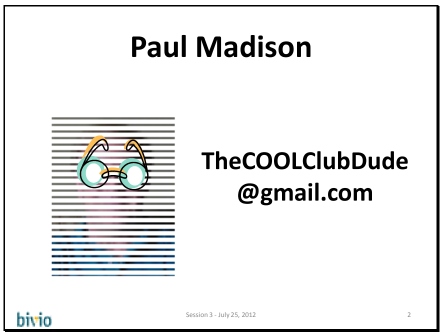

Welcome to our third session of the bivio Covered Online Options Learning Club!

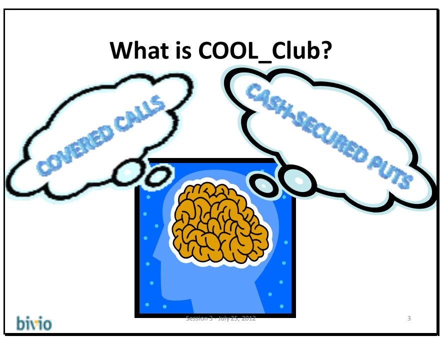
This week we will be looking at Covered Options on Broad Market Index ETFs




I am Paul Madison

The COOL_Club Dude, and will be leading us through these sessions

You can reach me buy sending me e-mail at TheCOOLClubDude@gmail.com.



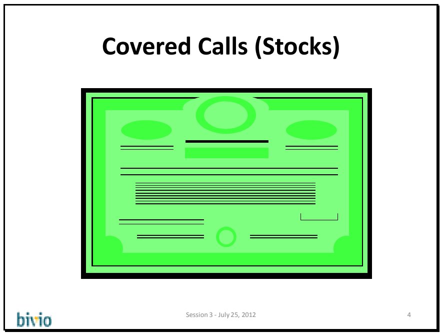

So just a reminder

(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.

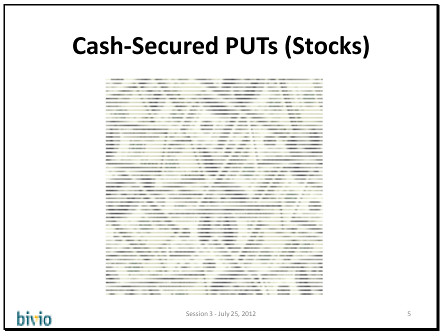
Going through the logic on why we are looking at a particular option on a particular stock.

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



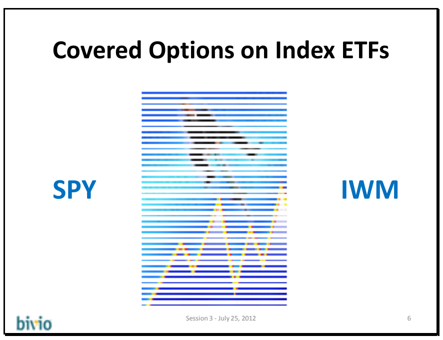

We have three broad types of Covered Options we are going to talk about and we are going to focus on one of the three in a three week rotation.

The first type are Covered Calls these represent potential sells against Stock you own in your portfolio. Covered Call is what we did in Week 1 and we will be doing again next 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 talked about last week and will be doing again in two weeks




And finally tonight and every three weeks 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

## If we have time each week

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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 a 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 (8/1) | 5pm ET |
| • Second Wednesday (8/8) | 8pm ET |
| • Third Wednesday (8/15) | 9pm ET |
| • Fourth Wednesday (8/22) | 10pm ET |
| • Fifth Wednesday (8/29) | Vacation |

***New monthly schedule starts next week***

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Our COOL Club Schedule is:

The first Wednesday of every month so August 1st, our schedule time will be 5pm ET

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

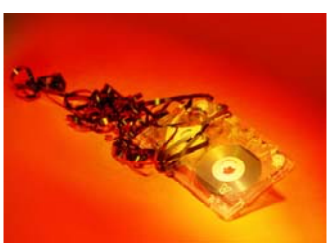
The third, August 15th, will be at 9pm ET

And the fourth, August 22nd 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 next week.

## Recordings



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Recordings of our first two sessions have been posted and I am happy to see we have had a lot of viewers.

## COOL_Club Home Page


*www.bivio.com/COOL_Club*



The COOL_Club home page continues to develop.

A live spreadsheet has been added 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

## Email Discussion Group

On our home page -www.bivio.com/COOL_Club

Click the COOL_Club Discussion List

After joining, questions can be sent to: Cool_Club@bivio.com



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.

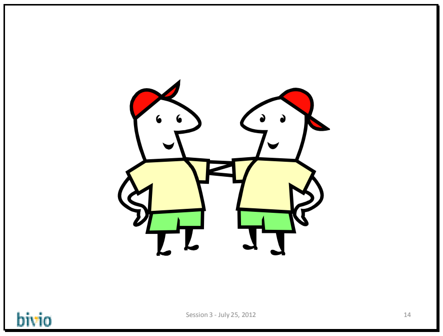
You can certainly still attend COOL_Club sessions without joining our email discussion group.

All questions and replies to COOL_Club will be sent to the entire email discussion group.

**QUESTIONS?**

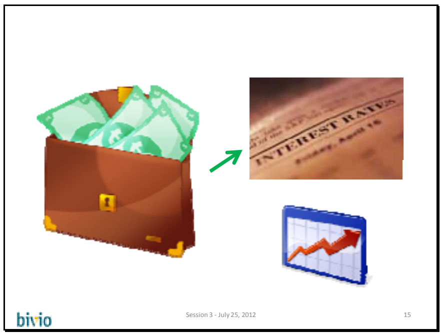


**COVERED OPTIONS**
**ON BROAD MARKET INDEX ETFS**




Lets start by saying logistically selling Covered CALLs and Cash-Secured PUTs on Broad Market Index ETFs looks identical to selling Covered CALLs and Cash-Secured PUTs on Stocks.

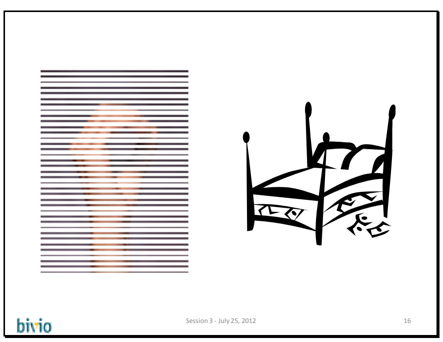
But for me it is how one plays them, and or what they use them for, that is where the difference lies.




Traditionally we have all had some amount of cash in our portfolio. That amount might vary in size depending on how bullish or bearish we are about the market and can also vary depending on other things going on in our own lives.

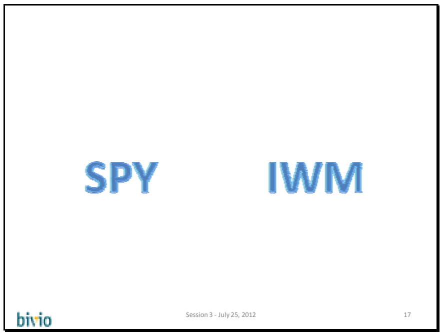
This is money that we are not looking to “be in the market” but rather generate some amount of interest. Interest rates on that money use to be fairly reasonable maybe even as much as half of what we expected our stock return to be.

We were comfortable with not getting price appreciation but just a reliable constant income stream.




But these days our interest on the cash portion of our portfolio is almost not worth talking about. So far they are not charging us to hold our cash, at least not in the US. I do have to say that Germany has had some short term bond auctions of late where the interest rate actually was slightly negative meaning that when people pulled their money out it would be less than what they put in.

It would seem there might be a better place.

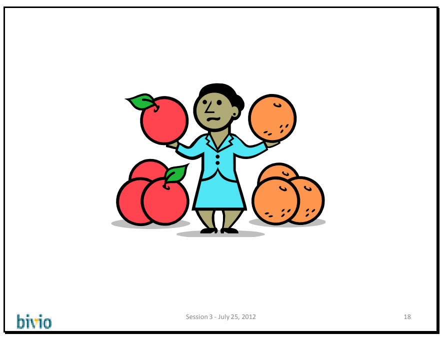



I believe done properly, Covered Options on Broad Market Index ETFs can somewhat take the place of our low risk reasonable interest rate portion of our portfolio.

And as you have heard me say a number of times my two favorites are

SPY – which is an ETF that emulates the S&P 500 index - The 500 largest US companies.

And IWM – which is an ETF that emulates the Russell 2000 – The 2000 largest US companies

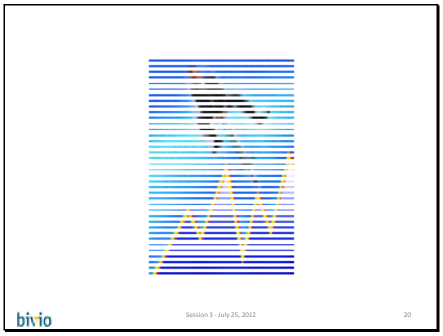



So what is different about Covered Options on Broad Market Index ETFs versus Stock.


When we do stock we should be doing fundamental analysis that tells us where we think the stock is undervalued, which we call our buy target, and where it begins being overvalued, which we call our sell target.

And we would expect that there is a fairly respectable difference in between these two numbers. We should be desiring to buy when it is undervalued and sell when it is overvalued. Our biggest gain should come from price appreciation.

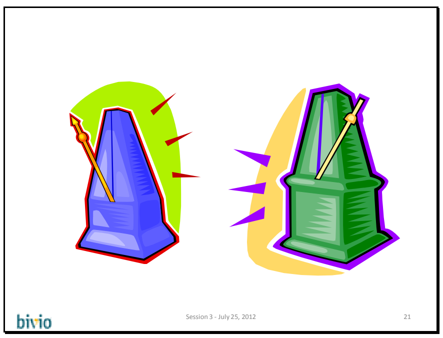
Selling covered options can add some return on the edges but it should be the smaller amount if we are sticking to High Quality Growth stocks. I cannot stress enough that fundamental analysis is the key to stock investing AND on doing covered options on stocks.




The way I approach Covered Options on Broad Market Index ETFs is to focus more on making sure I am consistently collecting option premiums over and over and over and I am not trying to make significant amounts on price appreciation.

What does that remind us of …oh yeah our Money Markets use to give us consistent payouts but did not give us any price appreciation ……………hmmmmmmmmmmmmmmmm

I have been told that institutional fund managers use this approach to generate a very respectable return on the cash portion of their portfolio, and I totally believe it!




The key to Broad Market Index ETFs Covered Options is learning to understand the “trading ranges” or what I call the rhythms of the market.

We want to be selling Cash Secured PUT’s on the down beat

and selling Covered CALLs on the upbeat

Now I have used a metronome example but this is a slow metronome that may take a week or two or longer to swing from down to up


First let me get something straight ….I don't do technicals. I am not opposed to them at all, I just don't do them. I have shown technicals some weeks because it is easier for you to see a picture with technicals than it is for me to say my gut tells me the range for a stock is here to there. But for the stocks I do, and I stick pretty much with a known set, I do develop a sense of the rhythm or trading range for both stocks and more importantly the broad market.

Here is a simple price chart of SPY for the last two years. A good discipline to start doing on a regular basis is to say what is the current trading range. So where are the prices that the market seems to bounce up off of and where are the places the price stops and goes down.

Often, but not always, you might see an inner range and outer range. These ranges are in the eye of the beholder and can be ascertained however you want to develop them.

So when I look at this chart, I currently see us in

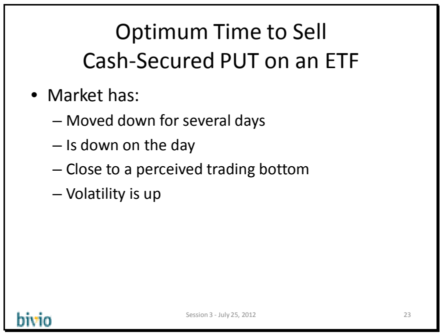
an inner band of 132-133 up to 137-138

and an outer band of 127-128 to maybe 141-142.

Next I need to say Markets are like great symphonies, they have lots and lots of sections to the music and just when you get use to the rhythm of a particular section then it will move up an octave or down an octave or the tempo may speed up or it might slow down. It is not important for you to be able to predict when the music will change just that you be able to understand when it has and adapt. You don't want to be still dancing the tango when the music has moved to a slow waltz.

When I look at this score I see at least two other shorter pieces and two other transition pieces what do you see in the music.

I encourage you before next weeks session to look at the chart of IWM and try to see it's rhythm and maybe we can do a little survey at the end of next week to see what people think.



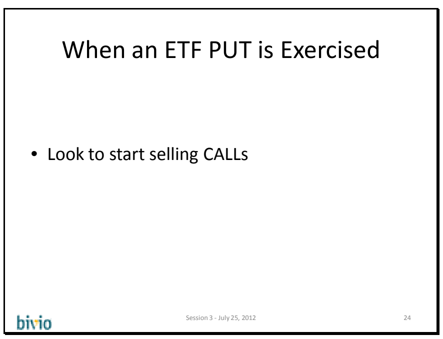

You will recognize this slide form the last week on the optimum time to sell a Cash-Secured PUT on a stock.

So we sell the put after the market has been moving down for a few days.

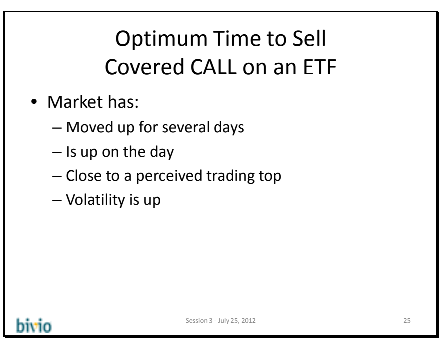
It is best if it is down on the day we are wanting to sell.

But in the case of Index ETFs rather than being close to our “BUY” range as we are not sure where that might be we want it to be close to what we believe is the bottom of the trading range.

Again Volatility is important and we will be talking more about it in future sessions but we would like to see it up on the day as well.




If you sell a PUT and hold it to expiration day and the ETF is PUT to you then you just turn around and look for the next opportunity to sell a CALL at a level higher than where the ETF was PUT to you.




Again when we are selling a CALL on our ETF we want the market to be up for several days and up on the day we are selling the CALL

We want to be selling at what we perceive to be towards the top of the trading range.

There is that Volatility character again and we will pay a visit to him sooner rather than later.

## When an ETF CALL is Exercised

- Look to start selling PUTs



When your ETF is finally called away you will be back to CASH and you can start the cycle all over again.

So your “CASH” portion of your portfolio will cycle between being in cash with covered PUTs on and owning the BroadMarket Index and having CALLs on.

## In other words….

Lather, rinse and repeat!



And so we turn to our shampoo bottle and remember……

Lather, rinse and repeat.

## Which Options

- Sell short term
  - At least front month
  - Weekly even better
- Sell as far Out-of-the-Money with acceptable return
- Nice rule of thumb
  - Premium = .5% of asset for each week the option is on



So which options

I like the shortest time frame on ETF options and will often do weeklies and certainly no more than front month.

This allows me a short time frame to capture premiums

I sell as far Out-of-the-Money and I want them close to my trading bottom …at least the inner range and maybe the outer range if my time frame is a month rather than a week.

A very nice rule of thumb is try to get at least ½ of 1% of the Asset Value for each week of time left to expiration. So for a 130 PUT that would be $.65 for one week or that would $2.60 for one month.

**TRADE EXAMPLE**



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

## COOL Examples

***REMINDER!***

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



## New Characters



Another housekeeping issue before we get into tonight's trade is I want to introduce you to two new characters who will be regulars at the COOL Club.

First we have Assertive Al

And second Cautious Carl

And let me tell you a little about both. Remember these guys are strictly fictitious and any resemblance to anyone in the audience or otherwise is strictly coincidence.

## Assertive Al (AA)

- More aggressive
  - At-The-Money or In-The-Money
  - Sure of market direction
  - Wants more APR!



Al is the more aggressive trader. He is so sure on market direction and is very greedy when it comes to APRs and so he goes much closer to At-The-Money or even In-The-Money Options which of course gives him much larger premiums

## Cautious Carl (CC)

- More conservative
  - Out-of-The-Money
  - Less sure of Market Direction
  - Willing to accept lower APRs



Carl on the other hand is a much more conservative trader and he is not as sure of being able to predict the Market Direction (maybe he has a tin ear) and so he does further Out-of-The-Money options which means smaller premiums and of course lower APRs.

Neither trader is always right. There will be times you will want to be more like Al and there will be times you feel like Carl. That's OK.

Especially when we do covered options on Broad Market Indexes for COOL_Club, we may check-in on both Al and Carl to see what trades they did and how they fared.

## S&P 500 Index

- ETF Ticker – SPY
- Trading Range:
  - Inner Band 132-133 up to 137-138
  - Outer Band 127-128 up to 141-142



Our trade tonight is against the broad market Index known as the Standard & Poor's 500 Index. This index is made of the 500 largest US companies.

For those of you who have seen my talk, this is what I like to recommend as the investment of choice for people who want to be in the market but do not have the time or interest to do individual stocks.

My favorite way to invest in the S&P 500 Index is the ETF managed by State Street Global Advisors with the ticker SPY which also has a plethora of options available. There are weeklies, monthlies, and quarterlies. Strike levels are at every $1.

## Account

- $27,000 of un-invested cash
- Can buy 200 shares of SPY at $133 ($26,600)



So the account that I was dealing with had over $27,000 of un-invested cash which is enough to buy 200 shares of SPY at 133.

By the way SPY ETFs price is roughly 1/10$^{th}$ of the S&P 500 index itself. So when I talk about a bottom or 132 to 133 that is equivalent to a S&P 500 Index of 1320 to 1330.


On Thursday July 12th Carl and Al got together at their usual coffee spot in the afternoon and talked about what they were seeing in the market.

Cautious Carl says “I having been watching the S&P today I think we may be getting close to a bottom although it might go just a bit lower first.’

Al, always the assertive one says “You are right on Carlos my boy, I received 64 technical signals that I am sure all said this market is ready to turn on a dime and go up from this 133 level and I think it is going to be sustained for quite awhile.”

Carl the quiet one said “well, I don’t think we are quite to the bottom but I agree it might go up a little over the next week or so.”

Al said “well let’s both put on an option on SPY without talking about it and see who plays it the best.”

Carl said “well maybe but I don’t want to bet any money as I can’t afford to lose any money while I am saving for my son’s college tuition which is only 15 years away.”

Al says “yeah you always were the life of the party Carl”. Slaps him on the back and heads off to place his trade.

Carl mumbles to himself “ I may not be the life of the party but you are sure quick to borrow money from me to pay for the party” and sits down at his trusty IBM 286 to put in his trade.


So right after afternoon coffee on July 12th with SPY trading right around 133, AL SOLD-TO-OPEN a cash-secured PUT on SPY

With a Strike price at-the-money

And he went out to the August 18th Expiration as he wanted lots of Premium.

He did 2 contracts and so he needed to have $26,600 of cash available to secure this PUT.

He collected a $2.55 premium but because Al does not really worry about the little things, he is with a Broker who charges $15 per trade (by the way the OIC simulator also uses $15 a trad) and so his net collect is $495.

He got a lot of Premium, but because we have 37 days left to expiration his APR in this case was only 19% ….slightly less than our target.


Carl on the other hand when back and studied his "options" (pun intended) for awhile and just before the market closed also with SPY at 133 he decided to do a SOLD-TO-OPEN Cash-Secured PUT at a Strike of $132 but on a July 21st expiration which had only 9 days left to expiration.

He also did 2 contracts and needed only $26,400 of cash to be able to put his trade on.

He collected a premium of $.75 and because Carl watches the little things he is at a broker where he only pays $5 of commissions and so his net was just under $145

APR 23%

### Tuesday July 17th




So on Tuesday July 17th. Carl bumps into Al as he is photocopying the office pool sheet for the British Open Golf tournament.

Carl says “You know Al I have to hand it to you, you were right on the market turning around. I cannot believe that it is up over $3 from Thursday. How did you do on your option? I took mine off this morning at 9 cents. I netted a cool $121.94, I think it was .94”

Al says “Uh, what, oh yeah our option “bet” wink wink. You know I need to check on my position maybe I should take mine off too.”

Al continues struggling with the copy machine for two days getting the pool printed up and it is not until Thursday that he checks his trade and decides he should get out too.”

### Carl’s Close

- Bought back July 17th
- SPY @ $136
- Paid $.09/share – Net paid $23.03
- Made $121.94 (Yes it was .94 Carl)
- Days on 5
- APR = 31%



So Tuesday with SPY at $136, Carl bought back his option at $.09. or he paid a net of $23.03 $18 plus $5.03 commission.

His trade was on for 5 days and his overall APR was 31%. In other words this was like a $26,400 CD that open for 5 days and paid a rate of 31% APR.

By the way the APR on the $.09 was 8% which is less than the 10% threshold return.

### Al's Close

- July 19th minutes before the close
- SPY @ \$137
- Bought back @ \$.85 – Net paid \$185
- Made - \$310 (\$15 commissions Al, Really?)
- On for 7 days
- APR = 61%



Al did not get back to his trade until the close of the market on Thursday by then SPY actually had moved up to \$137 (a \$1 higher).

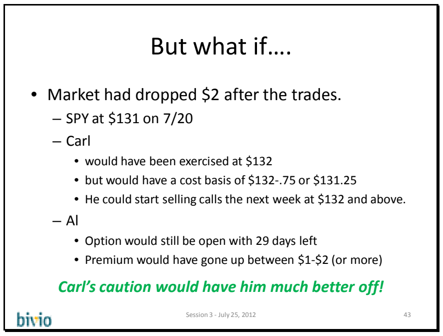
He bought back his option at an \$.85 premium and since there was still 30 days left to August 18th the APR on that premium had also fallen below 10% and was at about 8.5% APR.

He netted \$310 despite the fact that he paid \$15 commissions on both the Sell side and then buying it back. He paid \$30 in total where Carl paid \$10 in total. No wonder Al needs fat premiums!

AL's trade was on for 7 days and so his overall APR was 61% ..quite nice.

### Results

- Al's aggression paid off in this case.
- Market did turn on a dime.
- Both were able to close fairly quickly with nice profits.




Aggression worked in this case because the boys were right on direction….when you guess right on direction it pays to be aggressive.

However what if the boys and the 64 technical indicators were wrong.

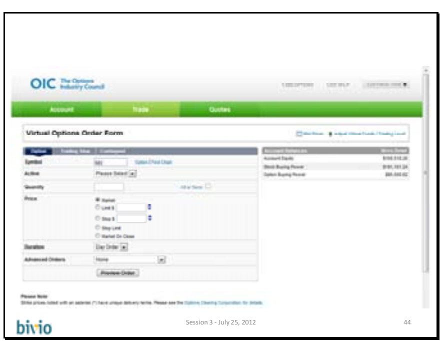
What if after the trade the market continued to slide and that by the next Friday, July 20th, the SPY's closed at $131 or down $2.

Carl's option was for $132 so he would have been exercised and have to buy SPYs for 132 but he would still have all of his premium and so his net cost would have been 131.275/share net of commissions.

So he would have bought only a .25 above the close on the 20th and so could start selling Covered Calls the next week at strike prices of at least $132 and above.

Al's trade would have been still on and the premium would have gone up somewhere between $1 and $2 (and possibly more if that mysterious character named Volatility jumped up). He would still have almost month to deal with this trade.

Carl's caution would have indeed protected him better on the market going opposite of what they were thinking was going to happen.

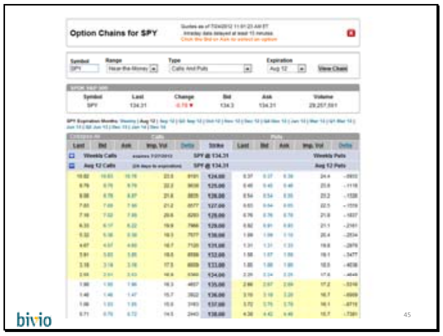



Since the boys were both successful they decided to go again this week since the market was down yesterday and today.

First let us look at Al's trade …he did it using the OIC's Virtual Trading System.

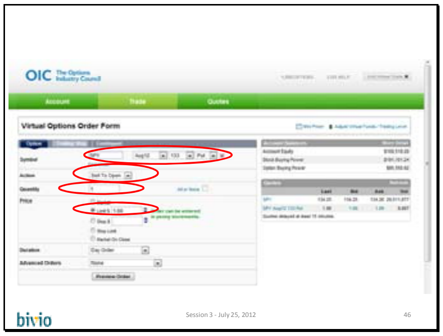
When we click on trade options we get this screen and we put in our ticker for our underlying security in this case SPY.

Then we click on Find Chain.




Up pops our chain.

He was so happy with the last trade he decides to do a 133 for Aug 18 again. So if he clicks on the Bid price which is 1.88




Then it fills in our order form.

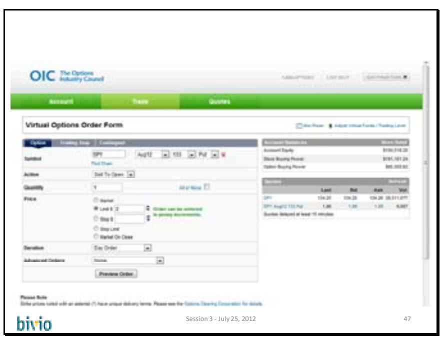
It show the expiration which is August monthly, strike of 133 and it is a PUT

and an Action of Sell-To-Open

We fill in the number of contracts and in this case Al only did 1.

The Best Bid price comes in on the Limit line but you can change that to whatever you want and Al elected to move it to a $2 limit order.

Then select Preview Order

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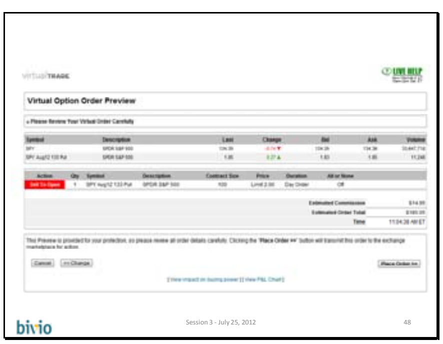
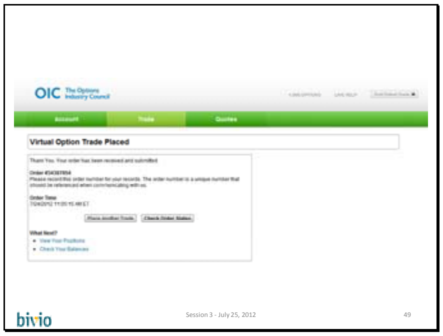
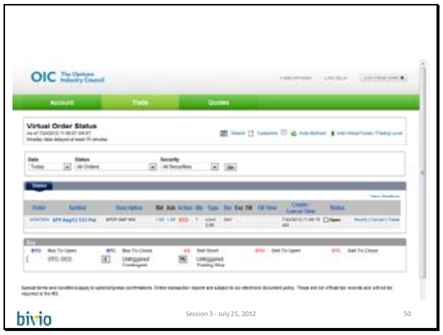
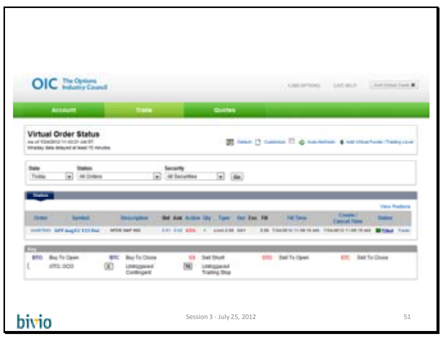
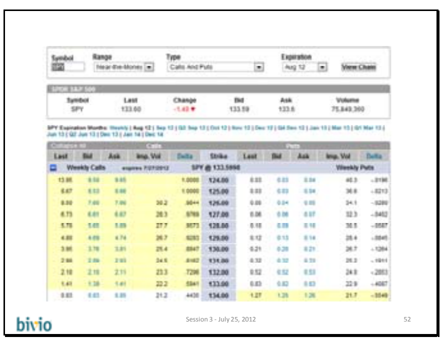




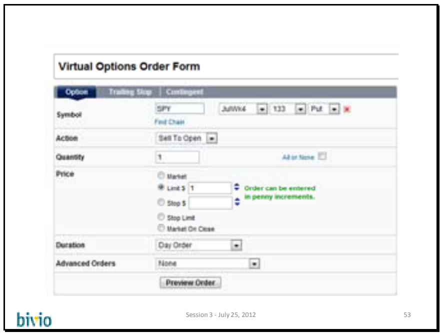




Now Carl's trade
He decided to stay with the short options and the shortest would be the weekly Jul 27th which expires in 3 days.

He decides because he is only going to do one contract that he is going to do the 133 PUT and try to get $1 premium which is .17-.18 higher than where the current bid-ask is.

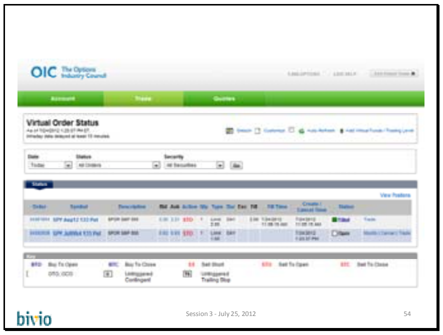
So we click on the .82 bid price next to the 133 strike



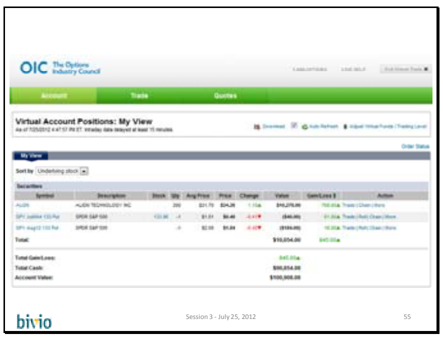

Our order entry screen comes up

We put in our quantity if it is different than 1

And then we change the limit to $1




When we check our status we see that Al's trade is on but Carl's is still waiting. However it did fill by the end of the day.




And here is where our boys were by the end of today. Both are positive but the short timeframe is really working for Carl and with only two days left it would look like he will have a great chance to buy back at a low price and or it could expire worthless on Friday. Al is ahead on his trade but not by as much as there obviously still a lot of angst left on for where SPY will be in August.