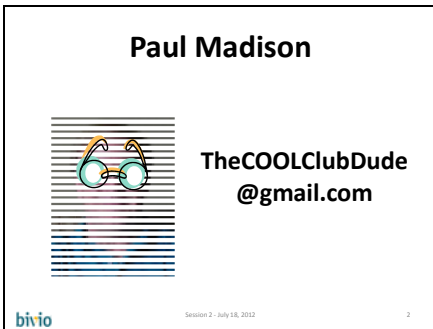




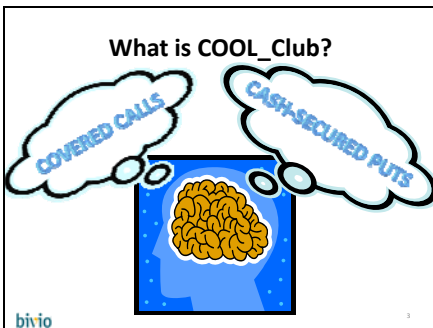
Welcome to our second session of the bivio Covered Online Options Learning Club!



Once again, I am Paul Madison and I will be

The COOL\_Club Dude and will be leading through these sessions

You can reach me by sending e-mail to [TheCOOLClubDude@gmail.com](mailto:TheCOOLClubDude@gmail.com).



So just a reminder

(click)

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

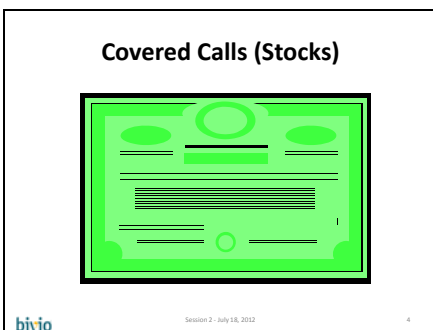
Every session we will walk through one or two trades from the recent past.

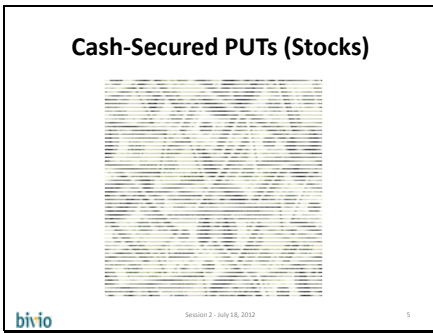
Going through the logic on why we are looking at a particular option on a particular stock.

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

We have three broad types of Covered Options we are going to talk about and we are going to focus on one of the three in a three week rotation.

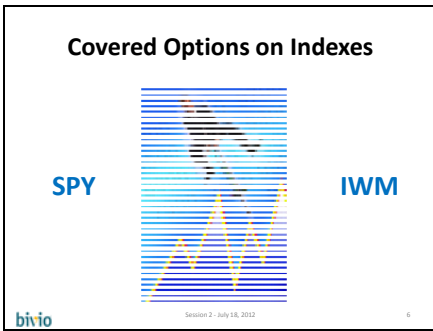
The first type are Covered Calls these represent potential sells against Stock you own in your portfolio. Covered Call is what we did last week.





The second type are Cash-Secured PUTs. As the name implies these are potential stock purchases that you have “secured” by having cash to cover the purchase in your account.

This is what we will talk about today.



Last we will talk about both Cash-Secured PUTs as well as Covered CALLs on broad market index ETFs.

There are some unique things with these that justify thinking about them differently than our Covered Stock options.

My two favorites ETFs that I will primarily talk about are (click)

SPY which is an ETF based on the S&P 500 index

(click)

And IWM which is an ETF based on the Russell 2000 index

We will be talking about doing a covered option on a broad market index next week.



If we have time we will allow attendees to ask about one or two stocks that they are considering options on.

We will talk through the pros and cons of doing either a call or a put on the stock without make recommendations on whether to or not to do an option on the stock.

In addition, we are going to strive really hard to keep to just 30 minutes each week

## COOL Schedule

- First Wednesday 5pm ET
- Second Wednesday 8pm ET
- Third Wednesday 9pm ET
- Fourth Wednesday 10pm ET
- Fifth Wednesday Vacation

*This schedule will begin in August*

Our COOL Club Schedule is:

The first Wednesday of every month our schedule time will be 5pm ET

The second Wednesday of every month our schedule time will be 8pm ET

The third will be at 9pm ET

And the fourth will be at 10pm ET.

The fifth Wednesday when it occurs will be a "Holiday" – nice...at least for me.

This new schedule will begin in August.

## Next Week

- July 25<sup>th</sup> 10pm ET

*Register at [www.bivio.com/COOL\\_Club](http://www.bivio.com/COOL_Club)*

To finish out July –

Next week's session on July 25<sup>th</sup> will be at 10pm ET which actually is the normal time for the fourth Thursday.

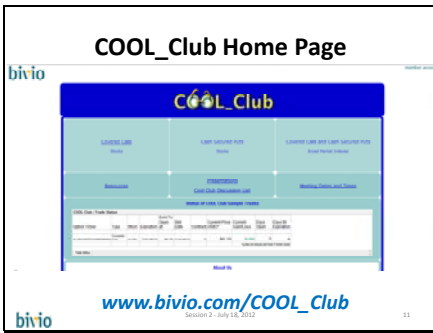
Register now at COOL\_Club under Meeting Dates and Times

For now, you will only be able to register for the upcoming meetings one at a time but we will be looking at ways to automate multiple registrations.

## Recordings



We are going to record these sessions so you can listen if you missed a session or you can go back and listen if you just want to hear it again. Last week's recording has been posted.



The COOL\_Club home page continues to develop.

We now have a little live spreadsheet that will show you the status of any open trades that we have talked about on COOL\_Club. You can see last week's there right now (we will come back to that later).

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

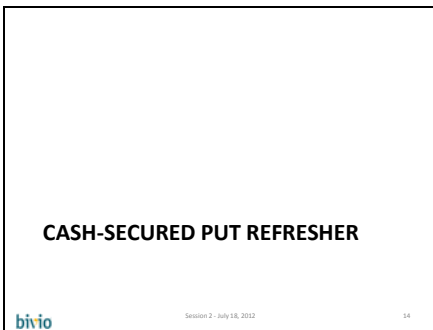


If you would like to join the COOL\_Club Discussion group

Go to the COOL\_Club home page to register for the email discussion list.

You can certainly still attend COOL\_Club sessions without joining our email discussion group.

All questions and replies to COOL\_Club will be sent to the entire email discussion group.



## What is a Cash-Secured PUT?

- Cash-Secured PUT
  - Option contract on a Stock
  - Buyer of PUT has the **OPTION** to *sell* stock
  - Seller of PUT has the **OBLIGATION** to *buy* their stock
  - **STRIKE** price is the price the stock sale would happen
  - **EXPIRATION DATE** – The day the contract expires if it has not been **EXERCISED**
  - Buyer pays Seller a **PREMIUM** for this **OPTION**

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Let us remind ourselves what a Cash Secured PUT is

It is an option contract on a given stock where the Buyer of the option has the right to Sell their stock at the strike price to the Seller of the option until the expiration date.

If the Buyer of the option chooses to exercise their right to Sell their stock then the Seller is obligated to buy the stock at the strike price.

For this right, the Buyer of the option pays a premium to the Seller that is paid up front and the Seller of the option keeps this premium regardless of whether the option is exercised or expires worthless.

## Why sell a Cash-Secured Put?



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So why might you want to sell a cash-secured PUT?

(click)

Maybe there is a Stock you want to buy and it has been correcting in price

(click)

But it is not quite to your buy level

***Despite not being at your buy price you are feeling like the stock might go up!***

Selling a Cash Secured PUT is a way for you to generate some income on the cash you have ready to buy the stock.



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## Selling a Cash-Secured PUT

- Enough cash to buy at least 100 shares for each contract
- Know your maximum buy price for the stock
- Look at selling front month *expiration*
- *Sell as far out-of-the-money as reasonable*

To get ready to sell a cash-secured PUT

You will need enough cash to buy 100 shares of the stock for each contract you want to sell

You need to know what **your** maximum buy price for the stock is as this sets the ceiling on what strikes you can do

I recommend when you are first doing options that you stick with doing the front month.

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

## After you have sold

One of three things will happen:

1. Option expires worthless
2. Option is bought back to close it
3. Option is exercised

## 1. PUT Option Expires Worthless

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

## 2. PUT 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)

### 3. PUT Option Gets Exercised

- Option open until *expiration date*
- Underlying stock closes below the *strike*
- Keep all the *premium* you collected
- You buy the stock at the *strike* price
- Cost basis = *strike* less the *premium*

If there are no questions at this time we will go into our Trade Example.

### TRADE EXAMPLE

### COOL Examples

#### REMINDER!

- Education purposes only!
- No recommendations to:
  - Buy or sell stock
  - Sell or buy options

## FASTENAL



- Ticker: FAST
- Based on Fundamental Analysis:
  - EPS Growth 18%
  - Buy < \$39
  - Sell > \$61

Our trade tonight is going to be on Fastenal. Ticker is FAST and this is an industrial company that sells fasteners in a variety of ways: through Retail Stores, through vending machines, and direct to OEMs (original equipment manufacturers). Fastenal is a very common stock among growth investors and it is a stock I have owned several different times. Growth has been fairly consistent and so opportunities to buy at a discount are often hard to find.

For my fundamental analysis I am using an earnings growth in the short term of 18%

My short term Buy target is less than \$39. I would be a seller if the stock went above \$61 in the short term.

## Cash available for Position

> \$8000

200 Shares @ \$39

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In this particular portfolio I had more than \$8,000 available to invest and that would easily buy 200 shares at my maximum buy price of \$39

## Optimum Time to Sell a Cash-Secured PUT

- **Cash-Secured PUT premiums are best when:**

- The stock has moved down for awhile
  - Peak Late March @ ~\$55 Bottom Late June ~\$38
- The stock is down on the day
  - July 12<sup>th</sup> Earnings – Stock jumped 5% ~\$42
- The market is down on the day
  - S&P was down .7% at time of trade
- Volatility is up
  - VIX was 18+ up slightly

*Technical analysis, look for “bullish” reversal indicators*

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Looking at the optimum time to sell a cash-secured PUT

Stock has gone down in price for awhile

FAST peaked in Late March at \$55 and has been trading off until late June at about \$38

It is also good if it is down on the day you want to sell the PUT

In FAST's case earnings had just come out on July 12<sup>th</sup> and they were better than expected and the price jumped 5% or so –

It will also help if the general market is also down on the day

The market was down in general on July 12<sup>th</sup> and was down roughly .7% at the time of the trade

And we won't spend much time tonight on Volatility (a measure of Angst in the market) but it would also be good for volatility to be up

VIX was about 18 and change and up just a little.....we will talk more about VIX in later weeks.

But for some reason, maybe

(Click)

Technicals, your sense is your stock is about to go up and not reach your Buy target

Selling a Cash-Secured PUT is a neutral to slightly-bearish move and it works best after a Bull run

It should be viewed as a contrarian play – you are bullish while the market is still some what bearish



## Technical Indicators



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So I couldn't tell but maybe they are bullish

When I look at Fastenal's chart it seems like the price gets support every time it gets to the 50 week moving average (somewhat typical of a strong growth stock).

And we had just barely busted that late June but had rallied back above it.

RSI seems very reasonable and we have .....

certainly cleared the snow off the mountain.

**OK, DECIDED TO SELL A PUT ....**

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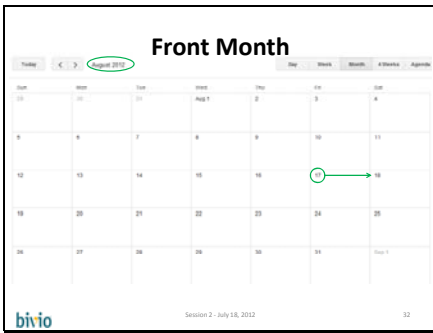
30

**.... BUT WHICH ONE?**

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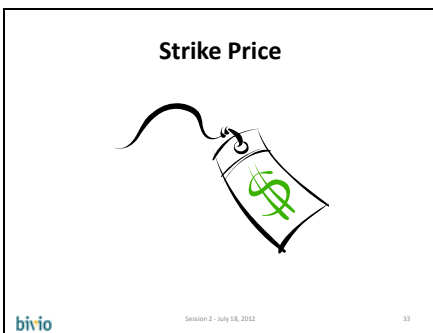


To begin with it is good to start with a front month expiration date that is roughly two to four weeks out.

Remember that each monthly expires on the Saturday after the third Friday.

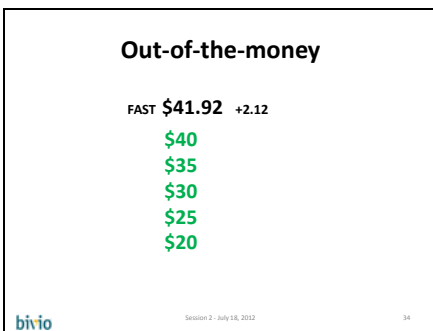
So on July 12<sup>th</sup> (the day I was doing the trade) there is only 9 days left to our July 21<sup>st</sup> expiration.

So I would recommend moving out to August Expiration ...the 3<sup>rd</sup> Friday in August is the 17<sup>th</sup> and so our expiration is the following Saturday or Aug 18<sup>th</sup>.



So we need to make sure we have in our mind what our minimum acceptable stock buying price is

For Fastenal I want to buy at \$39 or below.



Remember we want to BUY lower than the current market

So we want to sell PUTS that are below the current market price which we call out of the money strikes

So if our current price is almost \$42 then all strikes below \$42 are out-of-the-money ....I went by \$5 increments because that is what is available on Fastenal

Certainly all the strikes \$35 and lower are below my Buy Target and \$40 might be depending on the premium I receive.

Rules are made to be broken!



Last week I broke the Golden Rule on selling my CALL on Align Technology ahead of earnings.

I strongly encourage you not to break that rule when it comes to PUTs. Negative earnings surprises can have very steep drops to them and you do not want to be involved.

In this case I did not break the rule on the PUT on Fastenal, I waited until the earnings came out.

As I mentioned earlier the price was up about 5% on the back of a good earnings report. Strong price moves means that PUT premiums will go down and I might not be able to find a reasonable premium to sell but I wanted to look anyway.

TIME TO GO TRADE

So for tonight's example I am going to use Fidelity.

Once you have your Fidelity Page open

Click on Accounts & Trade

Then the submenu of Trade

Then on the side Trade Options.

- At Fidelity:
  - Click on "Accounts & Trade"
  - Click on "Trade"
  - Under "Act"
  - Click "Trade Options"

This screen will come up

On the line that says Symbol we put in our ticker

And then click on Option Chain

Put in Ticker  
Click on Option Chain

Symbol	Strike	Call	Put	Call Bid	Call Ask	Put Bid	Put Ask	Change
FAST	30							
FAST	35							
FAST	40							
FAST	45							
FAST	50							
FAST	55							
FAST	60							
FAST	65							
FAST	70							
FAST	75							
FAST	80							
FAST	85							
FAST	90							
FAST	95							
FAST	100							

So here is my option chain for FAST on July 12<sup>th</sup>. First I wanted say that I did not chose just PUTS so you are seeing both CALLS (on the left) and PUTs (on the right) Next I looked at the \$35 PUT premiums and I saw that the best buyer for \$35s was only \$.20 and since I am doing two contracts that does not meet my criteria of making sure I sell at least \$100 so that commissions do not eat up to much of my gains. So then I went up to the \$40 strike where I see the best buyer is \$1. A \$40 strike with a premium of \$1 does just barely get me to my buy target of \$39 and even though this premium has come down by over \$1 from the day before (you can see that in the change column). A \$1 premium is 2.5% of a \$40 strike and with 37 days left that is nice APR of 24% so this seems like a good opportunity.

I click on the Select on the PUT side of the strikes and then select Sell-To-Open

I get a Trade Options page that fills in my Symbol for a Fastenal Aug 18 \$40 PUT and it sets the Action to Sell to Open.

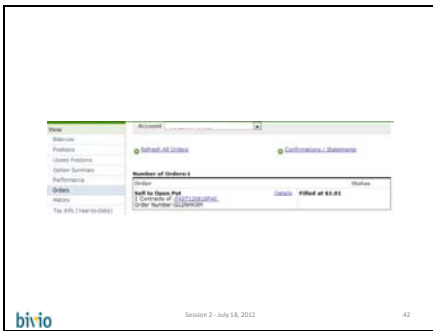
I need to fill in my Quantity of 2 contracts.

I chose and order type of Limit

And I picked \$1 limit price as I wanted to make sure it was filled and I left the Time in Force to a default of Day. Click on Preview Order

Here is the Preview Order Page and notice while I playing around capturing screens the best Buyer (or Bid Price) has moved down to .95 but at \$1 I became the best Seller as that was \$1.05. The last price actually was .95.

Now click on Place Order



When I checked on my order status it turns out that I actually got filled slightly better than my limit at \$1.01. So the limit just means do not sell for less than and if the broker can fill for better than my limit then they will as shown in this case.

### Recap of Trade

- Sold-to-Open:
  - Open Date: July 12<sup>th</sup>
  - Stock: FAST – Fastenal
  - Type: PUT
  - Strike: \$40 (Price obligated to buy the stock at)
  - Expiration: Aug 18<sup>th</sup> (37 days from sale)
  - 2 Contracts (requires \$8,000 of cash)
  - Premium collected \$1.01 per share or \$202
  - Commission (Fidelity) \$9.53
  - Net Premium = \$202-9.53 = \$191.47

Remember this is our formula for Acceptable Return

### Acceptable Return

$$APR = \frac{\text{Net Premium}}{\text{Stock Value}} \times \frac{365}{\text{Days left}}$$

*Net Premium = Premium Collected less commissions*

The Annualized Percent Return is equal to the net premium received after commission divided by the stocks value (which is strike price times shares) times 365 days divided by the number of days left to expiration on the option.

I do this APR calculation to help me better compare different opportunities with different strikes and different expirations

What is an acceptable return ...I like to target greater than 20% APR

### APR if the Option expires Worthless

$$APR = \frac{\text{Net Premium}}{\text{Shares} \times \text{Strike}} \times \frac{365}{\text{Days left}}$$

$$APR = \frac{\$191.47}{200 \times \$40} \times \frac{365}{37}$$

= 24%



## How I decide to buy back

APR drops below 10%

$$\text{APR} = \frac{\text{Net Premium Cost}}{\text{Shares} \times \text{Strike}} \times \frac{365}{\text{Days left}}$$

$$\text{APR} = \frac{(200 \times \$0.30) + \$8}{(200 \times \$40)} \times \frac{365}{31}$$

$$= 10\%$$

Remember I use the same formula on APR and look at cost to buy back to help me decide when to buy back the option. If the current APR drops below 10% then I buy back the option.

You can see at the \$.30 our APR has in fact hit our threshold level of 10%.

## Formula also works for what we made

$$\text{APR} = \frac{\text{Net Collected}}{\text{Shares} \times \text{Strike}} \times \frac{365}{\text{Days open}}$$

$$\text{APR} = \frac{\$191.47 - \$68}{(200 \times \$40)} \times \frac{365}{6}$$

$$= 94\%$$

The formula works to determine the APR we actually achieved. For the premium we use the Net Collected. That would be Sold premium – Cost premium both including the cost of commissions. We use the Days Open for our number of days.

So our actual achieved APR is 94%. What that means is that if you could achieve this same performance every 6 days for a year you would make a 94% return. Now you are not going to be able to do it every 6 days so your actual APR cannot be calculated until you reach the end of the year and we see what the total gain on the portfolio has been.

## Last Week's Trade

Status of COOL Club Sample Trades									
COOL Club Trade Status	Option Ticker	Type	Stock	Expiration	Open at Date	Current Price	Current Gain/Loss	Days Open	Days left
Unfilled	ALGN121215C00380000	Call	ALGN	12/15/12	\$37.75	\$38.00	\$180	7	4

Sample trades can be tracked at [www.bivio.com/COOL\\_Club](http://www.bivio.com/COOL_Club)

So here is our new live spreadsheet on COOL\_Club Home Page and we can see where we stood on last week's trade as of last night.

Our current gain (unrealized last ) is \$180. Because Align technology's price has corrected quite a bit (over \$3) our CALL option at \$38 has fallen quite a bit. And I could buy it back for 15 cents and close the trade.

In perfect hindsight, since ALGN has dropped almost 10%, the right trade would have been to sell ALGN at the \$35+ price that was available when we did this trade.

But by selling the covered CALL I have at least generated some income against this asset during this price correction and so I am better off than had I not done anything and watched my stock's price drop.

## How I decide to buy back

APR drops below 10%

$$\text{APR} = \frac{\text{Net Premium}}{\text{Stock Value}} \times \frac{365}{\text{Days left}}$$

$$\text{APR} = \frac{(300 \times \$0.15) + \$8}{(300 \times \$31.05)} \times \frac{365}{3}$$

$$= 72\%$$

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Using my formula it would say I should leave the option on as the APR on the premium left is still quite high.

However, when you get down to only a few days left it is almost impossible to get below a 10% APR. For instance just our Commission of \$8 would be an APR of 10.4% and we could only achieve that if we could buy the option back for zero cents (not going to happen.)

So we have to apply some other judgment.

## Why I decided to buy back ALGN Call

- When \$38 CALL sold .... ALGN was \$35+
- Price had been going up into earnings
- Since CALL was sold .... ALGN price down 10%+
- Market - expecting negative earnings surprise?
- Earnings come out tomorrow July 19<sup>th</sup>
- Can buy back at \$.15 and capture \$.60 of the \$.75
- If earnings are a positive .... Price may pop
- ....can then Sell a Call again!

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If I was not around the rest of the week on this trade

The screenshot shows a trading platform interface with several sections: 'Trade Options' on the left, 'Market Data' on the right, and 'Trade Execution' at the bottom. The 'Trade Execution' table shows a large volume of trades at a price of \$31.05, which is the price mentioned in the text as the price to buy back the call.

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## So how did we do on ALGN?

- Sold-To-Open
  - July 10<sup>th</sup>
  - Collected \$214.72
- Bought-To-Close
  - July 18<sup>th</sup>
  - Paid 300 \* \$.15 + Commission = \$53
- Total
  - Made \$161.72
  - Open for 8 days
  - % Earned = \$161.72 / (300 x \$31) = 1.7%
  - APR = 79%

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## What if I was tied up for rest of week?

- One of two things would happen at expiration:
  - Expired worthless (Friday closes below \$38)
    - Keep the entire premium collected \$214.72
    - Keep my stock
    - Smile
  - Exercised (Friday closes above \$38)
    - I would be "Called away"
    - Sales price would be:
      - \$38 + \$.75 premium ( less commissions)
    - Have cash
    - Smile

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## QUESTIONS?

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## Virtual Trading System

- The Options Industry Council
  - <http://www.optioneducation.org/en.html>



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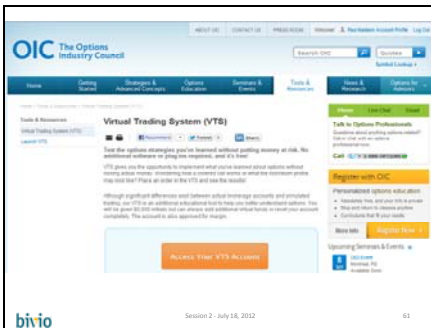
60

At the end of last week's COOL\_Club, Mark Robertson, of ManifestInvesting fame, mentioned in the chat that there was a Virtual Trading Simulator at The Options Industry Council.

Here is the weblink for that organization

You must register and then login to be able to use the VTS.

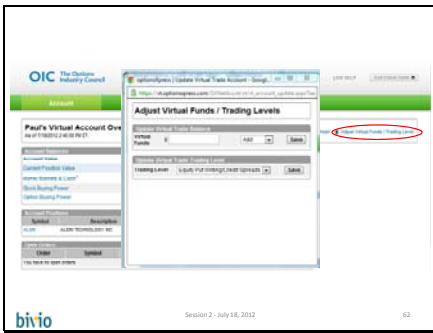
After you login go to "Tools & Resources" and then pick "Virtual Trading System" and you will get this screen. Click on the orange "Access Your VTS Account"



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Here is the next screen that will come up.

Note the button at the top of the upper right side of the screen that says “Adjust Virtual Funds / Trading Level”

You must set your Trading Level to “Equity Put Writing/Credit Spreads” to be able to sell Cash-Secured PUTs

You can add as much cash into the account as you would like to play with.

There is no way to add existing positions but because you can have unlimited cash you can buy companies that you want to simulate owning they just will not have your basis and buy date.

I will be using trades in this simulator next week and from time to time.



Next week’s session we will talk about doing covered options on Broad Market Index ETFs.

