

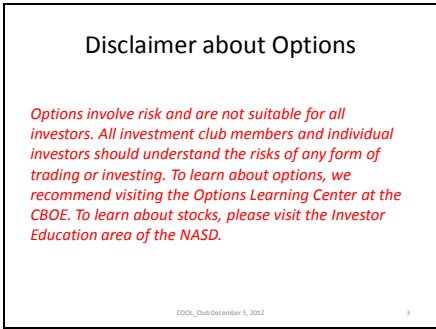


Good evening and welcome to the Covered Options Online Learning Club otherwise known as COOL\_Club.

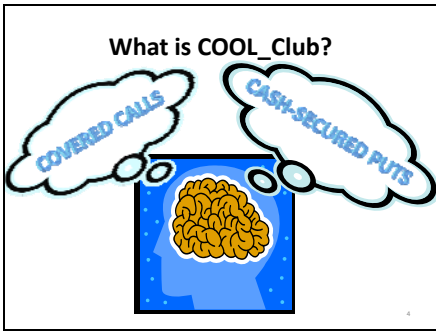


I am Paul Madison and I am your host for the COOL\_Club

You can write to me at the COOL\_Club discussion list which is COOL\_CLUB@bivio.com



Quick disclaimer that Options do involve risk and may not be suitable for all investors. I encourage you to learn more about options and stocks and the slide mentions a couple of resources for additional education.



COOL\_Club is 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 nights, like tonight, we will cover special topics.

## December Schedule

- First Wednesday (Dec 5th) 5 pm ET  
[Selling Covered CALLS](#)
- Second Wednesday (Dec 12<sup>th</sup>) 9 pm ET  
[Selling Covered Options – Index ETF](#)
- Holiday Break (Dec 19- Jan 2)

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For December we will only have two sessions. Today we will be talking about selling Covered Calls and next week we will meet at 9pm and talk about selling Covered Options on Index ETFs which still seems like a time appropriate subject.

## COOL\_Club Home Page



Here is our COOL\_Club home page

The link is [www.bivio.com/COOL\\_Club](http://www.bivio.com/COOL_Club)

Both Handouts and recordings are under the Presentations link

Join the email discussion list by clicking here

You can get to the Excel COOL TOOL spreadsheets by clicking on "Resources and Tools"

And finally the schedule and registration links are here.

## SELLING COVERED CALLS

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With our housekeeping done let's move into tonight's topic of Selling Covered Calls



A couple items for those that are new to Selling Covered Options

Something that is really different is the fact that your whole mindset is different.

When we are dealing with stock we always start by buying and then at some point we sell.

When we are doing Covered Options we have to think backwards

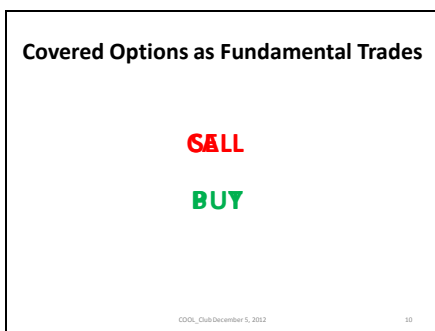
.... we start by first selling and then we might close it by buying (of course there are other ways to close like expiring worthless or being exercised).



So that means that whenever you are starting

or opening a trade

We want to do a Sell-To-Open ....please be sure this that is the action that you are selecting.



Here is another little visual picture that might help

When we sell covered CALLs , as we are talking about tonight, those CALLs with double LLs

can turn into stock SELLs with double LLs

If we are Selling Cash Secured PUTs then those PUTs with a U can

turn into stock BUYs with a U.



So why might you want to sell a covered call?

(click)

Maybe Your Stock is up nicely

(click)

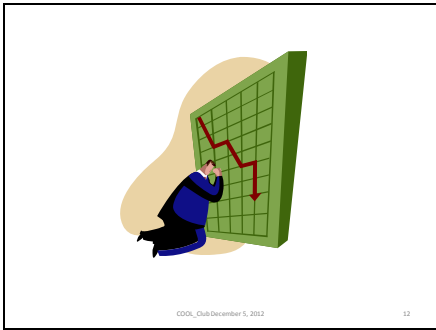
Your stock is not quite to a sell level however

Maybe Your stock's PAR or projected return has dropped below your threshold

Maybe You have made a nice gain in a short time

Maybe Your stock has moved quite a bit in a short time

But you are not ready to sell because it has not quite reached your sell target



Despite not quite being ready to sell you think your stock might pull back some.

Maybe not a precipitous fall like the picture, but maybe you are thinking it is about to experience a more minor correction just because it has moved up so fast or so long.

Selling a covered call is a way for you to generate some income on your appreciated asset after it has moved up in price but you are not to the point of selling.

By the way , if you do believe that your stock is going to have a significant drop you should consider just selling outright.

## Selling a Covered CALL

- Have at least 100 shares per contract
- Know your Minimum sell price for the stock
- Look at selling front month *expiration*
- *Sell as far out-of-the-money as reasonable*

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To get ready to sell a Covered CALL

You will need at least 100 shares of the stock for each contract you want to sell

You need to know what **your** minimum sell price for the stock is as this sets the floor on what strikes you can do

I recommend when you are first doing options on stocks that you stick with doing the front month (or second month if front month has only a week or less left). So by the end of next week, I would be moving out of doing December and start looking at January options.

I recommend selling as far out-of-the-money as reasonable. Reasonable meaning that you get a good return for putting the option on.

Dividends can confuse the issue of selling covered calls and with so many companies announcing early dividends and or special dividends I thought it would be good to talk a little bit more about this.

## COVERED CALLS & DIVIDENDS

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## Dividend Declaration Date



*Company Announces Dividend!*

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First let's review some Dividend Lingo as I think this is an area that is always a bit "foggy" for people.

We have four dates associated with a dividend both for normal quarterly dividends and also for special dividends.

First is the Declaration Date and that is simply the date that the company announces the dividend at that time they also set the Dividend Record Date and the Dividend Pay Date.



## Normal Quarterly Dividend

- CALL options that expire after Ex-Dividend Date
  - Day before Ex-Dividend
    - May get called away
    - Sales price = Strike price + Option premium - Commissions
- On Ex-Dividend date
  - Stock price drops by roughly dividend amount

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As we have mentioned before, if you sell a CALL option on a stock and the expiration date is after the Ex-Dividend date then there is a chance that you could be called away early on or before the day before Ex-Dividend. The reason this might happen is that the owner of the option decides that it is in their interest to be the owner of the stock ahead of Ex-Dividend and so they can qualify to receive the dividend.

If you get called away you will sell your stock at the Strike price. Your sales price will be the strike price plus the premium you collected when you sold the call less any commissions paid when the option was sold or for the option being exercised. You will not qualify to receive the dividend.

Finally you should know that often the market will drop the price of the stock on the ex-dividend date by the amount of the dividend. Some stocks move so much in a day that it is hard to see this but on average it does happen.

## Special Dividend

- CALL options that expire after Ex-Dividend Date
  - Day before Ex-Dividend
    - May get called away
    - Sales price = Strike price + Option premium - Commissions
- On Ex-Dividend date
  - Stock price drops by roughly dividend amount
- Options that expire after the Ex-Dividend
  - Strike prices are reduced by the special dividend amount

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Sometimes companies pay a dividend which is larger than usual to return some of their cash to shareholders. This is usually called a special dividend. The same two items are also true on Special Dividends but in addition there is one other thing that happens with them.

For Options that expire after the Ex-Dividend Date for a special Dividend, the option Strike price is reduced by the amount of the special dividend.

## Special Dividend Example

- Special Dividend \$2
- Prior to the Ex-Dividend Date
  - STO CALL @ \$100 Strike
- On the Ex-Dividend Date
  - Option strike is adjusted by Special Dividend
  - CALL is now a \$98 Strike

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Let's look at an example.

Let's say a company announces a special dividend of \$2

Prior to the Ex-Dividend Date you Sell-To-Open a Covered Call at the \$100 strike level with an expiration that is after the Ex-Dividend date.

On the Ex-Dividend Date all option strike prices will automatically go down by the amount of the special dividend. So your \$100 Call becomes a \$98 Call.

## QUESTIONS?

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## COVERED CALL COOL TOOL

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I have tried to codify my thought process in a spreadsheet we call the covered Call COOL TOOL and it is available on the COOL\_Club website.

## COOL TOOLS

- Excel Spreadsheets
  - Works on Windows versions of Excel
  - Does not work on Excel for Mac

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The COOL Tools are all Windows Excel Spreadsheets they are saved in Excel 97-2003 file formats but work with the newer versions of Excel as well.

The Tools currently do not work on Mac OS X Excel but could be run on a Mac that is capable of running Windows and Office for Windows through BootCamp or Parallels or VMWare's Fusion.

## Current Version 2.10

COVERED CALLS COOL TOOL **Self-To-Open**

Version 2.10

2. Selecting a possible option

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The current version of both COOL TOOLS, PUTs and CALLs for stocks, is 2.10. You can see this in light grey at the upper right hand corner of each sheet of the TOOL. If the number you see is less than 2.10 then you do not have the latest.

## Excel Security

- Allow Macros to be enabled:
  - One simple Macro that resets things
  - *If prompted to allow Macros – Chose YES*
- Enable all Data Connections:
  - Uses MSN quotes
  - *If prompted to enable external data – Chose YES*

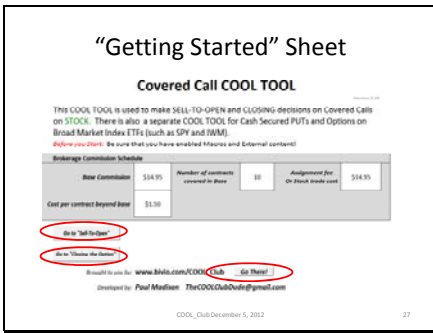
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To run the TOOLS most effectively you must enable Macros as there are simple macros for clearing data and for going out to the web for data.

You must also enable external content so that the TOOLS can go get delayed stock quotes.





The downloaded sheets will open on the Getting Started page.

This has a little bit of information about the COOL TOOL and is also where you would input the information about your particular broker's commission schedule.

At the bottom you have buttons that take you to the

“Sell-To-Open” sheet or the

“Closing the Option” sheet and

there is even a button to take you out to the COOL\_Club home page.

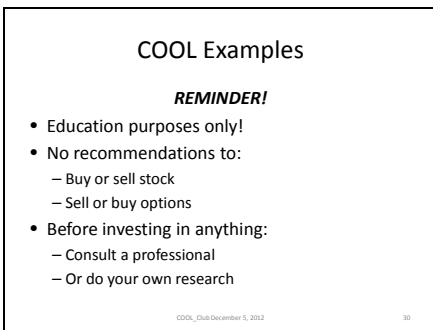


Reminder you can get the tools by clicking on the Resources and Tools link on the COOL\_Club home page and then you will see the tools under the COOL Tools heading on the lower right side.

Here you will find the TOOLS and we also have links that go to the presentations on how to use the tools.



Let's go look at some examples.



Reminder all of our examples are for education purposes only.

I am not making any recommendations to buy or sell stock or to sell or buy options.

Before you invest you should do your own research and or consult a professional.

## Emerson Electric (EMR)

**COVERED CALLS COOL TOOL** Sell-To-Open

Clear Data

Current Market Price	EMR	\$49.74	+0.14
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2. Selecting a possible option

Strike	Front Month	Second Month
EMR 7	EMR 22	EMR 29

3. Fundamental Quick Questions

How do you feel about the market?	Very
How do you feel about the stock?	Very
How do you feel about the industry?	Very
How do you feel about the company?	Very
How do you feel about the analyst?	Very
How do you feel about the analyst's firm?	Very
How do you feel about the analyst's firm's reputation?	Very
How do you feel about the analyst's firm's track record?	Very
How do you feel about the analyst's firm's history?	Very
How do you feel about the analyst's firm's future?	Very

4. Analyzing your selection

Strike	EMR 7	EMR 22	EMR 29
Call Premium	\$1.00	\$1.50	\$2.00
How many Contracts?	2		

APR 28% Net Premium \$185.05

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Let's start with an example on Emerson Electric I worked through yesterday after the market was closed.

## OTHER EXAMPLES

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## MALCOLM'S POST ON FAST

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### Malcolm's FAST –Special Dividend

COVERED CALLS COOL TOOL Sell-To-Open

2. Selecting a possible option

Weekly Expiration Date	Front Month	Second Month
Dec 7	Dec 22	Jan 27
Dec 14	Dec 29	Jan 31

Look for strikes above this sell price: \$41.00

3. Analyzing your strike choice

Strike	Option Cost	APR	Net Premium
\$39.79	\$2.65	49%	\$1,576.55

COOL\_Tool Example run roughly two weeks after Malcolm did the trade!

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Malcolm had a Thanksgiving post about buying Fastenal to capture the special dividend and then selling in the money CALLS.

I pulled together this look at his trade in the COOL\_Tool but did not do it until yesterday and so it is not quite what he was looking at the time he did the trade.

When he did the trade he bought FAST at just over \$41.

Something I wanted to point out is that the COOL\_Tool is assuming that you are doing out of the money options and so the APR can be misleading if you do an in the money option.

Malcolm sold a 39.79 call and collected \$2.65. The market was at \$41.05 (or at least that is what he bought for) and so \$1.26 is intrinsic value and the time premium piece is \$2.65 less \$1.26 or \$1.39. The APR on the time premium piece would be  $1.39/\$41.05 \times (365/59)$  or about 21%.

The special dividend does not improve this as you get \$.50 special dividend but then the CALL strike will be lowered by \$.50.

### Malcolm's FAST

- November 21<sup>st</sup>
- Bought 600 Shares at \$41.05 – Cost \$24,638.95
- FAST Special Dividend
  - \$.50
  - Ex-Dividend Date 12/5/12
  - Dividend Pay Date 12/21/12
- STO FAST CALL Jan 19 '13 Strike \$39.79
  - In-the-Money
  - Collected \$2.65
  - Net Premium collected \$1,577

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### Four Results

- Called Away Early (December 4<sup>th</sup>)
- Called Away on Expiration (January 19<sup>th</sup>)
- Not Called
- BTC the option

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There are four results on this trade, we will look at the first three because we have enough data to evaluate those. The BTC option we will just have to see if Malcolm does in fact do that and at what level.

### Called away early (were you?)

- Called away on Dec 4<sup>th</sup> - day before Ex-Dividend
  - Strike of \$39.79
  - Sold for
    - $(600 \times \$39.79) - \$8.95 + \$1,577 = \$25,442.05$
  - Bought for \$24,638.95
  - Net gain \$803.10
  - Trade on for 14 days
  - 90% APR

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The first thing that could have happened (and if he is here he can tell us if it did) is that yesterday, ahead of the Ex-Dividend day which is today he could have been called away.

If he was then he would have sold for 39.79 plus the premium collected minus commissions. That works out to be \$25,442 Since he bought for \$24,639 he would have a gain of \$803 for a trade that was on 14 days. Nice 90% APR

Remember because he was called away yesterday he will not be the owner of record for the dividend and will not receive it.

### Called away on Expiration

- Called away on Jan 19<sup>th</sup>
  - Strike of \$39.29
  - Sold for
    - $(600 \times \$39.29) - \$8.95 + \$1,577 = \$25,142.05$
  - Bought for \$24,638.95
  - Collected special dividend of \$300
  - Net gain \$803.10
  - Trade on for 59 days
  - 21% APR

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Another option is that he does not get called away until the expiration date which is January 19<sup>th</sup>.

In this case he will sell for \$39.29 since his original \$39.79 CALL would be adjusted down by the \$.50 that was the special dividend. But in this case he was the owner of record for the dividend and so he would receive the \$.50 times 600 shares or \$300. Notice how the gain is exactly the same as being called away early. The special dividend offsets what the CALL strike did. The only difference is the trade is on for 59 days and so the APR is much lower but still quite acceptable at 21%.

### Not Called

- Own 600 shares of Fast below \$39.29
- Collect \$300 Special Dividend
- Keep \$1,577 Call premium
- Total recognized gain of \$1,877
- Loss on position of greater than \$1,056

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If Fastenal closed on the expiration day below \$39.29 then Malcolm would still own his 600 Shares of FAST which he said he is very comfortable with. He would collect his \$300 special dividend and he would keep all of the original \$1,577 premium on the Covered Call sale. His total recognized gain would be \$1,877 but he would have a loss on his shares of at least \$1,056 and possibly much more depending how much lower than \$39.29 FAST was at.

But again if it is a good overall buy level that is no problem as you would expect it to turn around and go much higher.

## RECENT ETF OPTION CYCLE

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I wanted to walk through a recent virtual trade that I did for COOL Club on SPYs.

## Sold SPY PUT

- Nov 7<sup>th</sup>
  - STO SPY Nov 17<sup>th</sup> '12 \$137 PUT (done in VTS)
  - 2 contracts @ \$.75
  - Net Collected \$134.99
  - 20% APR

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So on November 7<sup>th</sup> I sold-to-open a Nov17<sup>th</sup> (the monthly) \$137 PUT on SPY in the virtual trading simulator.

I did two contracts @ \$.75

Net Collected \$135

COOL\_Tool told me it was a 20% APR.

## PUT Exercised

- November 17<sup>th</sup>
  - PUT was exercised
  - Bought 200 Shares of SPY @ \$137 strike
  - Cost Basis
    - $(200 \times \$137) + \$14.95 - (200 \times \$0.75) = \$15.01$
    - \$27,279.96 or \$136.40/share

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On November 17<sup>th</sup> the PUT was exercised and so I bought 200 shares of SPY @ \$137 strike

My cost basis was the 200 shares times the \$137 strike + trade commission (or assignment fee) minus 200 shares times the \$.75 premium collected on the PUT + the option commission. That worked out to be \$136.40/share.

## Sold SPY CALL

- November 20<sup>th</sup> (2<sup>nd</sup> trading day after 17<sup>th</sup>)
  - STO Nov 30<sup>th</sup> '12 \$140 CALL
  - 2 contracts @ \$.90
  - Net Collected \$164.99
  - APR 23.5 %

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The second trading day after I had the SPY put to me, November 20<sup>th</sup>, I sold covered CALLs.

I sold to open Nov 30<sup>th</sup> \$140 CALLs and collected \$.90 on each of the two contracts. Net collected \$165

APR was 23.5%

## CALL Exercised

- November 30<sup>th</sup>
  - Call was exercised
  - Sold 200 shares of SPY @ \$140 strike
  - Sales price
    - $(200 \times \$140) - \$14.95 + (200 \times .90) = \$15.01$
    - \$28,150.04 or \$140.75/share

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On November 30<sup>th</sup>, the expiration day, the CALLs were exercised and I sold my 200 shares of SPY @ \$140 strike level.

My net sales price was 200 shares times \$140 the strike price less trade commission plus 200 shares times \$.90 option premium minus option trade commission.

The net was \$140.75/share.

## Net Trade

- Started Nov 7<sup>th</sup>
- \$27,400 cash exposed
- Bought Nov 17<sup>th</sup> @ \$27,279.96
- Sold Nov 30<sup>th</sup> @ \$28,150.04
- Made \$870.08
- 23 days
- APR 50%
- \$570 price appreciation \$300 option gain

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So starting November 7<sup>th</sup>, I exposed \$27,400 of cash.

Bought SPY on November 17<sup>th</sup>.

Sold SPY on November 30<sup>th</sup> and was back to owning cash.

That cash was increased by \$870 in 23 days. That works out in this case to be a 50% APR.

In this case two thirds of the gain was price appreciation and one third was option premiums. Sometimes you will get to sell multiple PUTs before you are exercised and multiple CALLs before you are exercised and thus the balance might move to more option premiums and less price appreciation.

## By the Way

- Invest \$27,400 in a 10yr T-Bill @ 1.65%
- Would take almost two years to make \$870

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As a matter of reference, if you put the same \$27,400 into 10year treasury bills at a nominal 1.65% interest it would take you almost two whole years to make \$870.

We have done that in one month with lots of months left in one year to repeat it. If you only did that four times in one year you would still have a return over 10%.

**QUESTIONS?**

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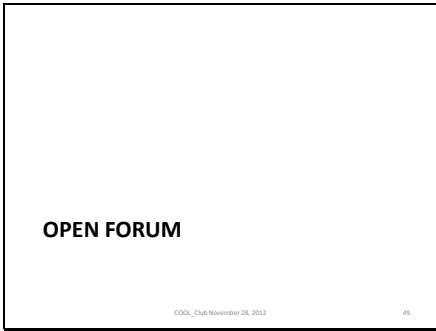
Before we go to an open floor let me just remind you that next week's session will be at 9 pm ET and we will be looking at Selling Covered Options on Index ETF's.

NEXT MEETING Dec 12<sup>th</sup> 9:00pm ET

**SELLING COVERED OPTIONS –  
INDEX ETF**

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At this juncture I would like to open up the floor to any questions.

In addition to questions, we can go through looking at covered options on any stock or index either CALLs or PUTs.

