

How to use options to make money if the market goes UP, DOWN, or SIDEWAYS

A few months back I published a post about [my large cash position](#). That position has only continued to grow as I find it difficult to put on any new investments at these lofty prices. As I stated previously, I have no idea when the market will turn, all I know is I don't want to be left holding the bag when it does. That's not because I don't think that over the long-term the prices will be higher, but rather because I believe there are much better prices ahead (like around the corner).

I also believe that the opportunity cost of sitting on the sidelines (holding out for lower prices) is much lower at this stage in the bull market (now 6+ years old). Sam over at Financial Samurai recently wrote an article about [cash as an investment](#) and wrote the following:

We're in the second half of a bull market, so cash is currently trash. It's very easy to say how everybody shouldn't have cash when everything else is doing so much better. But I can assure you that if there is ever a multi-year correction again, **cash will become king once more [my emphasis]**. Everybody will prefer earning 0.1% on their cash rather than losing 30% in the stock market.

I remember the difficult times during the Asian Financial Crisis in 1997, the dotcom implosion between 2000-2002, and the disaster of 2008-2009. People weren't just taking a hit on their investments. People were getting fired left and right as well. Having to sell something when you don't have to because of a liquidity crunch is the worst. Don't ever forget the bad times.

Everyone is a genius in a bull market and it's easy to say that any and all idle cash should be put to work immediately if not sooner, especially when you're essentially earning **zero percent in the bank**. It's funny how everyone forgets about the cyclical nature of the market. They forget that on one side of the coin the market goes up for extended periods of time, but on the other side it also goes down for extended periods of time.

This is not to say that you need to be liquidating all of your positions you have accumulated over the last 6 years. But here are a few moves you may consider:

1. Maybe you let some of those new deposits sit idle while you hold out for better prices. Build up the war chest to take advantage of lower prices.
2. Maybe you work to reduce your margin (borrowed money from your broker), that way you're not forced to sell anything when the inevitable correction does come.
3. Maybe you liquidate some of those positions you recently put on near all-time highs.
4. Maybe you sell covered calls against some of your positions to chip away at your cost basis.
5. **OR maybe you use options to get short the market with close to zero risk to the upside, an effective long price that is much lower than the current market high, and create a huge range of profitability.**

This post is geared towards option number 5.

Using options to customize an investment strategy based on your market thesis

Thesis: The stock market is getting overheated and we are due for a correction. There may be a few more percentage points (5-7%) of upside before a market correction begins. A correction could bring a decline of 20-30%.

Goals: Use options to create a custom strategy that allows for more than one way to win. I want to be able to make money if the market goes up, stays the same, or goes down. I also want my risk to be as close to **zero** as possible if the market exceeds my upside target. And lastly I want an opportunity to get long at much lower prices (8-10% lower from the highs).

Instrument: I will use options on the SPY ETF as a proxy for the S&P 500 to construct my strategy.

Upside Price Target: I don't think SPY will close above \$230 by the end of 2015. If I am wrong I want to structure my risk in a way that I could profit all the way up to this price and lose little to no money if we exceed this upside target. With a price ceiling of \$230 that would equate to a 12% return for 2015 (based on the closing price of \$205.54 on 12/31/15).

Long Entry: If the market does fall, the first price level I would be interested in getting long at would be around 8-10% lower from current all-time highs. As of 5/21/15 the all-time high was \$213.78. This means I am okay with an effective price between \$192 to \$197.

Now that I have my list of the requirements it is time to start piecing the strategy together.

The best thing about options....is that they give you options and many permutations to create custom strategies ☐

In order to meet all of the requirements it is going to require both selling options (both a put and a call) to collect a bucket load of premium as well as buying an option to cap risk to the upside (a call). I personally use [Think or Swim from TD Ameritrade](#) to play what if analysis in finding the right strategy. You will see some screenshots below.

Visualizing the options strategy's Profitability and Risk profile

The Trade: Sold 1 December 2015 213/230 Callspread @ \$6.53 & Sold 1 December 2015 \$212 put @ \$9.84 for a total credit of \$16.37 (\$1,637 in total premium collected)

Below you can visually see the area of profitability as well as both the upside and downside break even points.



Breakeven Points: \$195.63 & \$229.39 (breakevens includes \$2.25 in commissions or \$0.75/contract)

Based on the breakeven point to the upside that still allows the SPY to finish up approximately 12% on the year (based on a 2014 closing price of \$205.54), the risk to the upside is capped due to the purchase of the \$230 call (within the callspread).

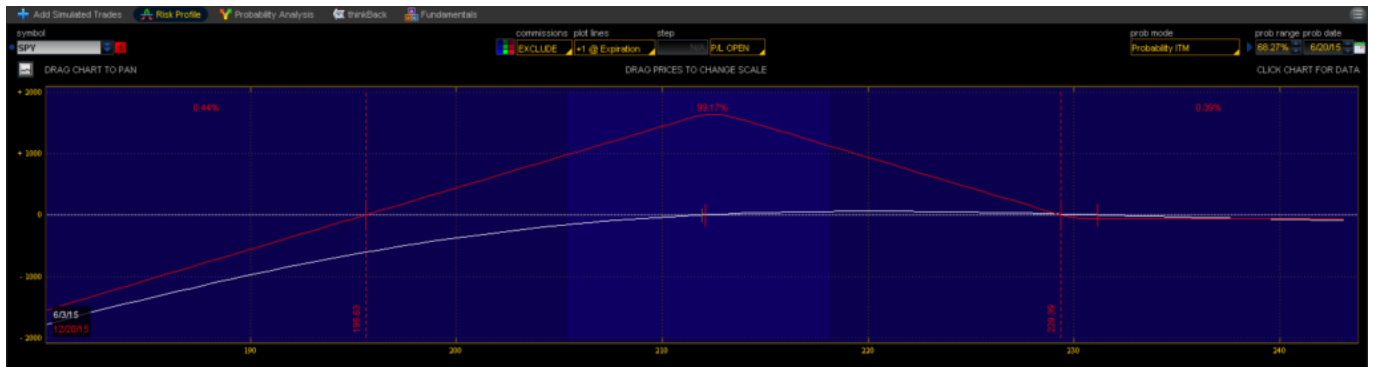
Upside Max Loss: The max loss is \$63 to the upside. It was the closest I could get to zero risk to the upside. I am totally fine with that.

Downside Max Loss: The max loss to the downside is theoretically \$19,563, but that would mean the ETF goes to zero. I am not concerned with the downside on this, because I am comfortable owning the ETF at \$195.63 if exercised and forced to take possession.

Profit Zone: Anything Greater than \$195.63 and Less Than \$229.39.

Max Profit: \$1,637 with SPY @ \$212.50

Let's take a look at the risk profile of this particular trade set up:



Notice the peak at approximately \$212.50, this is where maximum profit is earned (\$1,637).

Conclusion

With markets at all-time highs I am trying to find creative and interesting ways to put my capital to work for me. Some in the community would argue that the problem with having cash on the sidelines while waiting for a market to move lower is that most will get scared and never pull the trigger on the way down. This custom strategy forces my hand to get long at a price I am comfortable with (at least for my first tier of purchases).

I like that the risk to the upside is pretty close to zero (\$63) and that I have locked in a price to get long the SPY at \$195.63 should the market correct more than 8%. The worst case scenario to the downside is that I take ownership of the stock. Of course the market could keep falling, but that is true no matter what price you get long.

Remember this strategy is based on a thesis that there is **MAYBE** 7-8% left in the move this year. I am making a bet that the SPY will close below \$230 by the end of the year. And there are two outcomes that I am happy with either way:

1. I profit up to a max of \$1,637.
2. I take ownership of the SPY at a price that is currently about 8.5% lower than the current all-time high. To point out the obvious, if the SPY were to correct past my breakeven point of \$195.63, I would be in negative P&L position.

Does this sound interesting to you? Have you traded or invested with options? Do

you have any questions? Please share your thoughts and questions in the comments below. I promise to respond to everyone of them.

- Gen Y Finance Guy

In the next couple of months I am going to be launching a options coaching program. If you think you might be interested in learning how to use options to enhance your returns, reduce risk, and profit like a pro then enter your email below to be one of the first to be notified. The coaching program will have limited spots and will be on a first come first serve basis.

* indicates required

Email Address *



Gen Y Finance Guy

Hey, I'm Dom - the man behind the cartoon. You'll notice that I sign off as "Gen Y Finance Guy" on all my posts, due to the fact that I write this blog anonymously (at least for now). I like to think of myself as the *Chief Freedom Officer* here of my little corner of the internet. In the real world, I'm a 30-something former C-Suite executive turned entrepreneur turned capital allocator. I am trying to humanize finance by sharing my own journey to Financial Freedom. I believe in total *honesty* and *transparency*. That is why before I ever started blogging, I decided that I would share all of my own [financial stats](#). I do this not to brag, but instead to inspire motivate, and also to hold myself accountable. My goal is to be a beacon of hope, motivation, and inspiration for *you*, the reader, by living life by

example and sharing it **all** here on the blog. My sincere hope is that you will be able to learn from me - both from my successes and my failures! [Read More](#)