Rolling ITM or DITM puts

Theme

You know it. You sell a put option and the trade goes busted next day. If you have never experienced this, then you are still going to. That I can guarantee.

In the past, I tried to predict the market/stock direction so I could be on the right side of the trade.

Today, I laugh at such effort. It's futile and you will never be right. At most, you may get 50% chance to be right. But that 50% is nothing to spend an effort for.

TD Ameritrade has on its website a tool called "Predict Wall Street". If you decide to play it, you will find out that the community is 40% right (sometimes even 55%). My score of predicting stock movement is 50%. I can flip the coin and get the same result.

So, don't bother predicting stocks or the market.

Rather, learn techniques which help you when you are wrong.

When you sell a naked put and the trade heads south you have two ways how to react:

1) You are still bullish on the original trade and you consider the price drop just temporary.
2) You doubt your first assessment (you are probably no longer bullish) and want to improve your odds right away.

Below, I try to describe several situations which may happen and how I would react to them based on the above mentioned classifications.

A. The stock goes ITM but we have plenty of time (still bullish outlook)

For example, we sell a put with 30 dollars strike price. The stock trades at 32 dollars, and our expiration is 56 days away. The next day the stock plummets to 27 dollars a share.

What would we do?

Nothing. We still have plenty of time until expiration and the stock still may recover.

B. The stock goes ITM but we have plenty of time (not so sure about being a bull anymore)

For example, we sell a put with 30 dollars strike price. The stock trades at 32 dollars, and our expiration is 56 days away. The next day the stock plummets to 27 dollars a share.

What would we do?

Nothing, as above, we still have plenty of time until expiration and the stock still may recover.

But the following days the stock continues sliding down and it goes even lower down to 24 a share.

What would we do?

Now, the stock may recover, we still have more than 40 days to expiration and it really can do a lot. However, the stock would have to move up 25% to get us back on horse. That is very unlikely. I am not saying it won't ever happen, but it is not an everyday event. It would pay to roll the option down and away in time.

C. The stock goes ITM but we only have a few days left to expiration (still bullish outlook)

This can happen as a lighting. You sold a put, the trade was doing great, but it was "dancing on the floor" (meaning that the stock price was fluctuating around your strike all the time, so our 50% profit taking strategy didn't kick in). Suddenly, 4 days before expiration the stock tanks ITM.

What would we do?

If we are still bullish (and the whole market is still bullish) and there is a great chance that the stock would recovery easily except that it may not happen this expiration and we need more time. We would roll the trade away in time but keep the same strike.

For example, we sold a put option with 30 dollars strike and the stock went down to 28.50 a share. We think it is a temporary selloff, the stock has a great potential of moving higher then we roll into another month but keep the 30 dollar strike.

D. The stock goes ITM but we only have a few days left to expiration (not so bullish outlook)

If a situation as described in item "E" happens and we are not sure whether the stock recovers or keep sinking and we want to play this safely we would roll our put trade into the next available month and down in price. This strategy would improve our odds to make this a winning trade.

Some rules for rolling puts:

1. Always roll puts so the resulting trade will be a credit trade

   When rolling down and away in time always select a month and strike so the trade will be a credit trade. Never pay any debit rolling puts! If you cannot roll an ITM or DITM into OTM position then roll DITM into ITM first and later into OTM (See pictures below). If lowering strikes won't help, then roll into same strike as described above and give the stock time to provide a better opportunity to roll.

2. Never roll into 1:2 contracts

   When rolling puts down and away never roll into unequal contracts just to achieve a credit trade. For example, you do not want to roll from May into November because that is too long time to block your money (or margin) and rolling into June would make the trade a debit trade, so you decide to buy back 1 contract and sell 2 new contracts to make the trade a credit trade.

   Never, ever do that (unless you have plenty of free money and treat such trade as a completely new trade)! You are increasing your risk and if you get early assigned, you may end up in a margin call. Believe me, I have done that in the past and I lost tons of money.

3. If nothing works, then accept a stock assignment.

All the rules and strategies mentioned above are not a strict rules you have to follow at all cost. Consider it a computer game. You are playing a game where your enemy is Mr. Market trying to rob you off of your money. You play those strategies to make military-like moves to protect your kingdom. These strategies are bullet proof and Mr. Market has no defense or offense against them. You can play them with open mind and at your convenience and your own mood. You feel like rolling down and away in time makes the trade a lot better? Then do it. You cannot lose a penny doing so.

Yes, the only loss you will see is time. Instead of a next month expiration, you now have to wait another 5 months to get your money out.

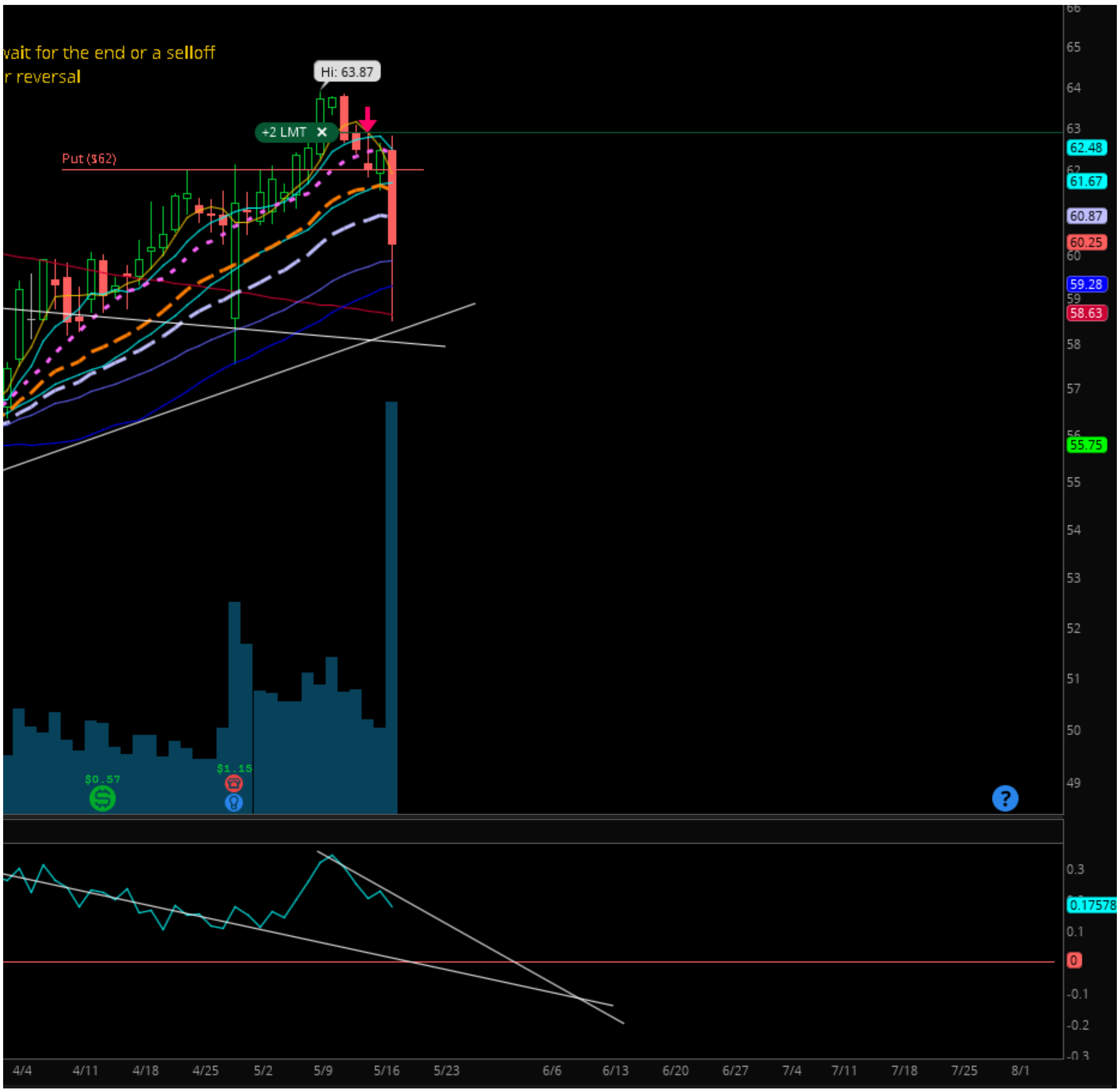
But look at it this way, some people bought a stock when it was trading at 135 a share and now it is trading at 11 a share. They may never recover, while you will be waiting just 5 more months to turn a busted trade into a profit. Guess what stock I was referring to (hint: GoPro).

My mentor once said, "It is great when everything goes well with your trades, but trader mastery is to have losing trades and still make money."

Practical example rolling puts

I want to use a recent stock trade (ABBV) to show you how I roll puts when the stock gets ITM or DITM.

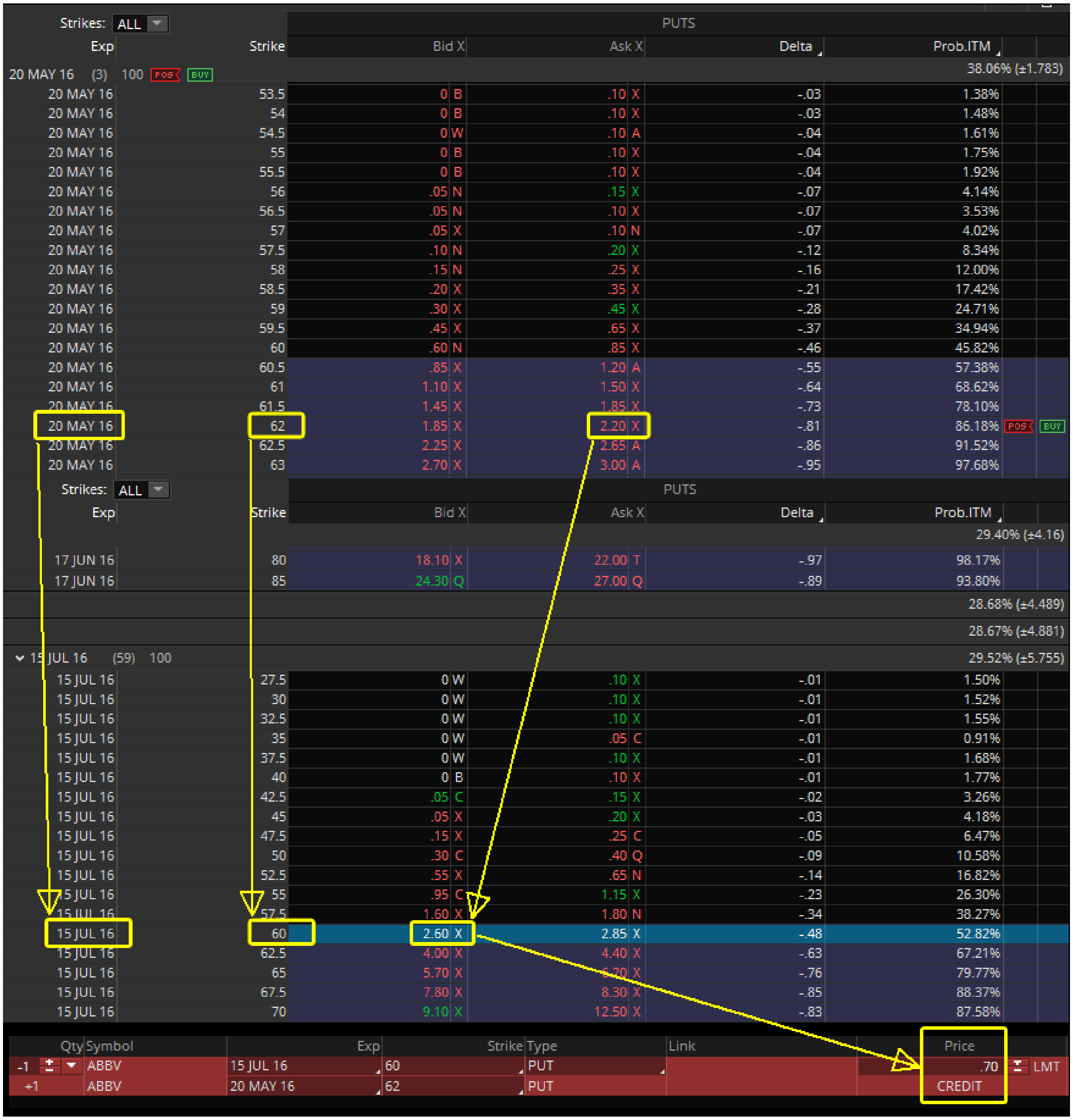
The trade was a risky one. When ABBV was selling at $62.50 I sold 62 strike put contracts, so already ATM trade. The trade was doing well until today when the stock sold of hard on patent issue. Here is a chart of the selloff:



The stock sold off on heavy volume. It went down to $58.50 a share. It only had 3 days to expiration. I was about to make a decision whether to roll right away or wait.

I decided to wait because such huge selloffs usually bounce and by the end of the day the stock recovered back to $60.25. By waiting, I had nothing to lose anyway. The trade was already busted.

However, in the next two days the put options were set to expire. I didn't want assignment so if the stock remained ITM I decided to roll.



As you can see on the picture above, I first look at for how much I would have to buy back the existing put contract.

The chain indicates that I would have to pay 2.20 to buy it back.

Then I look at the nearest month available which would allow me to lower the strike down and collect at least the same credit or more to pay for the purchase of the existing contract.

When looking at June month, I can lower the strike from 62 to 60 and collect 1.70 credit. But I would have to pay 2.20 debit (mid-point) to liquidate the old contract. This would result in 20 dollar debit trade and that is a no-no.

Then I look at July month and I can see that I could lower the strike from 62 to 60 and collect 2.60 credit. I need to pay 2.20 for the old contract so this trade would result in collecting another 70 credit (mid-point). This would be a perfect trade to roll.

If after rolling down the stock continues sliding down, then I would roll again lower using the same method of finding the next available month which would allow me to lower the strike and collect enough credit to pay for the old contract.

If there is no such month available, for example you already rolled twice and you are at the farthest month available in the chain, then you have to wait.

This strategy works the exact same way when rolling calls.

Good luck trading

Martin

ZZ Capital Management, LLC

2016-0517