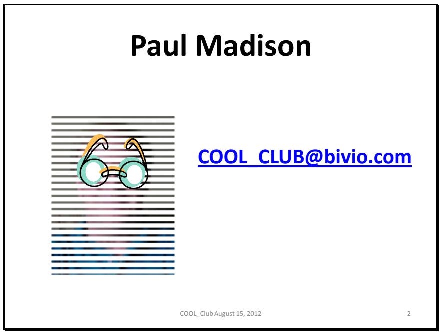
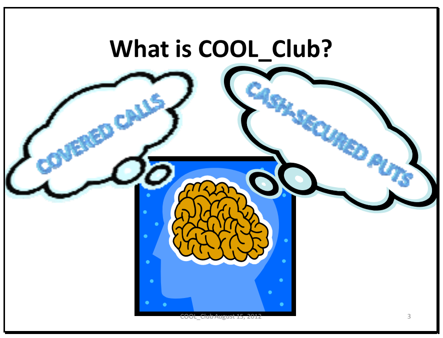

Good evening and welcome to the Covered Options Online Learning Club otherwise known as COOL_Club.




I am Paul Madison and I am your host for the COOL_Club

You can write to me at the COOL_Club discussion list which is COOL_CLUB@bivio.com




Reminder:

This will be a weekly 30 minute session where we explore the thought processes associated with actual Covered Option Trades.

Most sessions we will walk through one or two trades from the recent past.

Going through the logic on why we are looking at a particular option on a particular stock.

We will look at both when trades are put on and we will come back and look again at them when they are closed.

Some weeks, like tonight will be tools oriented rather than trades.

## COOL Schedule

| | | |
|---|---|---|
| • Fourth Wednesday | (Aug 22nd) | 10pm ET |
| • Fifth Wednesday | (Aug 29th) | Vacation |
| • First Wednesday | (Sep 5th) | 5 pm ET |
| • Second Wednesday | (Sep 12th) | 8 pm ET |
| • Third Wednesday | (Sep 19th) | 9 pm ET |
| • Fourth Wednesday | (Sep 26th) | 10pm ET |



Our next meeting is

The fourth Wednesday August 22nd, and will be at 10pm ET

August does have five Wednesdays so we will have a "Holiday"

And the September schedule is shown here as well.

## COOL_Club Home Page


*www.bivio.com/COOL_Club*



We are continuing to build out our COOL_Club home page
The link is www.bivio.com/COOL_Club
click
Remember you can click on the "Cool Club Discussion List" to join the e-mail discussion list. We have had some good discussions this past week on that list.
click
Clicking on Presentations will take you to copies of the handouts from previous COOL_Club sessions and also recordings of the sessions.
Click
Click on Resources and Tools to find the page where the Covered CALL COOL TOOL is
click
And of course we have a live spreadsheet showing any open trades we have talked about or maybe put on because of the discussion list.

**QUESTIONS?**

## Agenda

- Closing an Option
- *new version!* - Covered CALL COOL TOOL
- Some examples of closing options
- Talk about last weeks homework assignment

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**CLOSING AN OPTION (COVERED CALL)**

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## What determines option price?

Two main things (and that other thing)



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Dropping back for just a second ...we have not really talked about what drives option pricing.

There are two main things,

one is how long the option has to expiration ...in other words the longer time an option has to expire the more it is worth

The second is the underlying stock price  and this case the closer the option is to being in the money it's value goes up.

The third component is that nefarious critter that we will talk about but still not tonight, Mr. Volatility which is another name for fear and greed.

## Time premium

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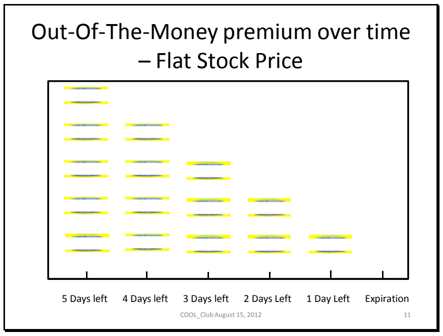
When an option is Out-Of-The-Money all of its premium is viewed as what is called "time premium".  And it is called that because it only has value while there is still time left to expiration.

Obviously no one would pay any money to buy an option to buy stock out of the money after the option reached expiration.  Once an option reaches expiration the time premium is zero!




If somebody wants to make sure they can buy your stock a dollar higher (because they think there is a chance it could quite a bit higher) with 5 days out they might pay you 50 cents.

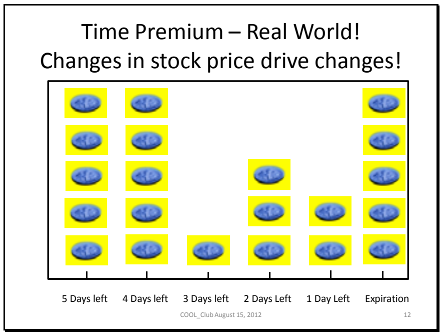
But the next day the stock still has not moved and so they aren't as sure about the price going way up so they will only pay you 40 cents

And the next day the stock price is still unmoved and so now they would only pay 30 cents

the next day they really are not excited and they will only pay 20 cents

and finally with only one day left they say oh well it might still pop and so I will pay one dime just to be sure I can have your stock if it pops.

Get to the end of the expiration and the stock has still not popped, the time premium is now zero.  The option expires worthless.




Now let’s look at a more real scenario

Same starting point with 5 days left they are willing to pay 50 cents to be able to buy my stock at a $1 higher price.

Now the next day the price of the stock actually goes up a little bit and so they are still excited (maybe even more excited) and so they will still pay me 50 cents to buy my stock.

By the third the underlying stock has had a bad news story that comes out and the stock price goes down by $1. So now the buyers are much less interested in buying the option and so it drops to 10 cents .....these are the kinds of opportunities where I look to buy back ...If I sold for 50 cents on the first day, I can now buy back 10 cents ...pocket 40 cents .....I still own my stock and I go about my business, with, of course, a smile on my face.

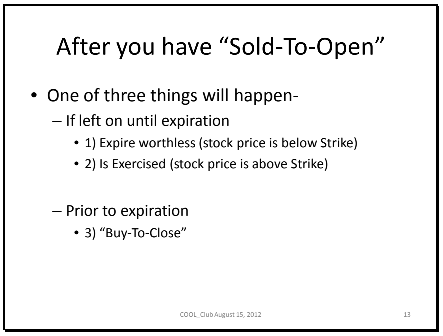
Now you might say why not just wait 3 days and see if it goes out worthless and not spend the money to buy it back. Great question and sometimes that is the right answer.

But sometimes Mr Market can be quite the AC/DC kind of guy and so the next day the stock has recovered the $1 because the news was erroneous.

The next day the stock was flat and still below our strike and so the premium goes down a little.

But then on the expiration day ...sure enough the stock jumps and is 50 cents above the strike and so the option is worth 50 cents

It is because of the market swings that drives me to want to buy back when I have golden opportunities like we saw on day three. Buy buying back on day 3 I have closed the option and so actually by the last day when it has jumped I could sell a new call for the next expiration date.




So now back to the rabbit.

We have done a "Sold-To-Open" Covered Call

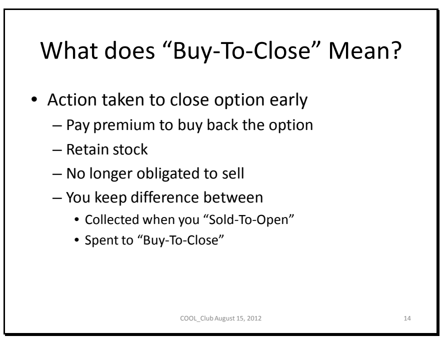
and we know one of three things will happen from this point

If I leave the option on to expiration
and the stock price on the expiration is below the strike then the option expires worthless and I get to pocket all the premium and smile ... and I still have my stock

however if on expiration day the stock price is above the strike then my stock will be sold at the strike price but I still get keep the premium that I sold and that becomes part of sales proceeds for the stock sale.

The other option is, Prior to expiration,

I can buy back the option to close out the position.



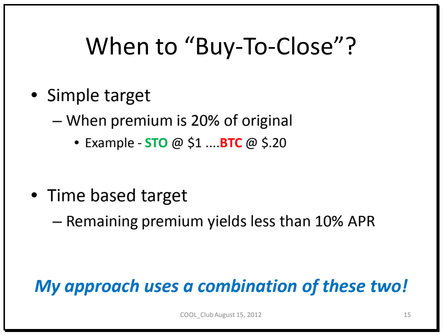

So as we said Buy-To-Close is a way that we can close our option before the expiration date.

We turn around and become a buyer of the same option that we sold. We would be paying a premium rather collecting a premium.

By closing the position, we retain our stock

... and we are no longer obligated to sell.

You get to keep the difference between what you collected when you "Sold-To-Open" and what it costs you to "Buy-To-Close"

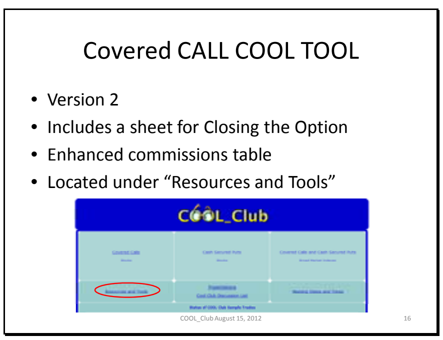



There are two approaches to determining when to Buy-To-Close

The simplest and easiest to do is to say when the premium drops to 20% of the original premium collected, I will buy it back. So an example would be if we Sold-To-Open an option at $1 we would wait to buy it back when it was .20 or a little lower if we do it net of commissions.

But I also like to take the time component in to account so I like to look at what the APR is on the remaining premium for the time left and if that drops below 10%, I consider that a time to buy the option back. That means if the option is going to remain on for me I want at least a 10% or better return.

The COOL thing is the COOL_TOOL will do the math for you and tell you what a maximum buy-back premium would be net of commissions and it looks at both of these approaches.




Now it is time to go look at the updated Covered CALL COOL TOOL.

In the updated tool there is a new sheet added for Closing the Option.

Also, based on a request at last week's COOL_Club we have enhanced the commissions table to handle more different brokerage house scenarios such as OptionsExpress.

The new file will take the place of the old file but it is in the exact same place on COOL_Club....From the Home page of COOL_Club go to "Resources and Tools


The tool is in the lower right corner.

I would delete you old version and download the new version. There is no reason to keep the older sheet.

**QUESTIONS**



**LET'S GO PLAY**



**TRADE RECAPS**



## ALGN

- Expiration 8/18
- Strike $36
- Premium collected $.70
- Contracts 3
- Day of trade 7/30
- Current best Ask $.10
- Market when sold $35



## AAPL

- Expiration 8/18
- Strike $640
- Premium collected $11
- Contracts 1
- Day of trade 7/19
- Current best Ask $1.01
- Market when sold $614

## CTSH

| | |
|---|---|
| • Expiration | 8/18 |
| • Strike | $60 |
| • Premium collected | $2.5 |
| • Contracts | 2 |
| • Day of trade | 7/18 |
| • Current best Ask | $3.90 |
| • Market when sold | $57 |



## WHR

| | |
|---|---|
| • Expiration | 8/18 |
| • Strike | $67.50 |
| • Premium collected | $1.35 |
| • Contracts | 2 |
| • Day of trade | 7/17 |
| • Current best Ask | $4.40 |
| • Market when sold | $57 |



## Scenario 1 (ALGN)

- Current Market was below Strike
- No advantage to buy back
- Low risk of exercise

**Recommend: Let expire worthless**



So we just went through 4 examples.

In Scenario 1 (ALGN)

The current price of the stock was below the strike

I could not get a buy back premium low enough to take it off.

There is a fairly low risk of being exercised and

So I would recommend letting expire worthless.

## Scenario 2 (AAPL)

- Market price below but close to strike price
- Can effectively Buy-To-Close
- High risk of exercise

**Recommend: “Buy-To-Close”**



Scenario 2 was the Apple

The current stock price was below the strike but on a percentage basis close to the strike

I could buy back at a premium below my Max premium buy back

Apple can be very volatile and so being less than $10 away from the strike my recommendation would be do a “Buy-To-Close”

### Scenario 3 (CTSH, WHR)

- Market price above strike price
- Would lose money if “Buy-To-Close”
- Almost certain exercise

**Recommend: Let option be exercised and stock sold!**



The third scenario was true for both CTSH and WHR.

The current stock price was above the strike price

Would lose money on the option if I did a “Buy-To-Close”

Almost certainly will get exercised.

My recommendation is let the option be exercised and the stock be sold afterall when we put it on we said we were comfortable to sell at that price!

**HOMEWORK ASSIGNMENT**



### Assignment

- Background
  - Disney bought Sep 28, 2011
  - 300 shares
  - Bought at $31.30/share
- Assignment
  - Sell a covered call
  - Out-Of-The-Money
  - Strive for largest APR



Here was the assignment from last week

### APR Submissions

- COOL Contestant 1 35%
- COOL Contestant 2 39%
- COOL Contestant 3 22%



Had three submissions that I know of. Hopefully others did it but did not submit your answer.

1 35%
2 39%
3 22%

and so contestant number 2 was the winning entry!

## COOLest CLUB Members

- **COOL Contestant 1**
  - **8/9**
    - **$50 strike (DIS was at $49.97)**
    - **8/18 Expiration**
    - **$.46 Premium – netted $123**
    - **APR 35%**
- **COOL Contestant 2**
  - **8/13**
    - **$50 strike (DIS was at $49.71)**
    - **8/18 Expiration**
    - **$.30 Premium –netted $75**
    - **APR 39%**
- **COOL Contestant 3**
  - **8/14**
    - **$50 strike (DIS was at $49.75)**
    - **8/18 Expiration**
    - **$.17 Premium –netted $36**
    - **APR 22%**



First notice that the longer people waited the premium went down. Our first gung ho person got with it the day after the COOL_Club and collected $.46 premium.

The second person went 4 days later (two days were weekend) and collected only .30 ...sixteen cents less but because of the lapse of days actually got the best APR.

Our third contestant went one day later and and received .13 less.

One of the lessons is it is not all about APR...APR helps to decide that it is good value (greater than 20%) but you are always going to get more money when there is more time.

I would probably rather do a 25% APR with 3 weeks to go than a 30% APR with 1 week to go.

## Some Comments

- Did not feel DIS was a good candidate for covered calls at this time.
- APR was higher for front month rather than second month even though the premium was less.
- I put my order in 6 cents above best “Bid” and had to wait a couple hours for the order to fill, no sooner had it filled, but the next trade was 2 cents higher.
- Had I waited one day more, I could have gotten 2 cents more.



## This week’s Homework

- Decide how to close your DIS call!



NEXT WEEK Aug 22nd 10:00pm EDT

**CASH SECURED PUTS – COOL TOOL**