

Maximum Profit To The Downside When Selling Premium: Writing Covered Puts

One of the most popular option trading strategies for creating ongoing consistent income is writing covered calls. In writing a covered call, our intention is twofold. We want to create a risk-free transaction where the alternatives are not maximum reward versus maximum risk but rather maximum reward versus minimum reward. We also want to create a transaction that lasts many premium cycles.

Here is the formula for Return on Invested Capital.

$$ROIC = \frac{\textit{Profit}}{\textit{Amount Invested}}$$

In trading vernacular, the "amount invested" can also be referred to as the "breakeven amount", "breakeven price", and "cost basis". When we write a covered call, we sell an option's premium for profit each cycle. At the end of each cycle, our cost basis is reduced by the profit from the previous cycle and we prepare to and ultimately sell premium for profit to start the next cycle. In the Return on Invested Capital formula, in a well architected covered call trade, the denominator reduces each cycle while the numerator stays constant or grows. Mathematically, this translates to exponentially increasing profits each cycle versus profits that grow linearly. Therefore, it makes sense that our intention is to have a transaction that lasts many cycles. That, and when we sell option premium in any form, by definition, we take on an obligation, a commitment, that we will perform on that option, if the buyer of that option exercises their right. Researching underlying security candidates that we feel confident about being in a commitment with, can be an arduous task. Another reason our intention is to create a transaction that lasts many premium cycles is to minimize how often we are called on to vet underlying candidates and therefore be picky about the one's we do pursue.

This is a topic we discuss often as part of our Trading Trainer '6 Percent Protocol' program.

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How do we create transactions that are risk free and that last many premium cycles? In scenario testing, an imperative for bound trading strategies, like writing covered calls, one of our outcomes is to define a trade's "channel zone", "trade zone" and "profit zone". The "channel zone" is simply the tested support to the tested resistance prices of a horizontal channel.



The "trade zone" is our bail-out price to our exercise price. Our bail-out price is where we have typically set semiautomatic or automatic unwinding mechanisms, to close positions and put us into a safe all cash position. We typically set our bail-out price where price action has not been since the underlying began channeling horizontally. We do not want to trigger a bail-out unless the unthinkable has happened. The exercise price is where our position is unwound by meeting the obligation of the sold premium trade, when our buyer decides it makes sense to transact their option contract(s).



Our "profit zone" is our cost basis to our exercise price. Our cost basis is our breakeven price; the amount we have invested. In a premium trade, our cost basis decreases each cycle we earn profits and apply the previous cycle's profits to the amount we have invested in the transaction.



When architecting a trade that profits on selling the theta decay component of an option's premium (the premium goes to zero as time passes and the option reaches its expiration date), quantified, our intention is to have our "profit zone" be larger than our "trade zone" which creates a risk-free trade, and our "trade zone" to be larger than our "channel zone" which creates a trade that lasts many premium cycles and gives us exponential profits over its life.

Over time, our "profit zone" will grow bigger than our "trade zone", as pointed out earlier, by our cost basis decreasing each time a cycle's profit is applied and a subsequent cycle's profit is secured. Many theta-decay premium trade architects therefore focus on making their "trade zone" which consists of selected values, larger than their "channel zone" which is pre-defined. This is where writing covered calls receives favor by seasoned trade architects. They are easy to leg into.

We buy underlying securities, call options, and sell or write put options, when prices are low but will go higher, after a technical bottom has been found. We sell or short securities, sell or write call options, and buy put options, when prices are high but will go lower, after a technical top has been found. By legging into a covered call writing transaction (buying the underlying security when a bottom has been found at channel support and selling the call premium when a top has been found at channel resistance) we can optimally have our "trade zone" larger than our "channel zone". As a side effect to legging in with a focus on having our "trade zone" larger than our "channel zone", it often works out that our "profit zone" is larger than our "trade zone". If our "profit zone" is not larger than our "trade zone" at the beginning of our first premium cycle, a well architected and managed trade will see the "profit zone" larger than the "trade zone" by the second or third premium cycle.

The key to protecting our investment and carefully building consistent income is to architect a theta-decay premium selling trade, create a plan for the transaction, and then follow the plan diligently step-by-step, being ready with alternative plans to deal with the unexpected. Learning to do this is the whole purpose of the '6 Percent Protocol' community at Trading Trainer.

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Architecting Theta-Decay Premium Trades That Exercise To The Down Side

Investors are worried about that black swan event that will cause the market to breakout down unexpectedly. The bear tends to jump out the window while the bull tends to climb up the stairs. How do we protect our investment even in the most well-constructed transaction, if it is possible that we will not be risk-free from the outset? We can put together a transaction that exercises at maximum profit, rather than gets bailed-out at maximum risk, to the down side. Covered put writing behaves this way.

Writing a covered put is like writing a covered call in that we search out a sideways-channeling underlying security that has clearly defined tested support and resistance. We do a soft data analysis to make sure there are no upcoming events that may trigger price action outside of our channel. Because we are looking to construct a trade that will last many cycles, we take our time and observe our underlying security candidate over time (at least one cycle) for any unexpected behaviors. We remember that once we have sold premium against this underlying security in any way, we have an obligation to make good on our commitment until we either unwind the transaction or the premium expires worthless. We do not take that commitment lightly, so we screen our underlying symbols thoroughly.

Once the underlying security is selected, we start writing a covered put by shorting the underlying security. This requires a margin trading account. We short an underlying security by "selling-to-open" it. We are borrowing an underlying security from our broker and selling it. To close our position, we buy it back; we "buy-to-close" it. While the position is sold, our broker holds an open tab for us, for the price of the underlying security. Our broker may make a margin call at any time, asking us to pay our tab. Often that requires us to buy back the security to fulfill our obligation. We short our underlying symbol after a technical top has been found to get the highest price we can while making sure the security will go lower in price.

The second step is to sell our put option premium. We sell our put option premium once a technical bottom has been found. The most premium will be found with an at-the-money put option. Most traders use the first out-of-the-money option because, by definition, an out-of-the-money option has no intrinsic value; the price of the option is all premium. Also, an out-of-the money option will have its exercise price lower than channel support if that is where the underlying symbol bottomed.

Our cost basis, because we shorted the underlying symbol and we sold the put option, becomes the summation of the two. Our "profit zone" is from the cost basis down to our exercise price. Notice that the exercise price is to the downside and the cost basis is to the upside.



It is worth taking a moment to review how a covered put trade is exercised. As with any American option, the buyer of a put has the right at any time between now and the expiration of the option, to give the seller a share of an underlying security and, in return, get the exercise price amount. They pay the option price for this right. Typically, the buyer would exercise this right if the underlying security was trading for less than the strike price of the option minus their premium paid. It makes sense that the buyer wants to sell their underlying security for the highest price possible when all costs are factored in.

A seller can assume that they will be exercised at expiration if the underlying security is less than the strike price of the option sold. Dividends may also play a role as to whether an option is exercised and at what price. If the buyer exercises their right, it makes sense that the seller would take that underlying security they receive and fulfill their obligation to their broker for their shorted security.

Because our exercise price is to the downside, we must pick a bail-out price to the upside. We set our bail-out price to the upside where price action has not been since the underlying security began channeling horizontally. We do not want to trigger a bail-out unless the unthinkable has happened. We set semiautomatic or automatic unwinding mechanisms at our bail-out price, to close positions and put us into a safe all cash position. For a covered call position, we would buy-to-close the call option (usually for very little) followed by selling-to-close the underlying security. For a covered put position, we would buy-to-close the put option (again, usually for very little) followed by buying-to-close the shorted underlying security. Our "trade zone" is from our bail-out price down to our exercise price.



Our maximum reward occurs when we are exercised to the downside. Our maximum risk (if our cost basis is less than our bail-out price; our "profit zone" is smaller than our "trade zone") or our minimum reward (if our cost basis is greater than our bail-out price; our "profit zone" is larger than our "trade zone") occurs when we are bailed-out to the upside. We are protected against black swan events where the bear surprisingly jumps out the window. In theory, we have more time to react to and adjust for an upside movement, as well, because bulls climb up the stairs in a more calculated way.

In architecting the optimal covered put, our intention is to have our exercise price below channel support and our cost basis above our bail-out price which is above channel resistance. This covered put transaction not only has its maximum reward to the downside, it is risk free, and it will last for many premium selling cycles.

These are the trades we repeatedly practice constructing as part of the Trading Trainer '6 Percent Protocol' program.

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