to our first target level but it's yet to really back off.

LITE is our best name from the past week. It shredded its way through our first and second resistance levels and it is homing in on Target level 3.

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They should all be this relentless for us!

We mentioned **IBM** and **DWDP** late in an update last week and both have moved up somewhat. **DWDP** pushed through one level but hasn't made it to second one. **IBM** hasn't busted through resistance level 1, which is something we mentioned in a separate update due to the interesting pattern that's present in **IBM's** chart.

In summary, the past week wasn't too bad, but we were hoping for more from more stocks. Had the rumble higher lifted all names a respectable amount, we'd have been happier than helping fewer names to a larger degree.

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Market Overview

Last week things were coming up roses across the board. We noted that in several ways in **MO** and here are a few choice cuts:

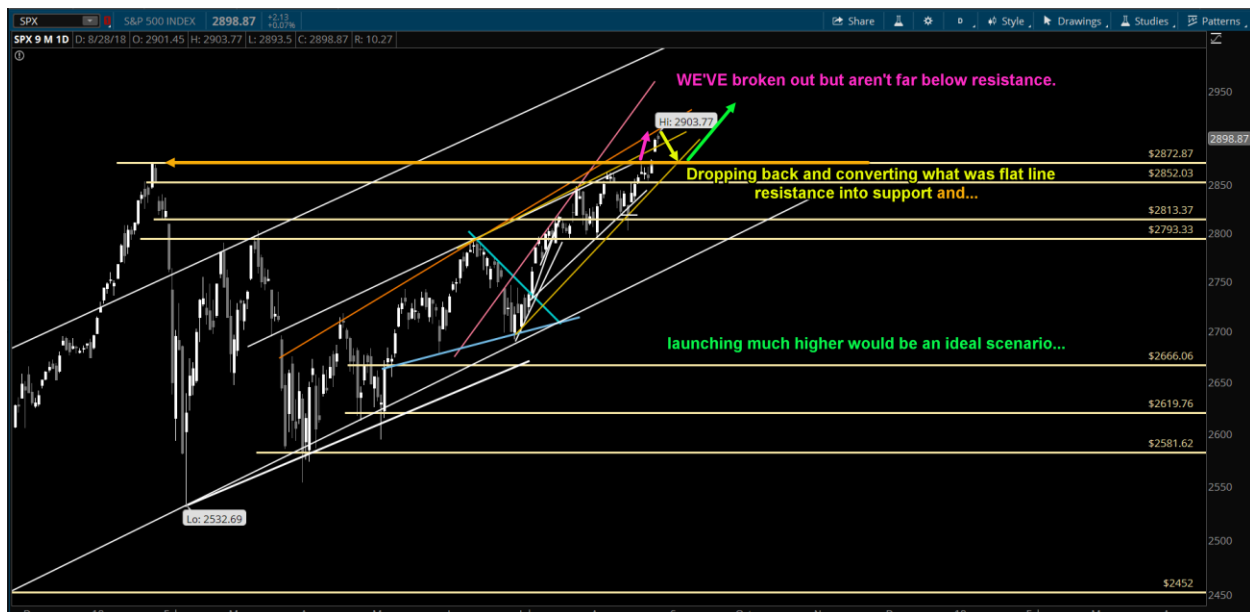
1. *We've got to believe that they're feeling better about the consumer if this is how they're behaving in XRT and that could bode well for the 2nd Half's GDP which would seemingly bode well for the major indices. The Nasdaq appears to be playing possum.*
2. *That's likely to be interpreted bullishly and received well! AND, things aren't overly frothy yet, and it is not even close.*
3. *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!*

With all the technical improvement we saw last week, we're happy to report that it all seemed to matter, and the markets have performed very well since then. The breakout we thought we saw coming has transpired and now we must wait and see if it becomes a *falsie*.

That's last week, so what about this week?

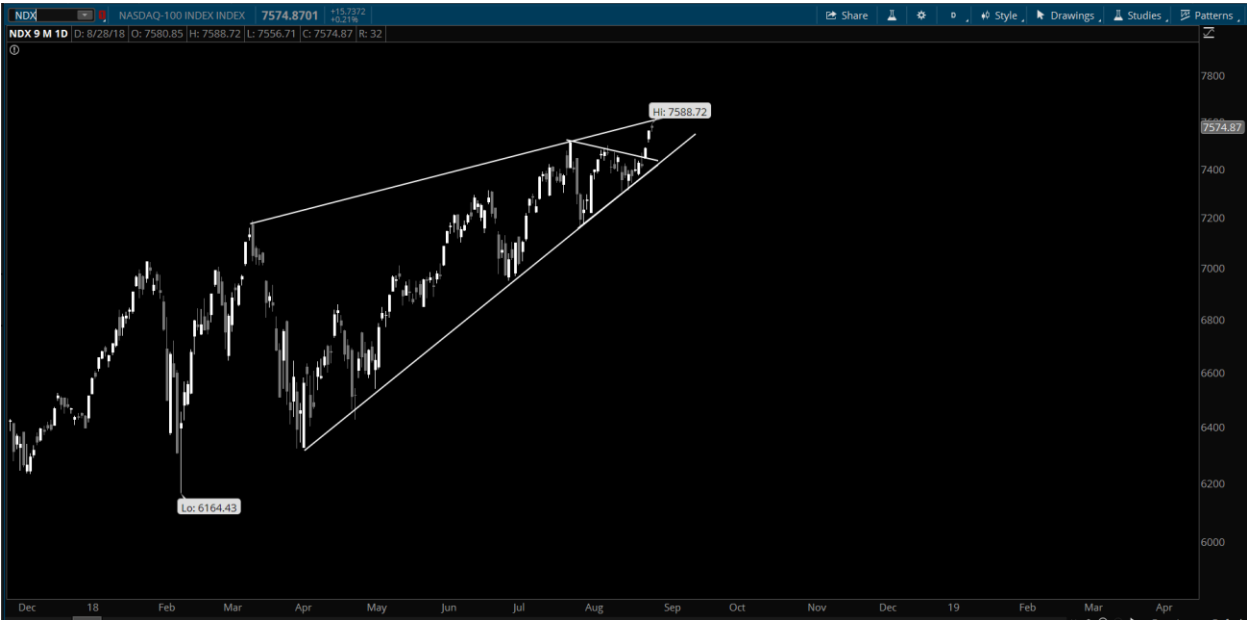
We're just going to keep it simple. This is the final week of the summer, or at least it is viewed that way. Many will be trying to turn the Labor Day long weekend into a very long weekend. It's possible that things go into **CHILL MODE** in more ways than one and soon!

At present, the markets are overbought and may try to pull off the old pullback and hold above the breakout level before launching again. That's one of many scenarios.

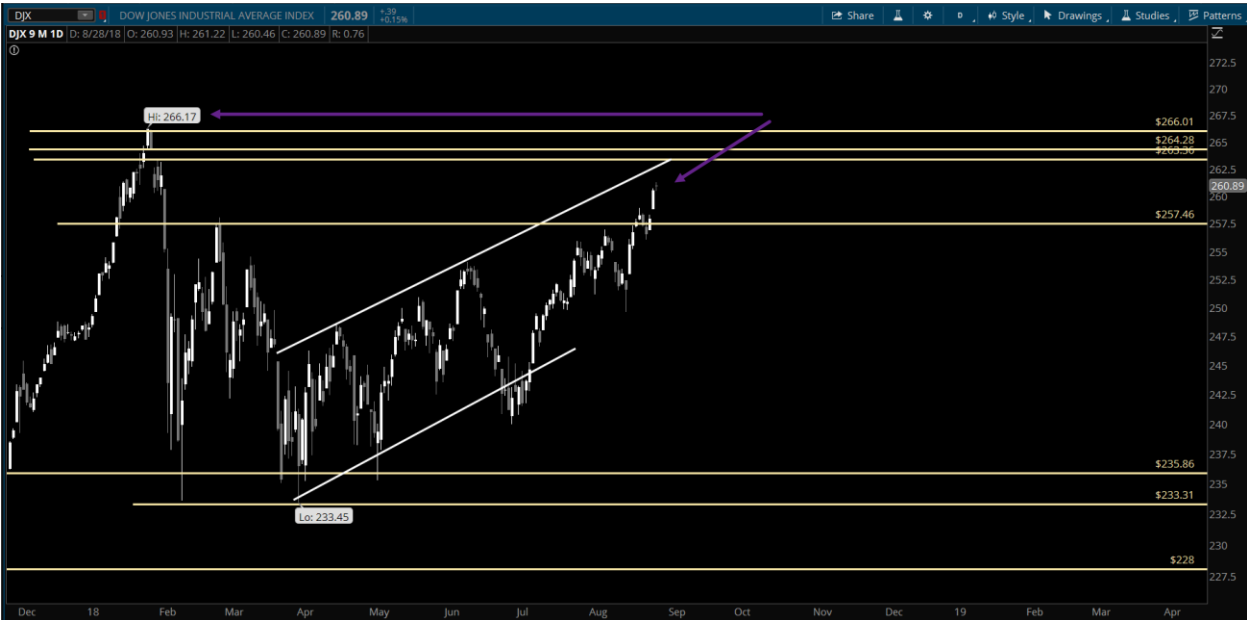


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Here's the NASDAQ blastoff with our resistance line from last week:



The DOW is still lagging but it's closing in too:



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Wrapping up with the VIX which has remained curiously resilient:



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We can't say much about this week's calendar because we expect traders to mail it in with this being the last week of the summer. Any number could be used for movement because markets may be thin.

This Week's Economic Calendar

TIME (ET)	REPORT	PERIOD	ACTUAL	MEDIAN FORECAST	PREVIOUS
MONDAY, AUG. 27					
8:30 am	<u>Chicago national activity index</u>	July	0.13	--	0.48
TUESDAY, AUG. 28					
8:30 am	<u>Advance trade in goods</u>	July	-\$72.2bln	-\$69.6bln	-\$67.9bln
9 am	<u>Case-Shiller home price index</u>	June	6.2%	--	6.4%
10 am	Consumer confidence index	Aug.	133.4	127.2	127.9
WEDNESDAY, AUG. 29					
8:30 am	Gross domestic product revision	Q2		4.1%	4.1%
10 am	Pending home sales	July		--	0.9%
THURSDAY, AUG. 30					
8:30 am	Weekly jobless claims	8/25		212,000	210,000
8:30 am	Personal income	July		0.4%	0.4%
8:30 am	Consumer spending	July		0.4%	0.4%
8:30 am	Core inflation	July		0.1%	0.1%
FRIDAY, AUG. 31					
9:45 am	Chicago PMI	Aug.		--	65.5
10 am	Consumer sentiment index	Aug.		95.4	97.9 July

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Below the Radar – Special Late Summer “Crickets” Edition!

As is often the case, when the market makes a strong move to the upside, the doomsayers recede for a while before regrouping. That’s what’s happened over the past week and as such, we’ll cover what little we could dig up. It mustn’t be easy to get *beared up* with Q3 possibly delivering a 4.6% GDP print!

<https://www.streetinsider.com/Fed/Atlanta+Fed+Raises+GDP+Forecast+to+4.6%25/14546182.html>

Atlanta Fed Raises GDP Forecast to 4.6%

Article

Stock Quotes (1)

Comments (15)

August 24, 2018 10:32 AM EDT

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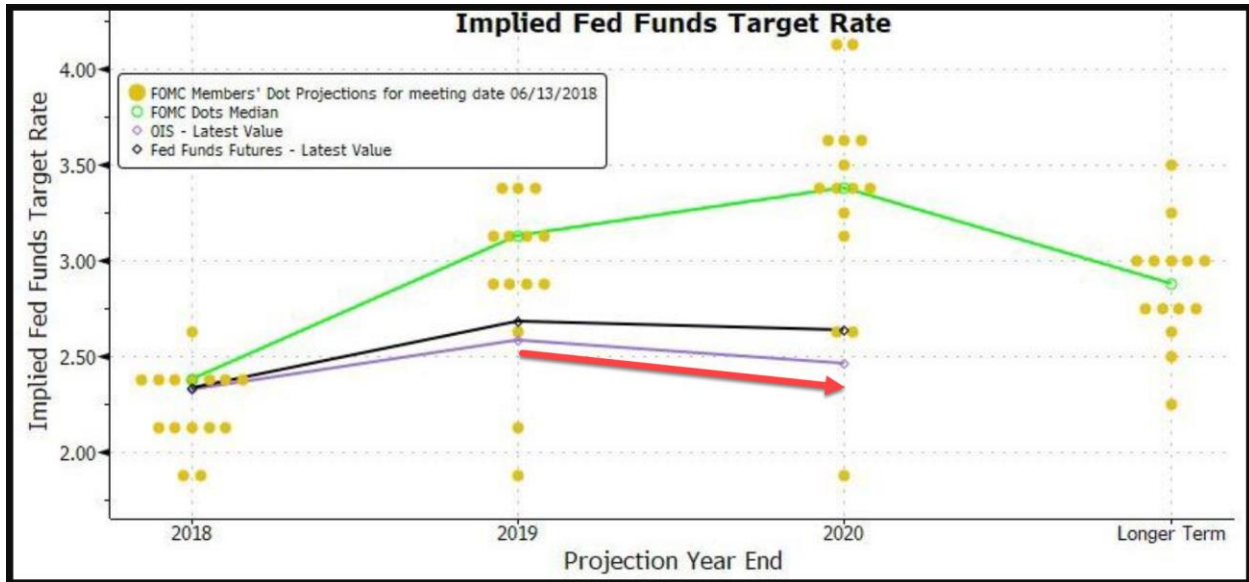
The GDPNow model estimate for real GDP growth (seasonally adjusted annual rate) in the third quarter of 2018 is 4.6 percent on August 24, up from 4.3 percent on August 16. After yesterday’s releases on new-home sales and costs from the U.S. Census Bureau, the nowcast of third-quarter real residential investment growth increased from -4.5 percent to -1.1 percent. After this morning’s advance durable manufacturing report from the Census Bureau, the nowcast of third-quarter real nonresidential equipment investment growth increased from 6.4 percent to 7.5 percent and the nowcast of the contribution of inventory investment to third-quarter real GDP growth increased from 1.92 percentage points to 2.03 percentage points.

And more good news on Q3: <https://www.zerohedge.com/news/2018-08-28/inventory-surge-signals-good-start-q3-gdp>

This rally has left many bears dumbfounded and nearly speechless. As usual, they’ve made a lot of good points but many of them simply ignore what the charts are *saying* to them if they’d only listen. As we noted last week, we believe that short-covering and now panic-buying are part of the mix as to why we’ve jammed higher, however, the charts suggested we were likely to witness what we have if the news cycle would cease being detrimental. And, it has. In fact, it’s actually aided the upside. Here’s another item that could be helping: The FED being close to PAUSING!

<https://www.zerohedge.com/news/2018-08-28/nomura-market-sniffing-out-possibility-2019-rate-hike-pause-fed>

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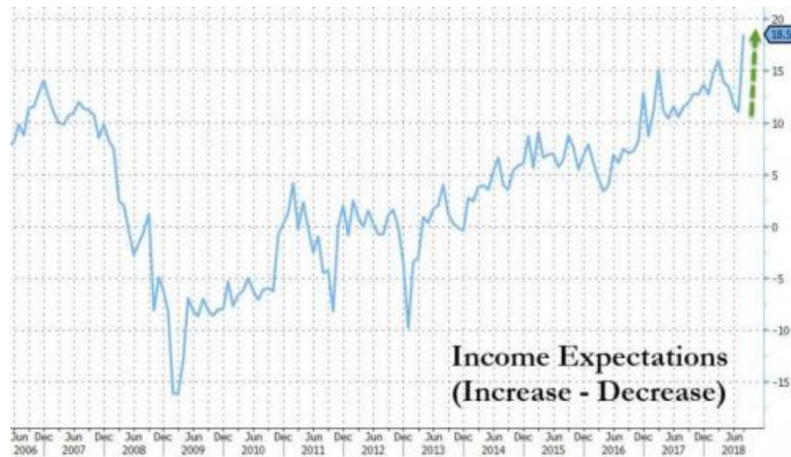
Other *good things* include:

Consumer Confidence is spiking like it has only once before and people are planning!:

Current Conditions spiked to 172.2 (18 year highs), Expectations rebounded to 107.6 (highest since Feb), driving the headline to Oct 2000 highs....

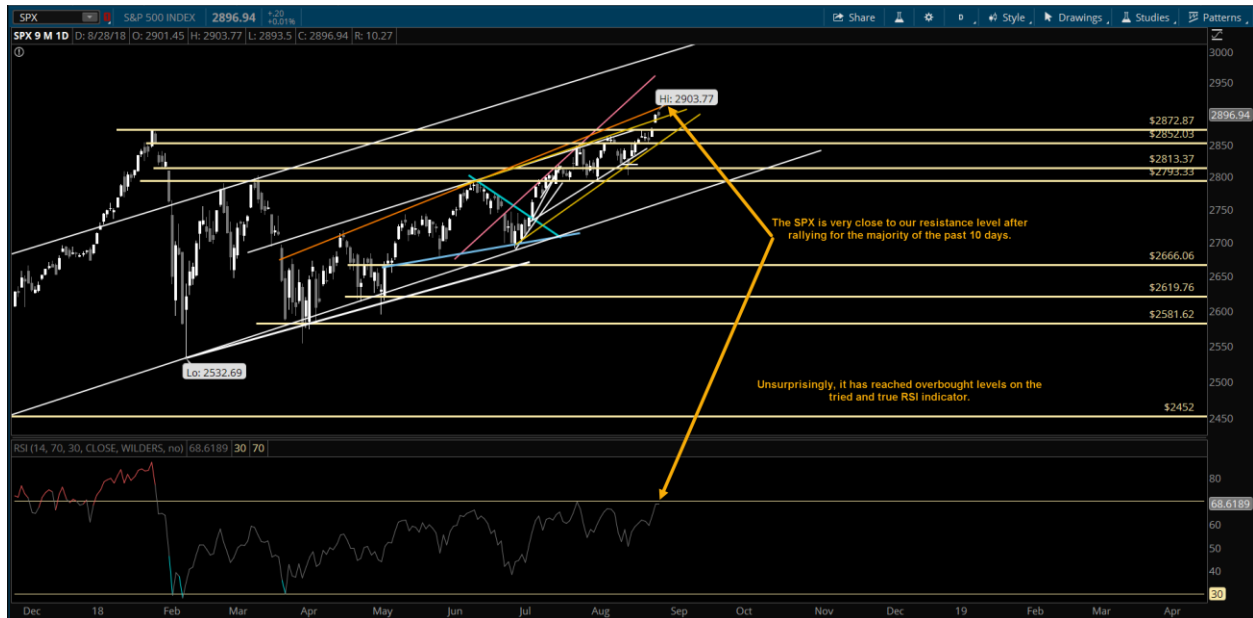


Plan to buy homes, cars, and appliances all surged as income expectations spiked to record highs...



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The rotting lining that we can find in all this is that it's NOT likely to get TOO MUCH better than this!
AND:



August is ending with us at All-Time-Highs but also being overbought. July and August played out according to the script we've been reading since late June. What if the script continues to do so?

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%

Enjoy the long weekend folks! 😊

Bank and Roll!

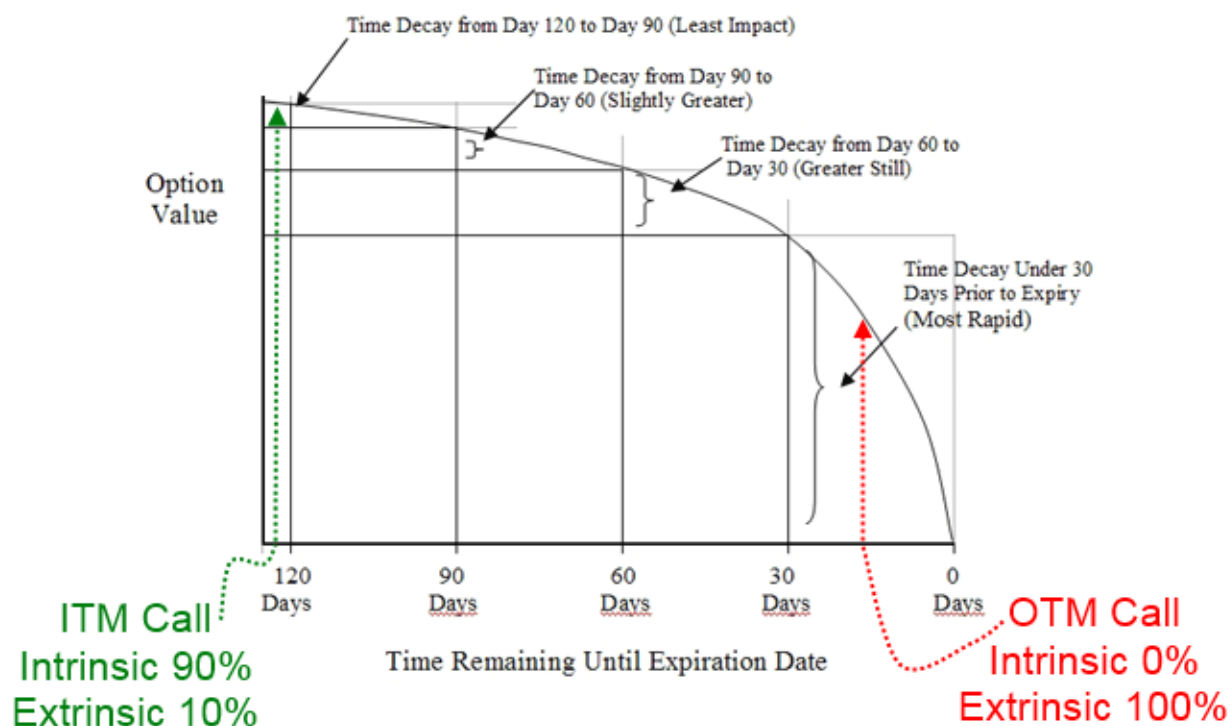
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Options Academy

This week we've reached the **Diagonal Spread** *further explored* stage!

Cutting to the chase here in this unofficial final week of the Summer of 2018, we love the **Diagonal Spread** because it capitalizes on the very nature of how options work! Let's explore that a little...

First up is our ever-reliable **Decay Curve**:



We're working on superior graphics but for now this will work. Take note of the "green" and the "red". **Green** we buy/own and **Red** we sell/short when employing the Diagonal.

The first thing we notice is that we're properly positioned on the decay curve. In fact, what we own is not only decaying slowly but what we've sold is decaying rapidly. It doesn't get much better than that. We're working the curve like champs!

Next up is that our short side is really on the worst part of the curve for the buyer and thus the best part for us, the seller. Selling with only a few weeks left while there's still enough premium worth selling, ONLY makes sense. Taking advantage of the fact that the Options Pricing Model discounts the purchase of time ONLY makes sense. We're crushing it when it comes to Decay Curve *Real Estate*!

Now let's tackle intrinsic vs. extrinsic value. What we're selling can be 100% extrinsic that's all set to **MELT** in the very near term. However, our long call is comprised of *very little* extrinsic value and what

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little it has will be decaying *very s l o w l y* by contrast. Additionally, the delta of what we're selling, since it is OTM, is < 50 delta and thus it has a longshot's chance to be worth anything at expiration.

Another big win!

We'll walk through a few outcomes just to see a little more awesomeness!

Recall that we've been approaching this from the bull side.

- A. If the stock price sits still we will win because decay will be on our side until the expiration of our short call, assuming we've structured the spread properly.
- B. If the stock moves up, you guessed it, we win because we're bulls and have net long delta with this spread.
- C. If stock goes down, we can still win or at least have the decline buffered by the short call that we will fully collect on.
- D. And, don't forget, that we have plenty more time for the stock to rebound since we own outer months calls as our **anchor call**.
- E. Lastly, if the stock zooms up, we still win but likely regret opting for a spread instead of simply a long call! Hey, we're human!

As we conclude for now, let's not forget that we're using a stock replacement call that allows us to maintain a hedged position but with a much smaller capital outlay than owning shares. We can go much bigger with the same amount of capital or control the same number of shares for much less. Bigger % returns or much bigger cash profits. What's not to love?

When all factors are considered, one is forced to appreciate the brilliance of the **Diagonal Spread**.

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

Below are all the recent reprints from the past several weeks that led to this discussion. We included them for Late Summer Reading and for an easy refresh.

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.

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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. $1.9\% \times 12 \text{ months} = 22.8\%$ 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: $2.47\% \text{ per month} \times 12 \text{ months} = 29.64\%$

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 \times 2\% \text{ lower} = \text{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.

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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. $7.6\% \times 12 \text{ months} = 91.2\%$ 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 $\times 12 \text{ months} = 102\%$ 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,

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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 last 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 "*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*.

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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*...

Slightly 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* can cost $\frac{1}{4}$ to $\frac{1}{2}$ 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* 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*. With *slightly* 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* are in the 65 to 75 delta range. And now for the P’s and C’s:

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Pros First:

AAPL		APPLE INC COM		209.3653	+0.4953 +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										
	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

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 Call** webinar ☺.

MARKET TRACTION

Reprint of a recent 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-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!:



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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:

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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.

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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 several 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.

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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 **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*

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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. 🗣️