Increase Your Chance For Success!

We've talked about the fact that in any business, there are three basic financial needs; cash flow, stability and growth. For growth in my net worth, I utilize long term trades involving mainly high quality blue chip stocks. The correlation between long term trading and the quality of the underlying company being traded should be obvious, so we'll leave that alone. Rather, let's discuss how to increase your likelihood for profit as the stock price goes back up. First, let's find a quality candidate stock on weakness.

A Likely Candidate

Here's one, Lehman Brothers. You can see that the stock is off a recent peak value of around $90. Due in part to the quality of the company, it's very likely to re-attain that value. Our trade of course would be to ride the stock price up. But the HOW here is important.

View BetterTrades Chart

The HOW

The stock price is free to move in any of several directions. Let's simplify that a bit by agreeing on only three; up, sideways and down. Our job is to select a strategy which will profit most often from each of these directions.

If we BUY the stock, the stock must go up in order for us to benefit. Any other movement could easily result in a loss. So our 'chances' of being profitable here are 1:3, about 33%, not good.

If we buy a CALL OPTION on the stock, the stock must likewise go up for us to profit. Movement to the side would result in the time value erosion from the premium, netting us a loss. Downward movement would result in loss of intrinsic value for in the money options or just overall premium deterioration for out of the money options; again another loss. So buying call options has the same likelihood of profit; 1:3; about 33%, still not very good

Bump UP Your Chances

Rather than being a BUYER of anything here, let's SELL a put! Check the figure below ...

View BetterTrades Chart 2

By selling a put having a strike price at or near the previous peak value ($90), your chance for profitability have increased considerably. In #1 above, you'll see the stock moves above $90 by expiration. You are profitable on the put you sold. In #2 above the stock moves higher but does not quite reach $90. That's okay, you're still profitable, being able to buy that put back for LESS than what you sold it. In #3 above, the stock simply moved sideways. This could have resulted in a loss had you bought a call option, but selling a put allows you to build profit as the time value erodes, lowering the premium. As before, buy your put back for less than what you collected when you sold it. In #4 above the stock price slips below the level where you sold the put. Left unchecked, your potential for loss here might be significant. However, if you are paying attention to your trade, you can mitigate that potential for loss with a simple stop loss, getting out until the stock price starts up again!

#1 - #2 - #3 - #4

These results speak for themselves. Of the 4 stock price moments described above, selling puts would have made you a profit in THREE of the four! Take a closer look at selling puts. It's NOT the 'get rich quick" strategy of the 1990s 'dot-com bubble days'!

Make it a great day!

Bob

About the Author

Content Source: Stock Classes from BetterTrade's Bob Eldridge and the new BetterTrades Option Trading