OptionsTradingIQ

EARNINGS SEASON MASTERY

Strategies for Consistent Success

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Introduction

Trading a stock around earnings can be a popular strategy but also has distinctive challenges for investors.

Stocks often see sharp moves around earnings announcements; for example, a positive surprise can drive a stock higher, while disappointing results can send it suddenly lower.

Traders can position their trades to take advantage of the volatility that rises before the earnings announcement or the drop in volatility after volatility declines.

It may be better for some traders to avoid trading a stock during this timeframe if they are not equipped to deal with the added complexity that comes into earnings season.

This e-book explores the opportunities and risks of trading during earnings season so you can understand the fundamentals of this important season for traders.

Chapter 1: Understanding Earnings Season

Earnings season is when most corporate earnings are released to the public each quarter.

It typically begins within the first couple weeks of January, April, July, and October and lasts about six weeks.

Investors and traders will analyze key components of an earnings report, such as Earnings Per Share, Revenue, Net Income, and Guidance, to help make informed decisions about buying, holding, or selling a stock.

A positive or negative surprise can lead to sharp movements in a stock, hence why volatility typically increases before the earnings report is released.

Once the data from the report is released and more certainty is known about the company's profitability, revenue, growth, and overall financial stability, volatility in the stock sharply declines.

This phenomenon is commonly referred to as IV Crush.

Traders can develop strategies to navigate earnings season's volatility and potential reward by knowing key dates, market expectations, and sentiment.

Chapter 2: Basics of Option Trading

This section will cover the basics of how options work and how they are usually used in today's modern financial markets.

If you're familiar with option basics, feel free to skip to the next chapter.

Options can be used for various purposes, such as speculation, hedging, and income generation.

However, before executing any complex earning trades, traders should deeply understand the basics of options trading.

Below are some key concepts and terminology every options trader should understand.

- A call option is a financial contract that gives the holder the right, but not the obligation, to purchase a certain underlying asset at a certain price, known as the strike price.

- A put option is a financial contract that gives the holder the right, but not the obligation, to sell a certain underlying asset at the strike price on or before expiry.

- The strike price is the price at which the holder can buy (call) or sell (put) the underlying asset.

- The expiration date is the date on which the option contract expires. After this date, the option becomes worthless if not exercised.

- The premium is the price paid for purchasing an option. It represents the cost of acquiring the right to buy or sell the underlying asset.

- Intrinsic value is determined by the difference between the stock's current price and the option's strike price.

- The extrinsic value is measured by the difference of the intrinsic value and total value of the option price. It is influenced significantly by implied volatility, the days to expiration and underlying trend (among many other factors).

Implied volatility is crucial in options trading, especially with earnings trades.

The implied volatility of a stock measures the market's expectations of an underlying asset's future move, or volatility.

The higher the implied volatility, the higher the expected price movement, and vice-versa.

Usually, higher implied volatility also means higher options premiums and risk.

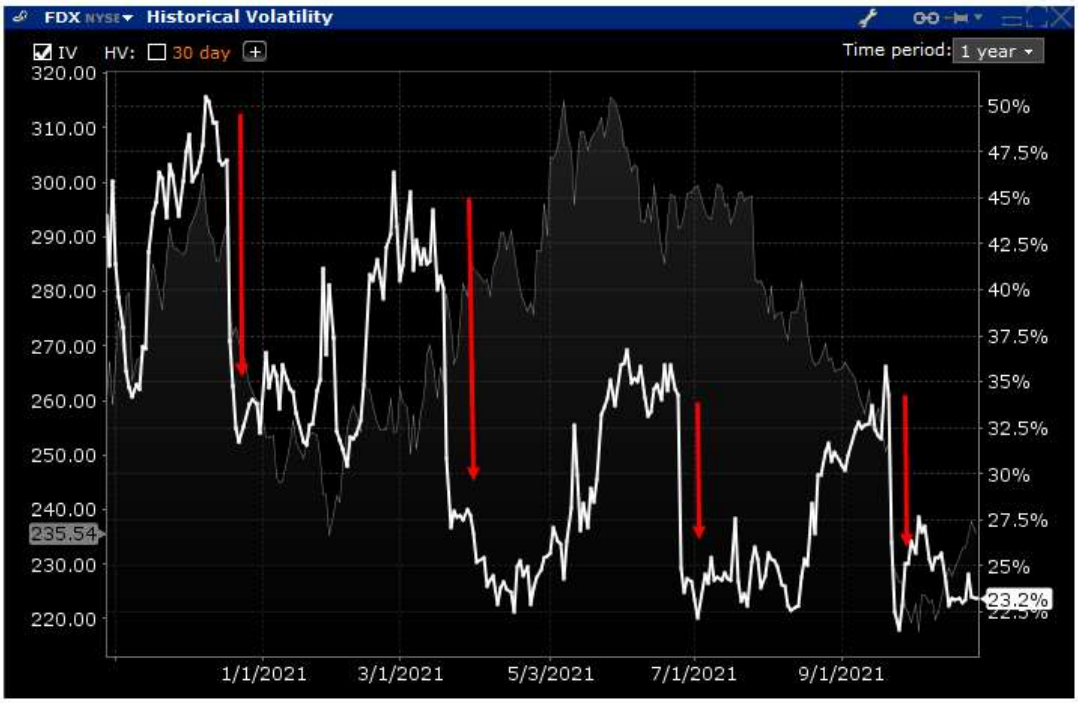
Chapter 3: The Impact of Earnings on Options

Earnings announcements are binary events – meaning they can either have a positive or a negative outcome.

When a company reports earnings significantly above or below analyst expectations, it can cause the stock price to move sharply.

Other factors influencing the stock price when earnings are released include market sentiment and future outlook.

It's been well documented that implied volatility tends to remain elevated in the lead up to earnings announcements and then gets crushed afterward.



Therefore, there are opportunities available to options traders to benefit from this phenomenon.

As earnings approach, traders anticipate potential price swings in the underlying price with the release of earnings.

This increase in expected move causes the implied volatility to increase, increasing the value of both call and put options.

This is implied volatility at work.

After earnings are released and uncertainty dissipates, the implied volatility rapidly decreases.

This phenomenon is known as Volatility Crush or IV Crush and can result in a sharp decline in the option's premium.

By understanding these dynamics and employing appropriate trading strategies, option traders can navigate the volatility and capitalize on the opportunities presented during the earnings season.

Chapter 4: Pre-earnings Strategies

Trading options before earnings announcements can be highly profitable but involves considerable risk.

Rather than holding options through earnings, the trader closes the trade on or before earnings to capitalize on the volatility and price movement before the earnings announcement.

This chapter will explore strategies traders can employ before earnings reports to maximize their returns and manage risk effectively.

DIAGONAL SPREADS

A pre-earnings strategy I like to use is the diagonal spread, which involves buying and selling an option at different strike prices and expiration dates.

I like setting these trades up by looking for stocks with a history of rallying into earnings and entering the trade about two weeks from the earnings date.

First, sell an OTM call at the expiration immediately after the earnings date (Earnings should be within the same week as expiration).

Then, buy the same number of calls at roughly the same price in the next expiration week.

Close the trade before the earnings event.

CALENDAR SPREADS

Calendar Spreads are widely used for pre-earnings trades and involve buying and selling an option with the same strike price, but different expiration dates.

The trade benefits from time decay, but this is partly offset by the expected rise in implied volatility.

The stock price also needs to stay within a certain range for the trade to be profitable.

If the stock moves significantly in either direction, the position may need to be adjusted to maintain the position.

LONG STRADDLE

Another common strategy is the Straddle, which involves purchasing both a call and a put option at the same strike price and expiration date, allowing traders to profit from significant price movement in either direction.

It provides exposure to increased implied volatility and potential price movement while managing directional risk.

As the stock price moves, more adjustments may be required to prevent the trade from becoming too bearish or bullish.

IRON CONDORS

Iron Condors are neutral strategies that can benefit from limited price movement and time decay.

A trader will sell an out-of-the-money call spread, and an out-of-the-money put spread.

This trade benefits from the limited price movement and tme decay of both options sold.

Pre-earnings strategies can provide opportunities to profit from the volatility and uncertainty surrounding earnings announcements.

Managing risk is essential, so keep positions small to limit exposure, spread trades across different stocks and sectors to avoid concentration risk, and know your stop loss limits to exit a trade and preserve capital.

Chapter 5: Post- Earnings Strategies

After an earnings announcement, the market often undergoes significant changes in volatility and stock prices.

Post-earnings strategies focus on capitalizing on these changes, especially the phenomenon known as volatility crush, where implied volatility drops sharply after the earnings report is released.

This chapter explores various strategies traders can employ after earnings announcements to exploit the new market conditions.

As noted in the prior chapter, implied volatility increases before earnings, but once the earnings are announced, it drops significantly after the announcement, reducing options premiums.

As investors and analysts reassess their positions and forecasts based on the new information, the stock price may experience a sharp movement immediately before stabilizing again.

If you are willing to buy the stock at a lower price, then selling cash-secured puts can be profitable.

If you are employing this strategy, you will want to select stocks or ETFs that you are willing to hold long term.

The setup involves selling a put option with a strike price slightly below the current stock price, ensuring you have enough cash to buy the stock if assigned.

The trader can earn premium income and potentially buy the stock at a discount.

If you expect the stock to trade within a range after the announcement, a more neutral trade like the iron condor might be an effective post-earnings strategy.

A key risk management control for post-earnings trades is to limit the size of each position to avoid excessive exposure and potential losses.

Chapter 6: Earnings Season Calendar

An important tool for a trader to have is an earnings season calendar to provide a structured approach to tracking and planning trades around earnings announcements.

It helps traders stay organized and identify potential opportunities.

The first step is to identify and list the earnings announcement dates for companies you are interested in.

I use Barchart and Market Chameleon to track company earnings dates.

Track the implied volatility levels for each company's options leading up to the earnings announcement.

This information helps identify potential opportunities for strategies that benefit from the changes in volatility.

Use calendar reminders or alerts to notify you of upcoming earnings reports, ensuring you have enough time to prepare and adjust your trading strategies.

Establish a repeatable process for yourself to help maximize your trading opportunities by using a trading calendar.

Before the earnings season begins, review your calendar and identify key earnings dates.

Then, use your calendar to schedule and execute your pre-earnings and post-earnings strategies.

Ensure you have a clear plan for each trade, including an entry, exit, stop loss, and position size.

After each earnings announcement, review the outcomes and market reactions.

Analyze the new information to see how it might correlate to your own strategies and positions and adjust as warranted.

Chapter 7: Case Studies and Examples

Understanding the theoretical aspects of trading options around earnings is crucial, but seeing these strategies in action provides invaluable insights.

This chapter explores case studies and examples, illustrating how different pre- and post-earnings strategies can be applied in real-world scenarios.

These case studies will help you understand the decision-making process, execution, and outcomes of various strategies.

Case Study 1: LULU Diagonal Call Spread

Trade Details:

Date: June 2, 2020

Stock Price: $308.69

Trade Set Up:

Sell 10 LULU June 12th, 350 calls @ $2.70

Buy 10 LULU June 19th, 360 calls @ $2.09

Premium: $610 Net Credit

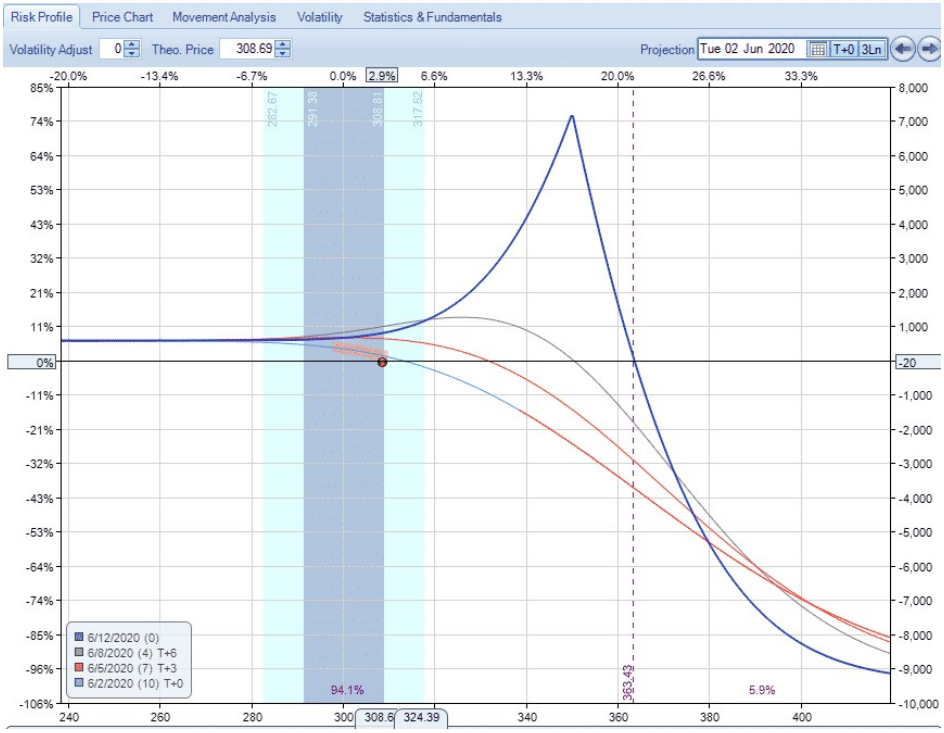
Capital At Risk: $9,390

With this trade, the worst that can happen on the downside is that both call options expire worthless, and we keep the $610 in premium for a return of 6.50%.

The risk with the trade is on the upside, and any big rally early in the trade will hurt.

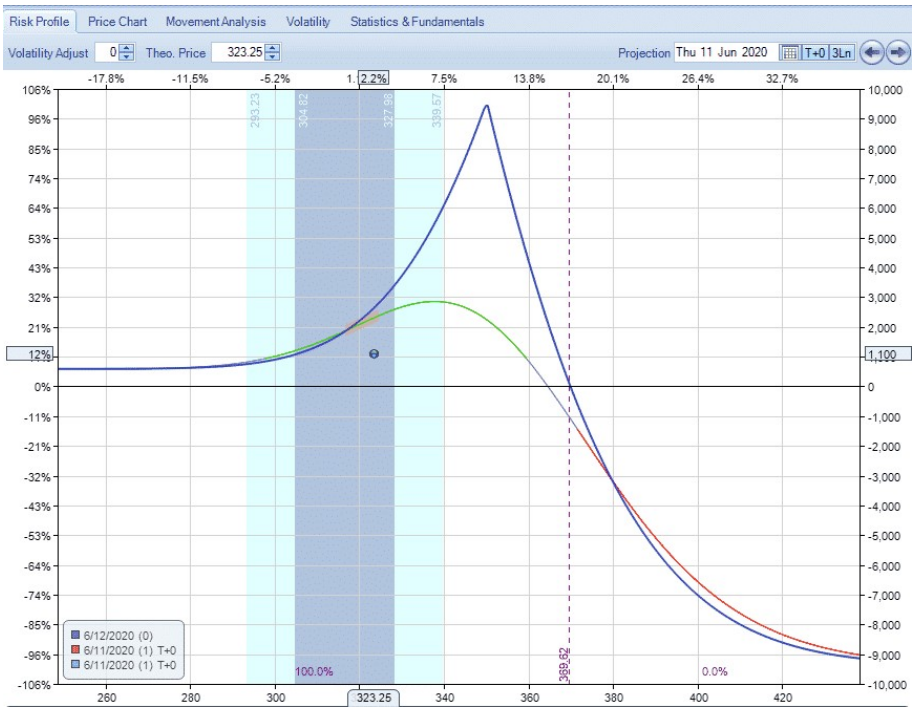
With such a short-term trade, they usually withstand moves higher pretty well, provided the stock doesn't go above the short strike.

Looking at the payoff diagram below, notice that a 13% rally (to $340) sees the trade in a loss on days 0 to 3 but in profit of about 10% on day 6.



Here's how the trade looked on the day before earnings, with a nice profit of about 12%.

This occurred even though the front week volatility shot through the roof and doubled while the back week only increased from 55% to 68%.



Case Study 2: COUP Diagonal Call Spread

Trade Details:

Date: June 2, 2020

Stock Price: $233.96

Trade Set Up:

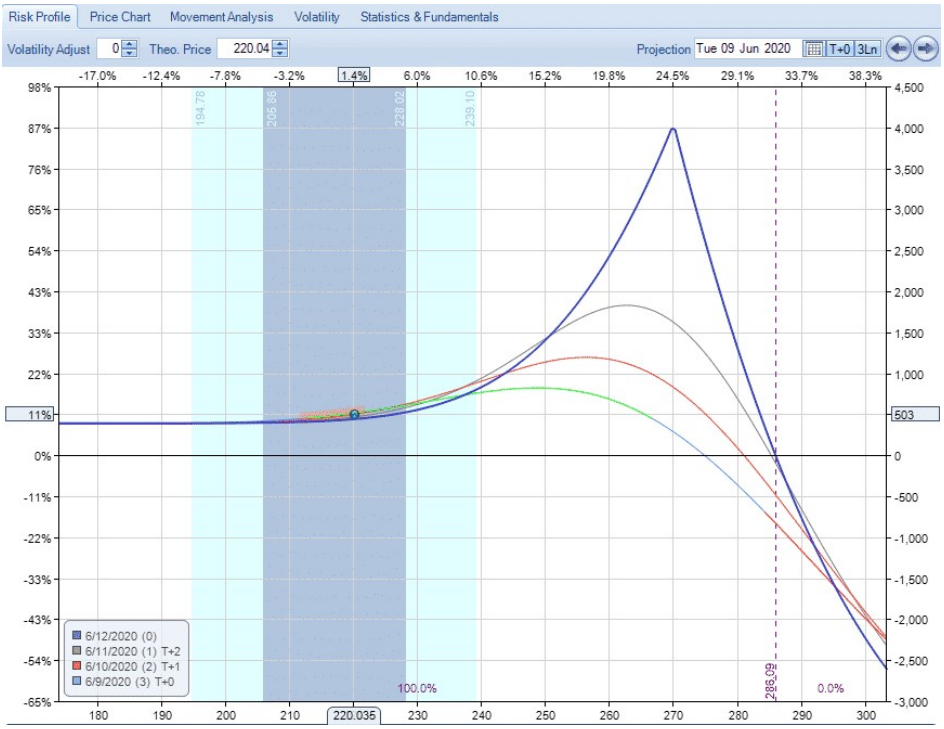
Sell 5 COUP June 12th, 270 calls @ $3.10

Buy 5 COUP June 19th, 280 calls @ $2.30

Premium: $400 Net Credit

Capital At Risk: $4,600

This is a similar setup to the LULU example and a similar result for a return of $500 or 11% on capital at risk.



Case Study 3: CRM Diagonal Put Spread

Trade Details:

Date: May 15, 2024

Stock Price: $287.54

Trade Set Up:

Sell 5 CRM May 31st, 262.50 calls @ $2.15

Buy 5 CRM June 7th, 260 calls @ $2.10

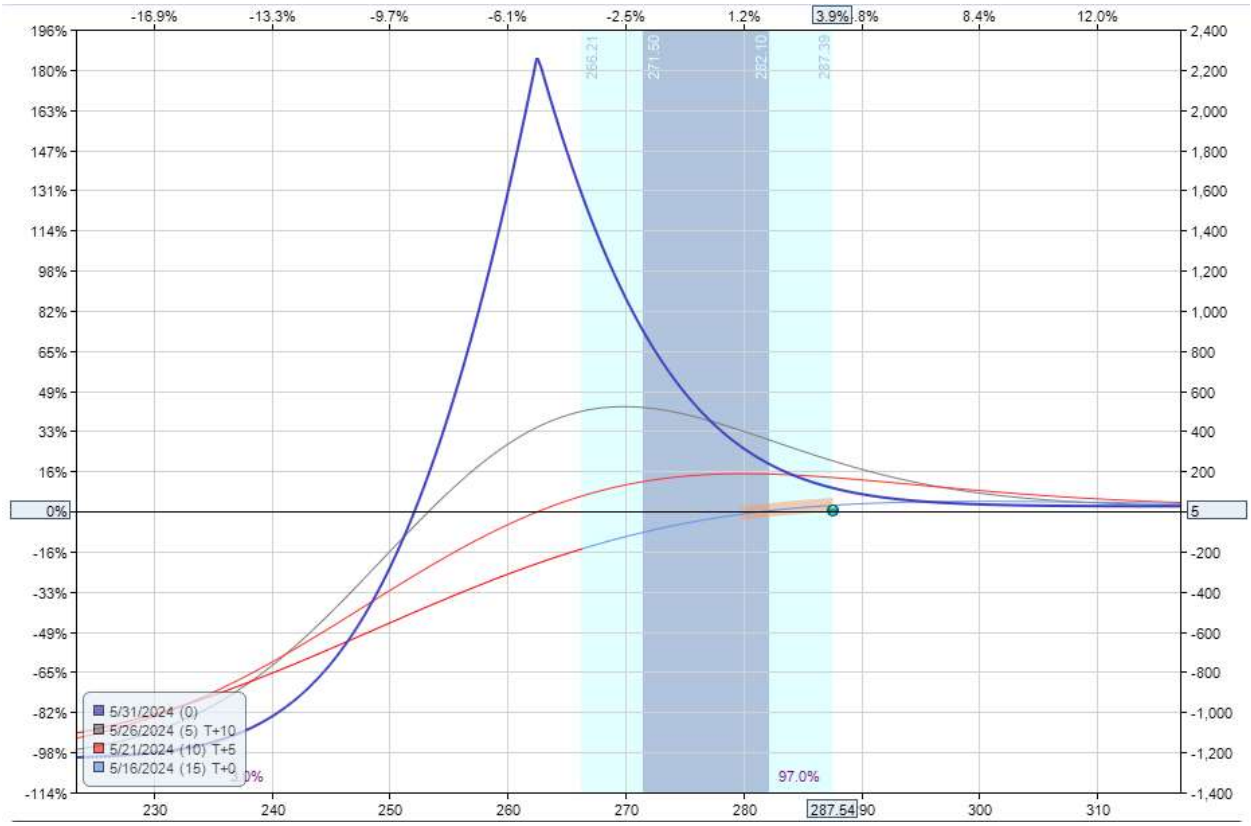
Premium: $25 Net Credit

Capital At Risk: $1,225

This trade is similar to the first two examples, but this time we are using puts which means our profit zone is on the downside.

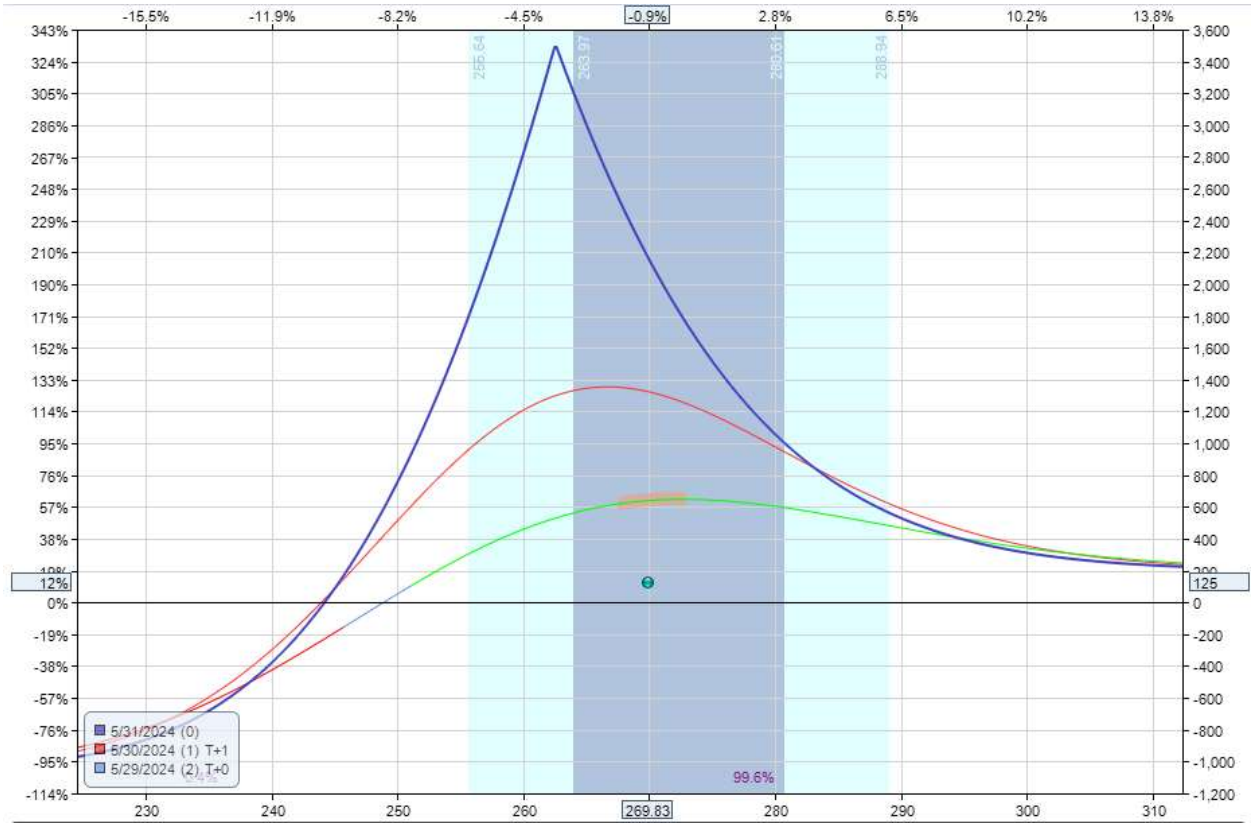
We want the stock to stay flat initially and slowly move into the profit zone as earnings approaches.

Here's how the trade looked at initiation.



Two days before earnings, CRM was sitting at 269.83 and right in our profit zone.

We were able to close the trade for a 12% gain without taking any earnings risk.



Case Study 4: AMD Cash Secured Put

Trade Details:

Date: May 3, 2023

Stock Price: $81.59

Trade Set Up:

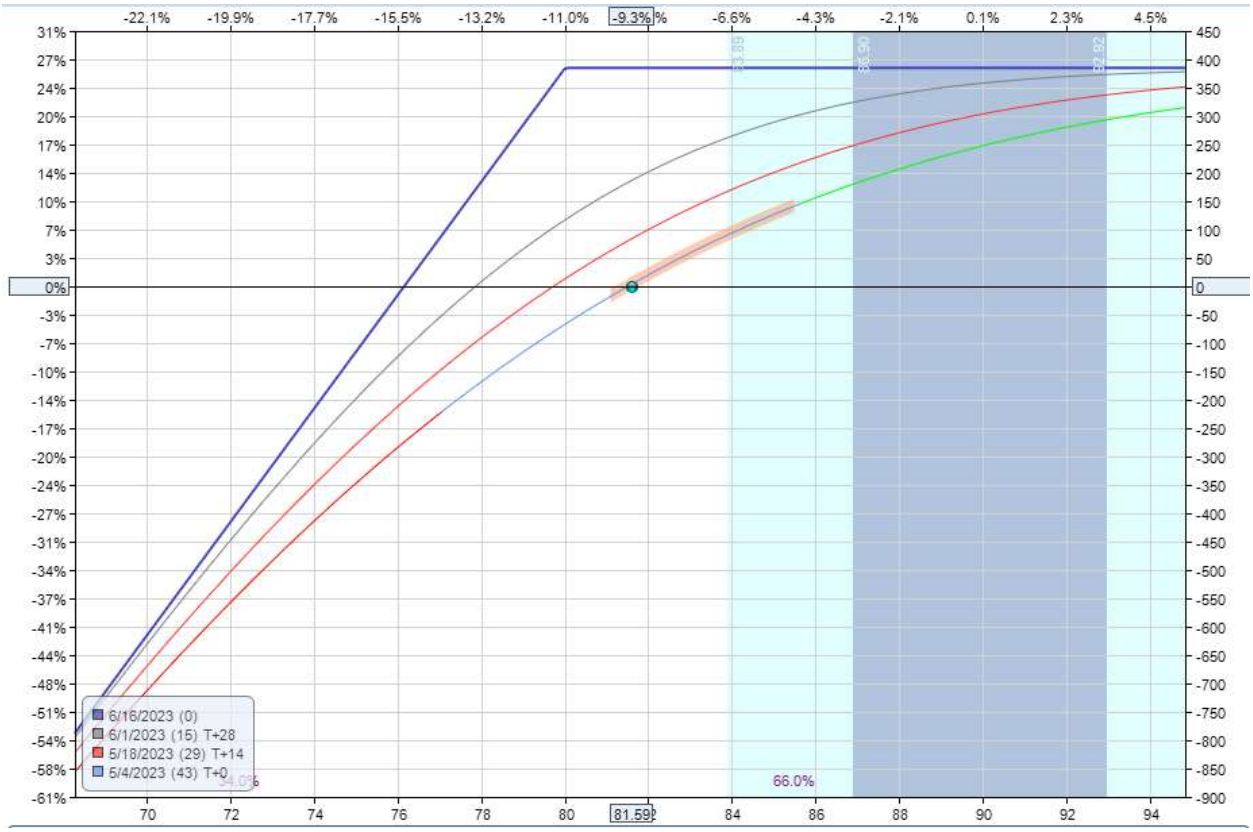
Sell 1 AMD June 16th, 80 put @ $3.88

Premium: $385 Net Credit

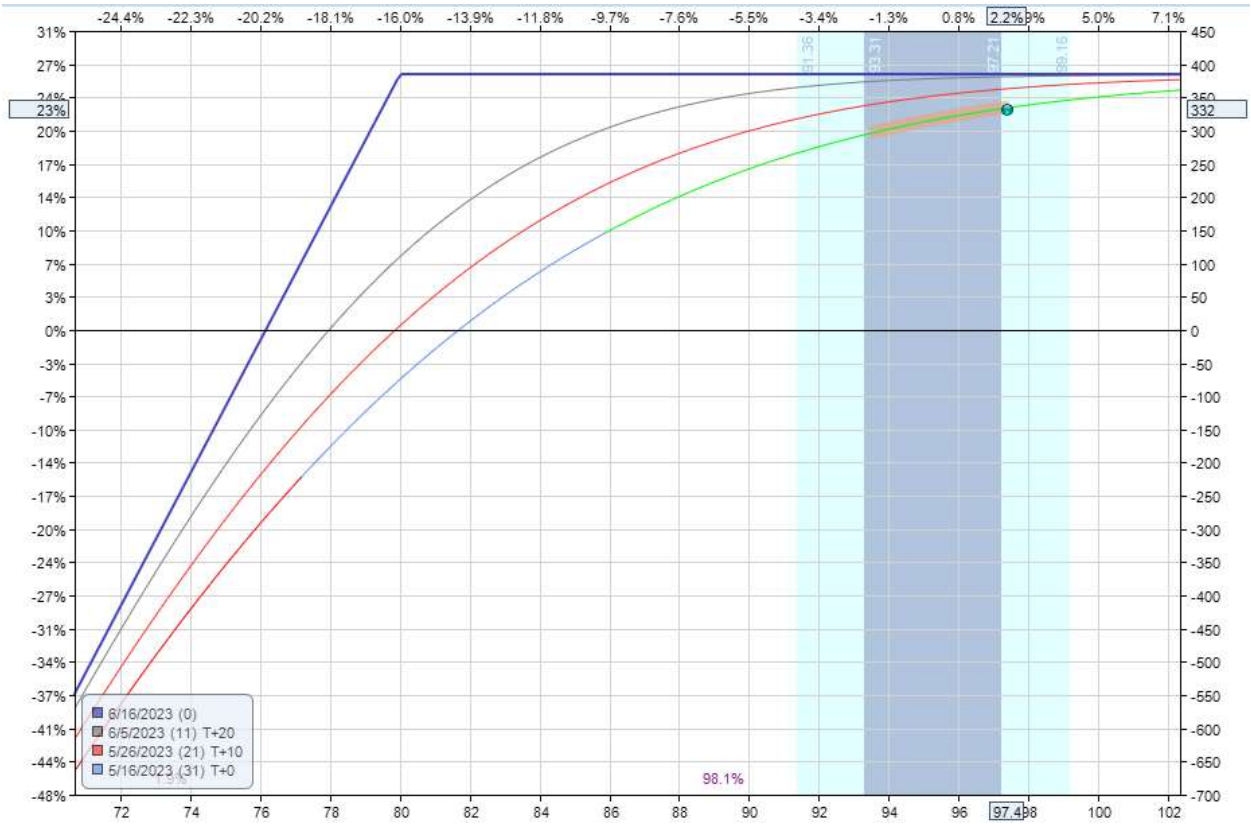
Capital At Risk: $7,615

In May 2023, AMD experienced a 9% drop after releasing their Q1 earnings report.

That move looked to be overdone, so we sold a June put at the $80 strike for $3.85.



By May 15th, the stock had recovered to $97.40 and most of the profit in the trade had been achieved allowing us to close the trade early for a 23% profit.



These case studies demonstrate the practical application of various pre-earnings and post-earnings strategies.

You now have a couple of fantastic strategies in your toolkit for trading earnings.

Chapter 8: Risk Management

Options trading inherently involves several types of risk, such as market, liquidity, and volatility risks.

However, managing risk within earnings strategies is paramount due to the heightened volatility and potential for significant price swings.

One of the most effective ways to manage risk is through proper position sizing and capital allocation.

A good rule of thumb is to allocate no more than 2% of your total capital on a single earnings trade. So, if your portfolio is worth $100,000, each trade should not exceed $2,000.

Another common risk management practice is using a stop-loss order, where a trade is automatically closed if certain predetermined loss levels are reached.

Alternatively, a trader may choose to set an alert to exit the trade if the loss tolerance threshold is reached.

Managing risk also involves maintaining the right mindset and discipline.

That is why it is important to develop a plan for each trade.

Stick to your trading plan and avoid making impulsive trades based on emotions or market noise.

It's also important to understand that not every trade will be a winner, and taking losses is part of the trading experience. Accept when those losses occur and focus on maintaining a positive risk-reward tradeoff.

Chapter 9: Tools and Resources

The right tools and resources are essential for effective options trading around earning season.

The first and most critical tool needed is a robust trading platform to execute trades and analyze data.

Key features to look for in a trading platform include access to real-time data, advanced charting, and features for analyzing options strategies, including profit/loss graphs, Greeks, and volatility analysis.

You will also want to ensure your platform supports various order types, including market, limit, stop-loss, and conditional orders.

There are several trading platforms, but some of the most common platforms traders use include ThinkorSwim and Interactive Brokers.

Barchart.com is another invaluable tool that helps me find and design option earnings trades.

Conclusion

Options trading around earnings can be highly rewarding for those who approach it with preparation, knowledge, and discipline.

By mastering the strategies and techniques outlined in this e-book, you can enhance your ability to profit from earnings season while effectively managing risk.

Stay informed, continuously educate yourself, and be adaptable to changing market conditions.

Remember that successful trading is a journey of constant learning and improvement.

By leveraging the insights and tools provided, you can develop a robust trading approach to capitalize on the unique opportunities presented by earnings announcements.

We hope this e-book has provided valuable guidance and inspiration for your options trading journey.

May your trades be profitable, your risks be well-managed, and your strategies be continuously refined for long-term success.

About Us

Our mission is to empower individuals to take control of their financial destinies.

Since our start in 2010, we've been driven by a deep-rooted conviction that financial freedom is not a distant dream but an achievable reality for everyone.

We've created free tutorials on just about every possible option topic.

If you think there is anything missing, drop us a line and we'll cover any subject matter you want to learn about.