COVERED OPTIONS: A TOOL FOR THE FUNDAMENTAL INVESTOR

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Remember

I am a volunteer presenter!

- Not soliciting you to buy or sell anything!
- This is free investment education
- Before investing in anything:
  - Consult a professional
  - Or do your own research

Disclaimer

- More advanced topic
- Best if basic knowledge of stock options
- …. and more importantly, fundamental investing

What is this Session about?

- Quick refresher on Covered Options basics
- Some of my own ideas about covered options
  - A few different twists, tips, and tricks
  - Real trades to look at
  - Ideas on what stocks work best for options

IN BASEBALL TERMS

Selling Covered Options:

Great Career of Singles

Not Home Runs

A Little Lingo

- “Buy” side options
  - Initiated by first buying an option
  - AKA Going long options
  - Opening trade is a “Buy-to-Open” or BTO
  - ☹☹☹☹
- “Sell” side options
  - Initiated by first selling an option
  - AKA Shorting options
  - Opening trade is a “Sell to Open” or STO
  - ☺☺☺☺

“Sell” side is what this session is about!

My Background

- Investing for 30+ years
- Commodity oil trader for a few years
- Tried “Buy” side options 20 years ago
  - “Lucky” & made $$$$
  - ….Then, lost $$$$$$
  - Back to just stocks!
- Attended InvestEd classes on Covered Options
- ***VERY*** active with “Sell” side options

Why "Sell" Side Options Work

Two Analogies for Two Types of Options

- "Lease to Buy" – Covered Calls
- "Insurance" – Cash-Secured Puts

"Lease to Buy"

- **Covered Calls**
  - You have an asset (your stock)
  - You want to sell at a specific price
  - Someone else may want to buy your asset
  - They ***Lease*** your asset for a short period
    (in Option lingo this is a premium)
  - During the period, They have the right to ***Buy*** at the agreed price
  - If They don't buy, you are free to ***Lease*** again

"Insurance"

- **Cash Secured Puts**
  - You have cash
  - You might buy a stock
  - Someone pays you (a premium) to ***insure*** they can, for a short period, sell at a certain price
  - Why does insurance works? – ***FEAR!*** - same for options!
  - Who makes money? The seller of insurance

Why Selling Option Wins

- Options are a Wasting Asset
  - The "time premium" decays to zero
- Better to Sell a Wasting Asset than Buy

We all own Wasting Assets called Cars!

Thought on “Buy” Side Options
(What I call “A Good Way to Lose Money”)

The people trying to get you to buy Options ….

Might be the people who are selling Options

Come to the “Sell” side & enjoy the profits!

The Big Picture

- The “real money” is made:
  - Doing fundamental analysis
  - Investing in ***good quality growth companies***
  - Using GARP principles
- Selling Options
  - Can supplement your returns
  - Does Requires more “attention”
  - Should also only be done on ….
    good quality growth companies

Refresher on Option Basics

- 1 option contract is 100 shares of stock
- Every option has a strike price
  - Call – Price option seller might have to sell their stock at
  - Put – Price option seller might have to buy the stock at
- Available Strike Prices
  - Increment is usually every $5
  - Some stocks are every $2.5
  - Index ETFs are every $1
- Every option has an expiration date

Common Option Expirations

- Monthly options
  - Most stocks
  - Expire Saturday after the 3rd Friday each month
  - Many stocks only have options for just a few months out
- Weekly options
  - Big companies, heavily traded companies and ETFs
  - Become available the preceding Thursday
  - Expire on the last trading day of the week
- Quarterlies
  - Index ETFS
  - Expire the last trading day of the quarter.

Two Types of Covered Options

- Covered Calls
  - For when a stock's price is close to your **Sell** level
- Covered Puts or Cash-Secured Puts
  - For when a stock's price is close to your Buy level

Buy & Sell levels should be based on fundamental analysis

Questions?

COVERED CALLS

Why sell a Covered Call?

- Your stock is up nicely…
- But you are not quite ready to sell!

BUT YOU THINK YOUR STOCK MIGHT GO DOWN

When to Sell a Covered Call

- *Covered Call premiums are best when:*
  - The stock has moved up for awhile
  - The stock is up on the day
  - The market is up on the day
  - Volatility is up

If you do technical analysis, look for "bearish" indicators

When to Just Sell the stock?

- Stock is WAY overvalued
- Significant *negative* change in fundamentals

How to Sell a Covered Call

- Must own at least 100 shares of a company
- Determine your Sell level – minimum *strike price*
- Start with selling front (first available) month *expiration*
- Sell one contract for each 100 shares

After you have sold

- One of three things will happen:
  - Option expires worthless
  - Option is bought back to close It
  - Option is exercised

Call Option Expires Worthless

- Option open until *expiration date*
- Underlying stock closes below the *strike*
- You retain your stock
- You keep all the *premium* you collected
- Taxable account - short term capital gain

Call Option is Bought Back to Close

- Prior to the *expiration date*
- Option is bought back to close the position
- Keep difference between *premium* you sold and the *premium* you paid to buy it back
- Released from obligation to sell stock
- Taxable account - short term capital gain (or loss)

Call Option Gets Exercised

- Option open until *expiration date*
- Underlying stock closes above the *strike*
- Keep all the *premium* you collected
- Stock is sold at *strike* price of the option
- “Sales basis” = *strike* plus the *premium*

Questions?

CASH-SECURED PUTS

Why sell a Cash-Secured Put?

- The stock is down…
- But you are not quite ready to buy!

BUT YOU THINK THE STOCK MIGHT GO UP

When to Sell a Cash-Secured Put

- *Put premiums are best when:*
  - The stock has moved down for awhile
  - The stock is down on the day
  - The market is down on the day
  - Volatility is up

If you do technical analysis, look for “bullish” indicators

When to just Buy the stock?

- Stock is WAY undervalued
- Significant *positive* change in fundamentals

When NOT to Sell PUT

Do not sell puts …..
when expiration is after an earnings release!

This is equivalent to an insurance company selling hurricane insurance after they know the hurricane is coming!

Selling a Cash-Secured Put

- Determine your Buy level – this sets the maximum *strike price*
- Determine cash available, sets shares
- To begin sell first month expiration
- Sell one contract for each 100 shares

After you have sold

- One of three things will happen:
  - Option expires worthless
  - Option is bought back to close it
  - Option is exercised

Put Option Gets Exercised

- Option open until *expiration date*
- Underlying stock closes below the *strike*
- Keep all the *premium* collected
- Have bought stock at the *strike* price
- “Purchase basis” = *strike* less *premium*

Reminder!

- Stock is a screaming *buy*
  don't sell PUTs…*buy the stock!*
- Stock is a screaming *sell*
  don't sell CALLs … *sell the stock!*
- Covered Options work best when:
  - Close to reasonable buy
  - Or close to reasonable sell

Questions?

VOLATILITY

Which would you fear more?

- Driving around town?
- Driving a race car?

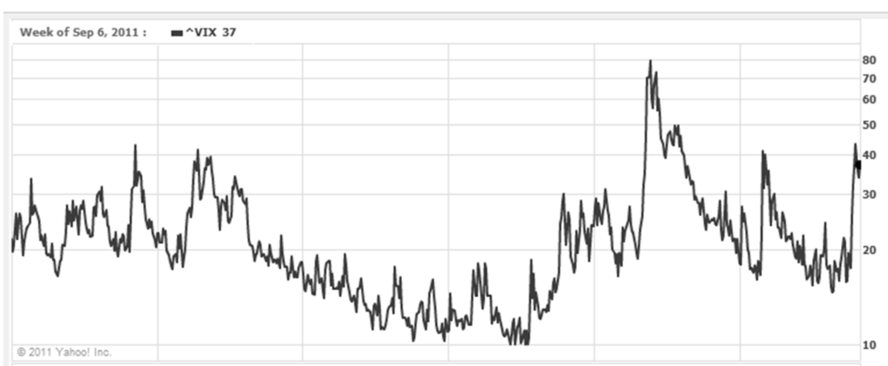
- Which activity would the expect the insurance premium to be higher for?

Stock Fear = Volatility

- What do investors fear:
  - Huge price drop
  - Missing a rocket

  - Volatility drives option premiums

Broad Market Volatility is measured by the VIX* index



** Yahoo Finance*

Ticker is $VIX at MSN and ^VIX at Yahoo

Which would you "fear" most?

- IBM
- Apple
- Colgate
- Google
- Medtronic

Apple and Google have more Volatility

Examples

February 4th, 2011 S&P 500 Volatility Index (VIX) - 16
March 19th Expiration (43 days out) – 1st Out of The Money Call

IBM

- Beta (long term volatility indicator) .74
- Stock Price $164
- Strike Price $165
- Option Premium $2.61 (1.6 % of the stock price)

Google

- Beta 1.2
- Stock Price $610.98
- Strike Price $615
- Option Premium $15.30 (2.5 % of the stock price)

Premium = Interest Earned

- Premium = Interest Earned for "use" of asset

- Example:
  - SPY (S&P 500 ETF) at $102
  - Sell first month out PUT $100 Strike $1.50 prem.
  - % Earned = Premium / Underlying Asset
    = $1.5/$100 or 1.5 %
  - If 28 days left to expiration
  - APR = % Earned * (365 / days left)
    = 1.5% * (365/28) = ~20% APR

Two more examples

- IBM (from earlier example)
  - Option premium = $2.61
  - Underlying price = $164
  - Interest Earned = $2.61/$164 = 1.6%
  - APR = 1.6% X (365/43) = 13.6%

- Google (from earlier example)
  - Option premium = $15.30
  - Underlying price = $610.98
  - Interest Earned = $15.30/$610.98 = 2.5%
  - APR = 2.5% X (365/43) = 21.2%

Questions?

MAKING IT HAPPEN

Rules & Targets

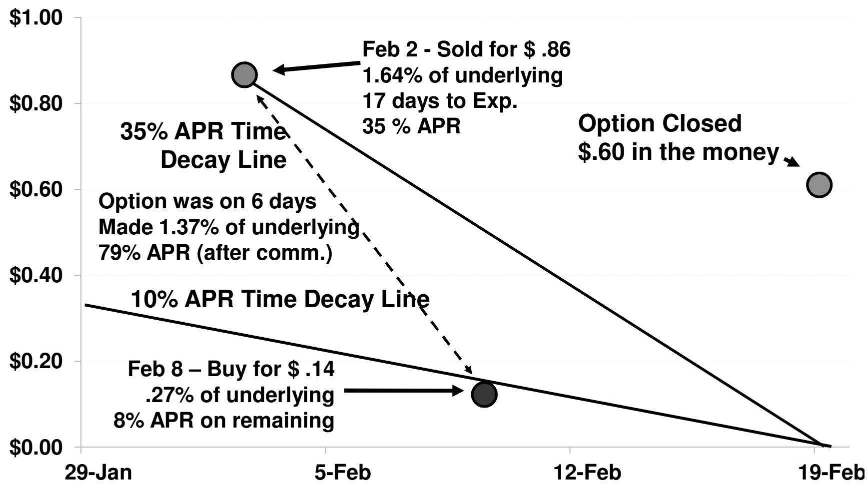
- Options - More Trading than Investing
- Develop a Trading Plan
  - Includes Rules & Targets
    - How far out of the money
    - Time frames
    - Types of stocks
    - Size of the trade
    - Threshold for buying back

Some of My Rules & Targets

- I shoot for 20% or greater APR on my sales!
- Do first (front) month or weeklies
- Buy back if the current premium < 10% APR

Anatomy of an Actual Trade

Target (TGT) -$52.50 PUT Feb 19th Exp.



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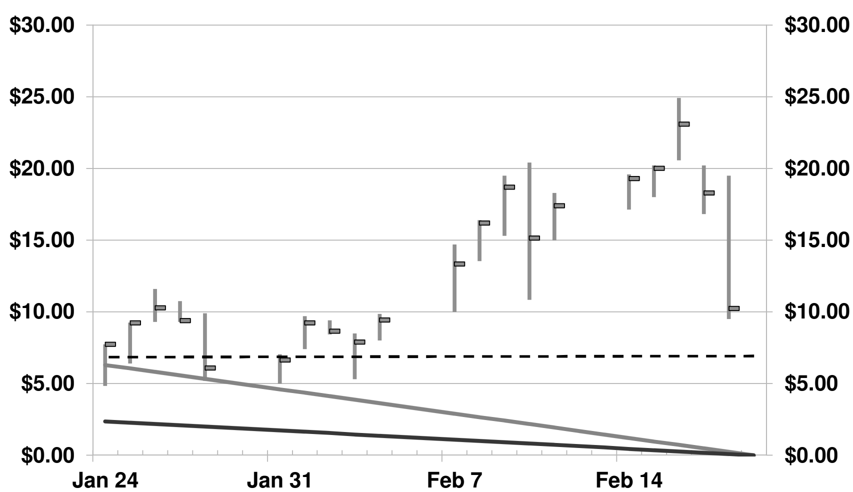
Another Trade!

Sold APPLE $340 CALL for $6.30



Did I make money on this trade?

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Another Trade – the details

- On Jan 24th With Apple at $333
  - Sold Apple $340 Call
  - Expiration Feb 19
  - Premium was $6.30 or $6.30/$333 = 1.9%
  - 1.9% over 26 days = 26.5% APR
- Got called away on Feb 19
  - Collected $340 +$6.30 = $346.30 = *Sales Basis*
  - Apple stock was bought below $346.30
  - Made money on the stock sale… was happy to be called away!

Could I have made more …..

Yes but that is almost always the case with stocks!

The Little Picture - Commissions

- Commissions can spoil your gains!
- Normal commissions on options-
  - $7-9 per trade
  - + $.75 for each contract in a trade
  - Example:
    - 1 contract (100 shares) sold at $.50 premium
    - Collect $50 but pay ~$10 in commission and net $40+

Equivalent to 20% Commission

Commission Strategy

- Look to collect a minimum $100+ on a trade
  - 1 contract: Premium > $ 1.00
  - 2 contracts: Premiums >$ .50
- To minimize commission percentage:
  - Maximize the number of contracts per trade
  - Look for stock options with higher premiums

Try to target a commission of < 2-5% of trade (this means a total trade value of $500-200)

My Metrics

- Some of my averages:
  - Days to expiration when sold 28 -> 23
  - Days held 16 -> 13.6
  - APR when sold 28% -> 29%
  - Actual APR achieved 40% -> 44%

Benchmark your total portfolio return against an index!

Selling “Calls” on Your Stocks

- Higher Volatility (beta>1) = Better Premiums.
- Must have 100 shares to sell a Call (1 contract).
- Easier to do on stocks that are broadly traded.

Be sure strike price meets your sell criteria!

Top Club Holdings

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Top Club Holdings

AAPL	36%	*
GE	27%	*
F	21%	*
JNJ	21%	*
SYK	20%	
MSFT	18%	*
INTC	16%	*
MCD	16%	*
TEVA	15%	
PEP	15%	

** Have both monthly and weekly options!*

Great Beginner Cash-Secured Puts

- Broad Market ETFs
  - SPY – S&P 500
  - IWM – Russell 2000
- Lower Risk than individual stocks
- Plethora of Strikes and Expirations
- Lots of volume
- If Exercised you can immediately start selling Covered Calls on the position

This is a great way to generate some income on your portfolio cash

Speaking of Beginning

- Start slow
- 1 or 2 contract trades
- Front month expiration
- Broad Market Index
- Paper Trade

Really high premiums are the "sirens" of Selling Covered Options!

Options & Taxes

- "Expired worthless" or "Closed by buying back"
  - Short Term Capital Gains
  - Gain = Premium collected – buy back price
  - Buy back is zero in the case of "Expired worthless"
- "Exercised options"
  - The premium is rolled into the underlying transaction
    - Calls – the premium is added to the sale price
    - Puts – the purchase price is strike less the premium
  - Capital gains is then determined by the how long the underlying security was held (Calls) or is held (Puts)

IRAs & Options

- Only Selling Covered options allowed!
  - Viewed as reasonably low risk!
  - *Corollary: Buying options is too high risk!*

IRAs are a great place to Sell options as there is no tax consequence in the short term

Investment Clubs

- Learn options with friends
- Easier to get to 100 shares
- Requires more active club than once per month
- bivio can handle options accounting in the *ActivePartnership* subscription

Quick Recap

- First - Invest in *Good Quality Growth* Stocks
- Supplement Returns by *Selling Options*
- Make sure *commissions* do not eat profits
- Beware of *tax considerations*
- Consider selling options in *IRA accounts*
- Consider *Investment Clubs* as place to learn!

One last thing….

- When you go to your Broker:
  - They understand Covered Calls
  - Cash-Secured Puts, some may want to say a margin account is required, it is not
  - You do not need (or want) margin to be able to do cash-secured puts!!
  - Do not quit until you have the ability to do both covered calls and cash-secured puts without having a margin account!

Thank you for attending!

Questions?

Cool_club@bivio.com

COOL_Club

Covered Options Online Learning Club

Purpose:

Learn process around selecting Covered Options by discussing recent trades

Covered Options Online Learning Club

- Kickoff & Introduction Session
  - Wednesday July 11th
  - 8:30pm EDT
  - Register at www.bivio.com/Club_Cafe
- Weekly 30 minute discussions
- Wednesday, Time TBD

Interested?

Cool_club@bivio.com