ReadySetCrypto Income Through Options Masterclass

Module Five: Income Through Cash-Secured Puts

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Income Through Cash-Secured Puts

By Doc Severson

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Earning Income through Cash-Secured Puts

By now, I'm hoping that you know what an Option is, why we'd want to trade one, the inherent advantages behind trading them, as well as some of the risks that we'll bear. If you really don't know any of those points, and just came to this module looking for entry rules so that you can get some positions in play, then I would really recommend slowing down and truly understanding what you're about to do.

Once you begin to understand the power of Options, there is always a big push to "get something in play," which turns into a feeling of betrayal when you realize that you learned 80% of what you needed to know. Like Master Yoda imploring Luke Skywalker to "*complete your training*," my guidance is that you'll have the whole rest of your life to get good at this strategy. Options have been around for almost 50 years and they will only continue to spread to different financial markets, Crypto being one of them.

So go slowly…ease into trading live only after you have successfully conquered a few simulated trades, and more importantly, made mistakes with virtual capital and not the real thing. In some ways, I'm saying "*do as I say and not as I did*." I was very aggressive and paid for it right out of the gate with my impatience to start my future.

The Cash-Secured Short Put Trade

Some of you might have heard of this trading strategy referred to as "selling naked puts." Beyond the silly nature of the name, there's a reason why I don't refer to this strategy with this term. "Naked" means that you are selling an uncovered or unsecured Option, and generally implies that you are using MARGIN to compensate for your lack of capital. We are not going to do it this way; you should NEVER sell a Put Option if you cannot "cover" or "secure" 100% of the position size that you're obligating yourself to. In other words, if you sell a put to obligate yourself to buy one BTC at the $9000 strike price, you'd better commit to having at LEAST $9k worth of "capital" in your account.

Depending on the broker/exchange that we use, this may or may not be the case. Some of the brokers that we'll explore in this course will offer the ability to trade position sizes requiring less than one "coin" to be put up as margin, with assignment sizes as low as .1 units. **For simplicity's sake, let's proceed with this module with the assumption that we need to maintain a cash balance in our account to absorb the assignment of one full-sized contract.** This means we have "cash-secured" our ability to be assigned or exercised.

Let's recall what a short, or sold Put Option is:

Short Puts - selling a Put Option causes the broker to immediately deposit the cash from the sale of the Put into our account. We will be obligated to buy one "unit" of the underlying spot crypto per contract sold, at the strike price of the Option, if the Option is ITM by Expiration Day closing time.

Let's remember what "in the money" is for a Put Option....an Option is ITM if the price of the underlying spot is at or below the strike price of the Option; this is opposite that of Call Options, so it can be confusing until you practice. To get oriented, you can always look at your broker's Options chain. In Figure 1 below, you can see that the Options chain for Bitcoin on Deribit (with the spot price at $11,800) shows "in the money" Options at the $12,000 strike price and higher, while "out of the money" Options are shown at $11,500 and lower prices. (which ironically are located "higher" on the chain).

Figure 1

9 Aug 2019 Expires In 3 days 18 hours 38 minutes **Price = $11,800** Puts

Strike	Size	Bid	Ask	Size	Δ|Delta
6500	-	- -	0.0005 $5.90	30.0	0.00
7000	-	- -	0.0005 $5.90	30.0	0.00
7500	-	- -	0.0005 $5.90	29.2	0.00
8000	-	- -	0.0005 $5.90	4.3	0.00
8500	-	- -	0.0015 $17.70	2.3	-0.01
9000	31.7	0.0005 $5.90	0.0020 $23.61	2.3	-0.02
9500	34.1	0.0015 $17.70	0.0030 $35.41	1.0	-0.04
10000	0.5	0.0040 $47.21	0.0055 $64.91	0.9	-0.08
10500	1.0	0.0095 $112.12	0.0100 $118.03	1.0	-0.15
11000	26.9	0.0180 $212.45	0.0190 $224.25	1.0	-0.25
11500	12.6	0.0325 $383.58	0.0345 $407.19	0.8	-0.39
12000	0.4	0.0495 $584.30	0.0550 $649.22	0.8	-0.54
12500	0.4	0.0770 $908.91	0.0820 $967.94	0.8	-0.67
13000	0.4	0.1100 $1298.28	0.1150 $1357.29	0.4	-0.79

We are ALWAYS going to be selling the OTM or "out of the money" Options with the Cash-Secured Put Strategy.

The Basic Premise of the Cash-Secured Put Strategy

Since we know that we earn income for agreeing to buy the underlying Spot Currency at a fixed price, here are the basic premises for the Cash-Secured Put strategy:

- **First, and most importantly, you would LIKE TO OWN the underlying Spot Currency, or at least not mind owning it for a short period of time.**
- **You just don't want to pay "retail" for the Spot Currency, you would like to buy it "wholesale" or at a discount.**
- **You will sell Puts at regular intervals to collect income.**
- **As long as the price of the underlying Spot Currency is above your strike price by the Expiration date, your Put Option will expire OTM and you can keep doing this until you are finally "put" the Spot Currency when it is ITM at Expiration.**

That's it! How much simpler can it be? This is one of my favorite strategies to execute during uptrends because the underlying Spot Currency just keeps "running away" from my short Put Option, allowing it to expire worthless. What usually happens is that I'll eventually see a major retracement that puts the Put Option ITM. At this point I can decide whether or not I want to allow the Option to be exercised or not.

And After You Get Put the Spot Currency....

Guess what? After you get "put" the Spot Currency after selling your Cash-Secured Puts, you now own the Spot Currency shares....so why not start selling Calls against them using the Covered Call strategy by being a "Landlord?" (which we'll cover in the next module) Generally the cycle that I'll go through over time is to sell Puts regularly until a deeper correction hits and I'm put the Spot Currency at a "discount," after which I'll manage the Spot Currency position by selling Calls against it until I can verify that my cost basis is well below any potential exercise.

But not all brokers treat the "exercise" in the same manner; we have to cover the "settlement" process next to ensure that we get the right result at expiration.

Physical vs. Cash-Settled Options

One of the differences that you'll find with brokers is how they "settle" the transaction at expiration. It's critical that you understand this process because it will effect the eventual outcome of the trade.

- **Physical Settlement** - This is where the trade is finalized (after expiration) by your assignment of the actual cryptocurrency that you were obligated to buy when you sold the Put Option. For example, if you sold the 30AUG Bitcoin $10,000 put option, and the price "settled" at $9990 on the 30th of August, you would be obligated to buy one Bitcoin for every contract that you sold. Depending on how you use the Cash-Secured Put strategy, this is not actually a "bad thing" because you're only going to use this strategy on assets that you want to accumulate, indicating that you wanted to buy more BTC anyway.

- **Cash Settlement** - After expiration, the broker simply figures the cash difference between the strike price that you sold and the final "settlement price" at expiration, and deducts the cash from your balance. You are not assigned to buy any of the spot currency. For example, if you had sold one contract of the 30AUG Bitcoin $10,000 puts, and the settlement price of Bitcoin on 30AUG was $9990, then the broker would subtract an equivalent $10 from your account to "settle" the transaction.

Hopefully you can see the difference between the two settlement methods. When we go more into detail on the available Options brokers that service the crypto space, we'll call out this difference. For the rest of this module, we'll make the assumption that we are going to use Physical Settlement even though it won't make much difference in the end how we settle the transaction.

Suggested Trading Rules for Cash-Secured Puts

Again, this is a perfect time to experiment with Cash-Secured Puts in your broker's sim account. (you can sign up with a free Deribit test account at test.deribit.com) It will allow you to gain experience with Options in a very simple manner. You may be surprised to find that many Options traders learn these two strategies (cash-secured puts and then covered calls) and never find the need to learn anything else. This strategy can also be easily accomplished while you hold a day job.

Offensive Rules (establishing the position)

- **You must want to own the Spot Currency!** If you're not sure if you want to accept assignment of the Spot Currency after you sell the Put, then exit the position and wait until you're ready to accept potential assignment. (Don't get cold feet unless there's a really good reason for not wanting to own the Spot Currency any more!) For this specific reason I am generally selling Puts on a major crypto asset such as Bitcoin, which should retain enough intrinsic value not go to "zero."
- You will either sell Puts OTM or ATM; if you go too far OTM then the return that you receive might not be worth enough to gain a required level of income. A suggestion would be to sell a strike that corresponds with a support level. If that is unavailable, I will choose a strike price to create a MINIMUM of a 1% return.
- The further in time that you sell the position, the more credit that you will receive, yet the more risk that you will take of the Spot Currency moving strongly towards or against your position. A suggested timeframe is 4-6 weeks to start with.
- Sell one contract of Put Options (sell to open) for every full unit/coin of Spot Currency that you intend to own. Make sure that you have enough capital in your account to be able to accept assignment of the position size that you have the potential of being put. Keep your position size very small to begin with while you learn. We'll cover more specific Risk rules in an upcoming module.
- The underlying Spot Currency must be in a primary long-term uptrend, or at the very least flat, for me to consider selling Puts against it. I will judge long-term trends by the Weekly chart trend. I do not want to be fighting the trend with this strategy and typically do not sell Puts if we are in a primary Bear Market.
- You can sell more than one monthly cycle at a time however keep in mind that you could be put the Spot Currency on all of the open contracts. I must ensure that I have enough cash to accept assignment on all of the positions.
- I will look for the underlying Spot Currency to make a pullback in the midst of an uptrend before I enter my short Put order.

Defensive Rules (maintaining the position)

- I generally do not “defend” these positions. I wanted to purchase the Spot Currency at this price so I’m OK with being exercised. The only time that I will change my mind is when the character and trend have changed on the underlying Spot Currency, and it no longer has a “tailwind” behind it.

- If I have more than one month of Cash-Secured Puts in play at the same time, I may not necessarily want to be assigned on BOTH monthly positions. If so, I will close the front month position by buying back the short Puts for a few pennies to close my obligation.

- When possible, I will allow my short put position to expire vs. closing it early at a specific target. This is more aggressive than pre-determining a specific price at which to buy back the short option and terminate your obligation. Find a method that works best for you and stick with it on every trade.

Cash-Secured Put Example

Let's show a live example on BTC Options using Deribit. On the 22nd of July Bitcoin was showing a choppy corrective pattern on the Weekly chart, while starting to slow down on the daily chart, throwing off positive divergences. I felt that the $9000 strike price about five weeks out offered a nice credit and a potential return of about 6.4%.

Figure 2

I used a position size of .1 BTC with Deribit, meaning that I was on the hook for a potential cash settlement of .1 BTC by expiration. The credit on the Option was .064 BTC, bringing in a .0064 BTC credit due to it being a size of .1 BTC.

Figure 3

Date (UTC)	Instrument	Type	Side	Quantity	Price	Cash Flow	Funding	Fee Rate	Fee Paid	Change
22 Jul 2019 12:35:58	BTC-30AUG19-9000-P	trade	open sell	0.10	₿ 0.0640	0.00640000	-	0.0004	0.00004000	0.00636000

Note that the cash came directly into my account in the form of more BTC, which is the underlying currency of Deribit. You can see in Figure 2 that the red line represents the price level that I believe will be “support,” and also represents the strike price that I sold the position at.

Now let’s view the trade a few days later:

Figure 4

Note that BTC has actually ***dropped*** about $1000 from my entry point! At this point most inexperienced Retail traders would likely eject from the position, concerned that BTC is heading to the magic figure of “zero” again! Fear can definitely play a role in how you manage a position, and there is little substitute for experience and confidence of knowing that you know where you will actually “buy to close” the position. In my case I felt that as long as the $8000 level held, I would stay in the position.

Let’s see where it is today:

Figure 5

The support held, and my position is now “in the black” meaning that I can buy it back for a cheaper price than when I sold it. I can also choose to just let the price expire out of the money.

Here is how Deribit reflects my current position P/L:

Figure 6

	Equity	Available Balance	Margin Balance	PNL	Initial Margin	Maintenance Margin
BTC	₿ **0.2385**	₿ 0.2285	₿ 0.2403	₿ 0.0046	₿ 0.0118	₿ 0.0093

The position is showing UP .0046 BTC, meaning that I could probably buy the position back for about .018 BTC (looking at the chain), meaning that it's achieved about 75% of its profitability. Again, everyone will have to choose their own risk barometer to determine your exits ahead of time.

What have I been required to do to potentially earn 6% on my invested capital on this trade? Very little. I chose to do the "difficult" thing of selling while BTC was trending slightly down, which allowed me to secure a deeper OTM fill, aligning with where I believed "support" would be. Knowing where my exit was ahead of time meant that I wasn't "freaking out" when the price continued somewhat lower and put my position underwater for some time.

There is a real magic about not having to be "right" about the direction of price day-to-day, and just letting time decay do its' thing.

Your Risks With Cash-Secured Puts

Just because these are simple Options strategies, doesn't mean that they don't carry risk. And my caution is that you don't trade these strategies in any size until you begin to simple Risk Management techniques. I would suggest very small positions until you really understand the risks and obligations of selling Options, and this is AFTER you have learned the mechanics of Options via a testnet interface such as that found on Deribit.

The often-repeated story that I hear is how someone sold Cash-Secured Puts for years during a Bull Market, then gave most of it back during one or two bad months of a correction or as the Market turned down into a Bear. It can be very risky if we have a true Black Swan event that leads Markets lower; you're stuck with inventory that looked like a bargain a week ago as the market topped out, and now it's like a ball and chain as the chart plummets lower.

This is why I get very cautious with this strategy when markets are in a "runaway" condition; every parabolic rally has a "hairy back" to it.

Your risk management control might be as simple as closing the position down if/when the 50 day moving average dips below the 200 day moving average, signifying a move to a longer-term downtrend. Is it just a dip in price, or are Markets moving into a true Bear? This is very difficult to judge, but could be crucial to you preserving your capital.

We've shown that Naked Calls have "unlimited upside risk" so we say "DON'T TRADE THEM!" And we've seen that Naked Puts/Covered Calls also have unlimited DOWNSIDE risk, but in effect we've given you a wink and said "but it shouldn't go to zero, so that doesn't really count." Again, this is why I do not play these strategies with any assets that I'm not sure will survive the "crypto apocalypse."

Disregard the downside risk of these supposedly "conservative" trades at your own peril. These are terrific trades...they're simple to learn and very effective, but "unlimited downside risk" means exactly that. Stick to very small positions for now, and continue to practice your active management of them by understanding where your exits are BEFORE you enter the trade.

Tasks - Cash-Secured Puts

Here is your "homework" for this chapter.

- [ ] Ensure that you have a virtual testnet broker account set up by now.
- [ ] Find a Spot Currency that you like and will specialize in.
- [ ] Look for pullbacks in this chart to sell Cash-Secured Put positions, assuming that it's in a primary uptrend.
- [ ] What is the biggest risk with this strategy? What could we do to mitigate this risk?

Summary - Options Income Strategies

In this module we got right into some of the details of how to create our first income trades. We saw how we could create bullish income trades by selling cash-secured puts. We did not “cover” these trades because the idea is to accept assignment into the Spot Currency at a “discount” price, however we also have unlimited downside risk.

There are many, many traders out there who do nothing but sell Puts and Covered Calls month after month and they do nothing else. Frankly, it does take somewhat of a larger account to swing these strategies and get anywhere with them. And they are “lumbering” trades, where you can rarely dart in and out with the flow of the Market, especially if you’re holding long Spot Currency and waiting for your sell point.

Let’s cover the “other” half of our Income Trades, the one where we own enough “land” to become a “Landlord” by selling covered calls against our Spot currency…which we’ll cover in Module Six.