

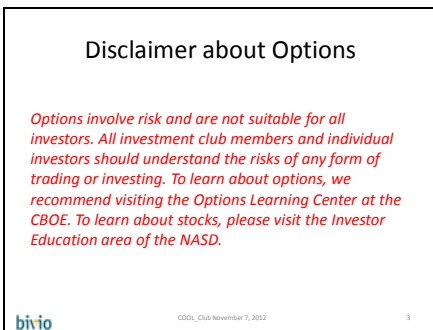


Good afternoon and welcome to the Covered Options Online Learning Club otherwise known as COOL\_Club. I see we have some new people in the audience tonight and so an even harder welcome to you. We are very casual here in the clubhouse so if you have any questions you can type them into the GoToMeeting questions box and Laurie Frederiksen will monitor those and get them to me.

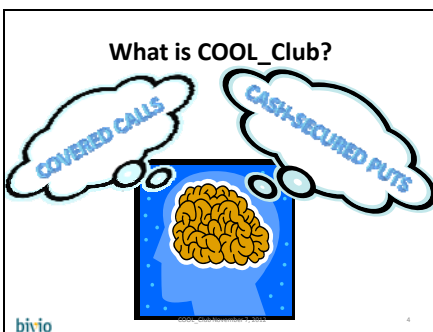


I am Paul Madison and I am your host for the COOL\_Club

If you want to contact me you can write to me at the COOL\_Club discussion list which is [COOL\\_CLUB@bivio.com](mailto:COOL_CLUB@bivio.com)



Remember that options do involve risk and are not suitable for all investors. All investors should understand the risks involved in any investment instrument including stocks and options. The slide mentions a few places that you can do some additional research around both options and stocks.



For those that are new to COOL\_Club.

This is a weekly 30 minute session where we explore the thought processes associated with actual Covered Option Trades. We will entertain questions and discussion for up to an extra 30 minutes after our presentation.

## November Schedule

- First Wednesday (Nov 7th) 5 pm ET  
*Selling Covered Options – Index ETF*
- Second Wednesday (Nov 14<sup>th</sup>) 9 pm ET  
*Selling Cash Secured PUTs*
- Third Wednesday (Nov 21<sup>st</sup>) Break  
*Thanksgiving Week*
- Fourth Wednesday (Nov 28<sup>th</sup>) 9 pm ET  
*Covered Options & Taxes*

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We have now posted our sessions for the rest of the year. Due to the holidays we will have a couple of breaks in the COOL\_Club. First we will skip the Thanksgiving week so that we can all lay around stuffed and watch a crazy ball bounce around.

Note that times are a little different than our normal schedule. Both the second and fourth week our start time will be 9pm Eastern.

We will do a special topic the fourth Wednesday on Covered Options and Taxes. This probably will not be an all inclusive tax discussion but it will cover a lot of normal tax considerations associated with doing Covered Options.

## 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)

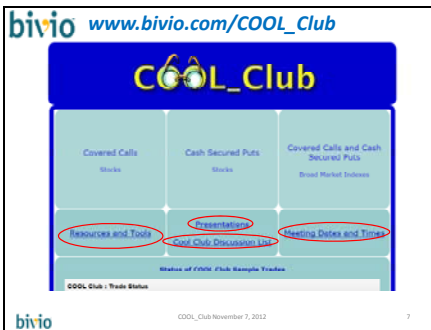
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We will only do two sessions in December the 5<sup>th</sup> and 12<sup>th</sup> and not the second week time is at 9pm Eastern.

So that the Cool Club Dude has plenty of time to buy presents and then play with presents we will take a three week break and return to the clubhouse on January 9<sup>th</sup>. I am sure we will all be rip, roaring and ready to go.



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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 COOL TOOLS like we are using tonight by clicking on “Resources and Tools”

And finally the schedule and registration links are here.

## Tonight

- Refresher on Covered Options Index ETFs
- Index ETF COOL TOOL
- Work through some examples
- Open Floor

We will do a little bit of a refresher on selling Covered Options on the Index ETFs.

Using the Index ETF COOL TOOL

We walk through some examples.

Then we can open up the floor for questions and discussion.

## COVERED OPTIONS: INDEX ETF

## Word of Caution

- In this presentation I may use the following interchangeably:
  - Broad Market
  - Index
  - ETF
- The right phrase should be Broad Market Index ETF but that is a lot to type and say

Before I get started again I did to make sure you understand that when I say Broad Market or Index or ETF I am really always talking about the same thing. I should always be saying Broad Market Index ETF. I just don't remember to say it as it is a mouthful.

## Different Mindset!



First some general reminders about Covered Options

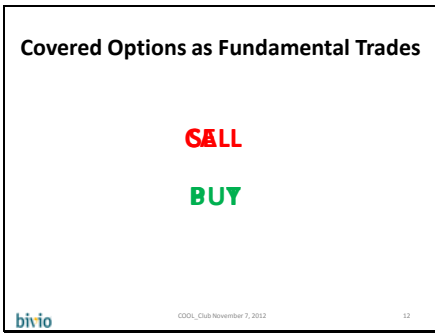
Something that is really hard for people when they start is the fact that your whole mindset is different.

When we are dealing with stock we always start by buying and then at some point we sell (although some of us never get to that side of the equation)

When we are doing Covered Options we have to think backwards

... we start by first selling and then we have to close the option

which often means a BUY

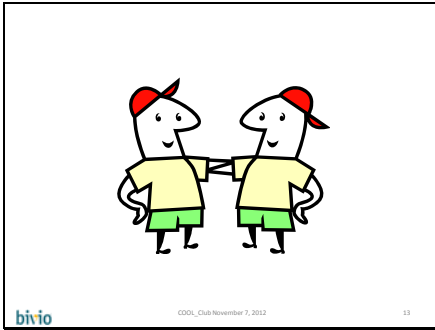


Also the following little picture may help you remember that Selling Covered CALLS

can turn into stock SELLS

And Selling Cash Secured PUTs can

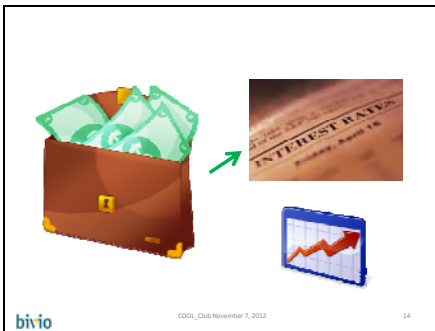
turn into stock BUYS



Ok, enough housekeeping. Let's talk Covered Options on Index ETFs.

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

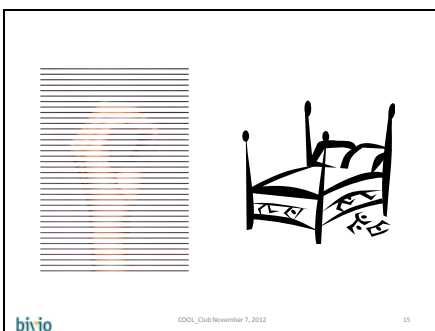
But, for me, it is how one plays them, and or what they use them for, that is where the difference lies.



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.

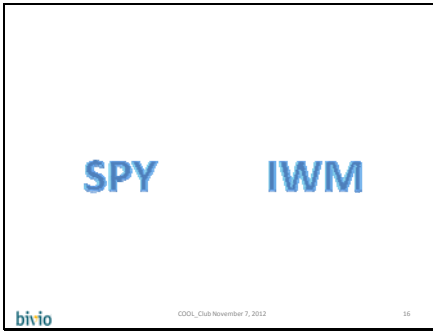
This is money that we are not looking to "be in the market" with but rather to generate some amount of interest. Interest rates on such cash used to be fairly reasonable, maybe even as much as half of what we expected our stock return to be.

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



These days the 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), Europe is another story.

It would seem there might be a better way to earn some income on it.

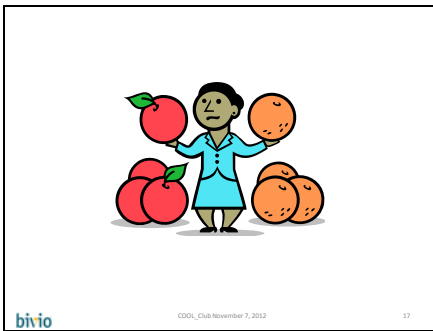


I believe that done properly, Covered Options on Index ETFs can somewhat take the place of our low risk reasonable interest rate portion of our portfolio.

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 – I have mis-represented the IWM on previous occasions so I need to at this point correct what it actually is. The IWM is the bottom 2000 smallest US companies in the larger Russell 3000 index. It is a Small Cap Index. The median Market Cap of the companies in the Russell 2000 is just over \$500 million as of summer of last year. The average market Cap is over twice that so that tells you there are a lot that are really small that pull the median down.



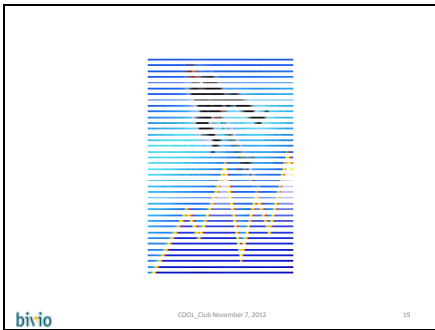
So what is different about Covered Options on Index ETFs versus Stock.



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

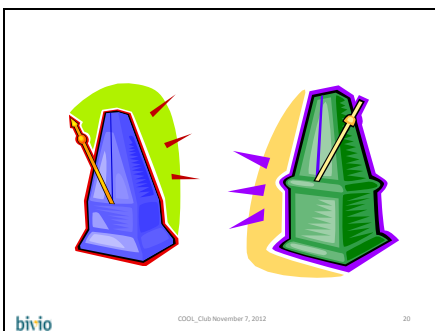
Selling covered options can add some return on the edges but it should be the smaller amount if we are sticking to High Quality Growth stocks. I cannot stress enough that for at least me, fundamental analysis is the key to stock investing AND to selling covered options on stocks.



The way I approach Covered Options on Index ETFs is to focus more on making sure I am consistently collecting option premiums over and over and over. 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 .....hmmmmmmmmmmmmmmmmmm

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 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

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

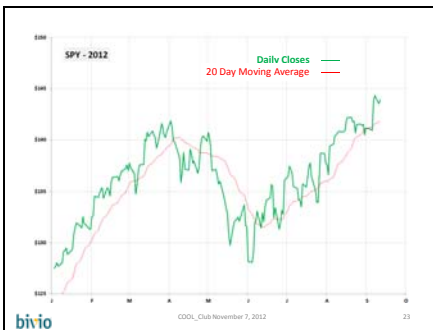


Sometimes when I have talked about Index ETF's I told you that you had to decide the trading range of the index you are looking at. But I have introduced another approach in the COOL\_Tool that you might like even better.

I personally do use a gut approach to determining market ranges but that is not for everybody, especially if you are new and have not developed that gut. It is a bit like Chefs when they cook. They don't use recipes because they just know what works and what doesn't. But when you are just learning to cook, recipes are a much better way to start off. This approach gives you a bit more of a "recipe" to follow at least until you are ready to play with spicing it up.

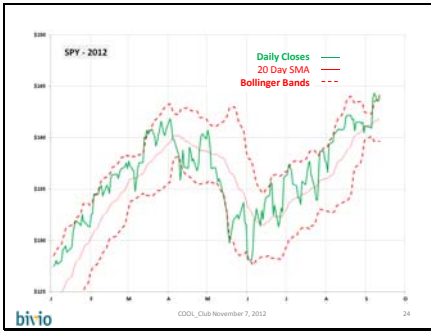


Here is a simple line graph of the daily closing prices of SPY for this year. The line connects the actual data points from each day. This only goes through mid September but don't worry, we will be looking at some live data as well.



Now lets add a line to this graph that is what is called a simple moving average. You will sometimes see this abbreviated as SMA.

What the computers do is everyday they average the last 20 days of closing prices. This gives us a new number that we can plot and look at versus every other day that we did the same average. It is called a moving average because every day we add today's price into the average and we drop off the oldest day that was used in the average the previous trading day.



OK here comes a little statistics part so everybody take a deep breath and swallow a big gulp of coffee if you have it.

In addition to calculating the moving average the computer can crunch standard deviations. This is a statistical measure around how much variation there is in the 20 numbers that are being averaged. The good news, NO make that the really good news, is that you do not need to know how to calculate standard deviations, the computers will do that for you.

What you may remember of your college statistics course (unless this lecture fell on a Wednesday after election night and you were napping) is that 68% of all the data is within one Standard Deviation of the average but if you go up to two times the standard deviation then 95% of all the points will be within a range of the + or – two standard deviations from the average.

So you can see we have added two dashed lines representing + or – two standard deviations from the moving average.

Before we go any further lets see if there are any questions around this (I am about to get to why this is important but just wanted to make sure everybody understands what we are looking at).

OK because some smart Cool Dude named John Bollinger was the first to realize that these bands had real meaning in stock prices. So we don't call these Standard Deviation Bands we call them Bollinger Bands. As the Bard said "What's in a name? That which we call a standard deviation By any other name would still be really sweet". Or something like that.

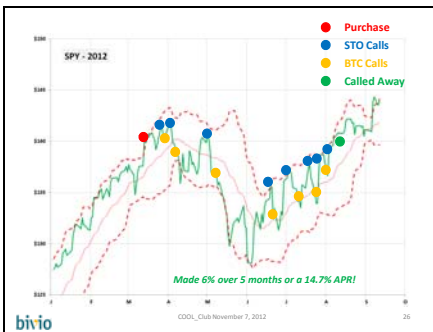




Some of what John Bollinger discovered is that when a price moves up close to the two standard deviation line it often means that it is about to reverse direction. Not always but often.

You can see most of this year we have been trending up. But you can also see we have bumped the top band a number of times, about 6 or 7 in 9 months. Almost every time we did, the market retrenched a bit.

We have not had near as many opportunities on bumping the lower band but we did have about 1 a month in April, May, June period. The same phenomenon happened once the band was hit the price bounced or rallied.



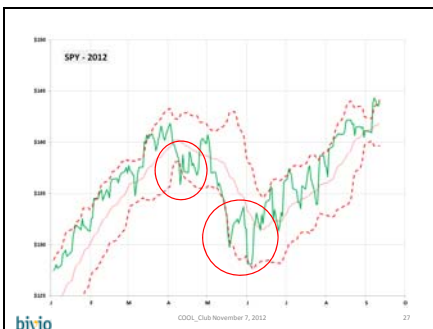
So let's see how this works. This is a series that I did in one of my portfolios this summer.

I bought some SPY in Mar right around the \$140 level.

Then whenever the market was pushing to its upper bounds I would sell calls and collect premiums. Consistently the market would pull back and I would buy the calls back at low cost and get ready to do it again.

I did this throughout April, May, June, and July

Finally in August it was called away from me. I owned the SPY for five months and between dividends (paid twice in that time span) and call premiums collected I made 6% on my money for an APR of 14.7%.



So if you have cash how do you get started? Well, you look for periods like this where the prices are touching the lower part of your trading bands and you start selling Cash Secured Puts. Which kinds of sound like where we might be starting to get to. More on that when we go live.

### Optimum Time to Sell Cash-Secured PUT on an ETF

- Market has:
  - Moved down for several days
  - Is down on the day
  - Close to a perceived trading bottom
  - Volatility is up

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The best time to sell puts is when the market has been trading down and is down on the day and is close to a perceived trading bottom. The Bollinger Bands can help us see that. You also want our friend Mr. Volatility going up.

### When an ETF PUT is Exercised

- Look to start selling CALLS

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If you sell a PUT and hold it till expiration 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.

### Optimum Time to Sell Covered CALL on an ETF

- Market has:
  - Moved up for several days
  - Is up on the day
  - Close to a perceived trading top
  - Volatility is up

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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. Again the Bollinger Bands may help us in understanding where that short term top in the market might be.

And it is good if Mr. Volatility is up as well.

### When an ETF CALL is Exercised

- Look to start selling PUTS

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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 ETF Index and having CALLs on.

**In other words....**

You have Cash:

- STO → BTC Puts
- STO → BTC Puts
- STO Puts



Eventually get exercised and own the ETF

You own an ETF:

- STO → BTC Calls
- STO → BTC Calls
- STO Calls

Eventually get exercised and be back to Cash

*Lather, rinse, and repeat!*

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If we have cash

We start by Selling To Open (STO) PUTS which we then Buy To Close (BTC) and we keep repeating that until we have the index PUT to us via an exercised option.

Once we own the Index then we start Selling To Open (STO) CALLS which we then Buy To Close (BTC) until our Index is CALLED away from us via an exercised option.

And as our shampoo bottle reminds us.....

Lather, rinse and repeat.

**INDEX ETF COOL TOOL**

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**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 through BootCamp or Parallels or VMWare's Fusion.

**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.





**Puts**

Strike	Bid	Mid	Ask	Change	Change (Point)	Change (Percent)	Implied Volatility	Delta	Gamma	Theta	Change of Requirement
79.00	0.39	0.31	0.32	+0.13	+0.00	+0.00%	23.2	0.39	0.23	-0.01	1.678
80.00	0.45	0.41	0.47	+0.20	+0.00	+0.00%	21.2	0.41	0.30	-0.01	20.30
81.00	0.68	0.70	0.71	+0.27	0.00	+0.00%	22.2	0.68	0.11	-0.01	29.37
82.00	1.02	1.04	1.06	+0.20	0.00	+0.00%	21.2	0.84	0.13	-0.01	30.92
83.00	1.48	1.51	1.54	+0.44	0.00	+0.00%	20.1	0.71	0.12	-0.01	38.85
84.00	2.08	2.14	2.19	+0.52	0.00	+0.00%	19.4	0.59	0.19	-0.01	43.81
85.00	2.83	2.89	2.94	+0.50	0.00	+0.00%	18.8	0.50	0.19	-0.01	47.51
86.00	3.60	3.77	3.85	+0.63	0.00	+0.00%	18.8	0.23	0.21	-0.01	48.87

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This is an option chain for IWM at Morningstar. It is free and you can customize the other data that you see. I added the Delta so that we can see that yesterday when the 80 PUT closed the bid ask was .45-.46 and the delta was over 40%. That means for every dollar move down for IWM the option premium will move more than 40 cents.

**Index ETF COOL TOOL Sell To Open**

Symbol: IWM Price: \$62.34

2. Fundamental Index Questions

What is the delta hedge? 588  
 What is the weekly delta hedge? 506  
 What is the monthly delta hedge? 477

Which do you want to sell? PUTS  
 Cash available for profit: \$14,000

3. Analyzing your selection

Net Premium: \$165.05  
 APR: 37%

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So if it went out at roughly \$.45 yesterday and IWM might be going down by \$1 and the delta is 40%+ it seemed like I might be able to sell for \$.90. I put that into the COOL\_Tool before the market and sure enough it was a nice 37% APR.



Again looking at the plot of where it traded up to about 2:30 ET. We see that the \$.90 would have been filled. It got as high as \$1.15.

**Index ETF COOL TOOL Sell To Open**

Symbol: IWM Price: \$62.34

2. Fundamental Index Questions

What is the delta hedge? 588  
 What is the weekly delta hedge? 506  
 What is the monthly delta hedge? 477

Which do you want to sell? PUTS  
 Cash available for profit: \$14,000

3. Analyzing your selection

Net Premium: \$165.05  
 APR: 30%

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But I decided I did not want to sell too early so I got more aggressive. I went down to a 79 PUT and looked at what the APR would be for \$.75 and thought that 30% was pretty good.

**OIC The Options Industry Council**

Account: Trade Quotes

Virtual Options Order Form

Symbol: IWM Price: \$62.34

Quantity: 2

Strike: 79

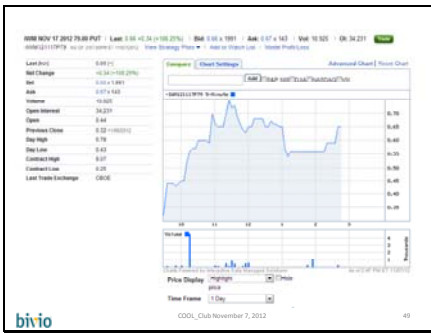
Option Type: Put

Order Type: Sell To Open

Advanced Orders: None

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Unfortunately when I went to put the trade into the Virtual Trading System, I got a little more greedy and decided to put the 79 PUT in at \$.80 (wanted one more nickel).



Turns out that was two cents too greedy. The high for the day was \$.78. I don't mind as I still feel we are trading lower so tomorrow is another day.

**POSTS**

We continue to have some great posts on the discussion list and I want to thank all for their contributions. I have been running hard for awhile and so have not been able to respond to all the great posts. I will try to do better over the next couple months.

**Post from Malcolm**

"I turned to Conservative option selling to increase my annual dividends on positions I already have, and to cost efficiently increase my current positions or start new positions."

I did want to recognize a post from one person who through all his posts has provided us insight, education, thought provoking questions and most importantly a chuckle every now and then.

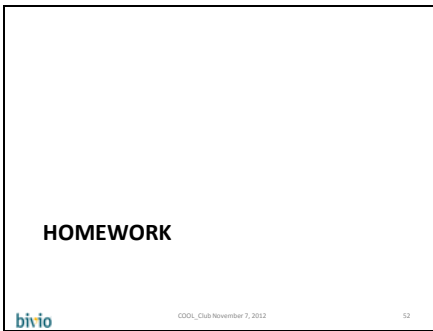
Malcolm just recently had a wonderful post about Portfolio Strategy with Conservative Options. I thought he did an excellent job of identifying the problem which is lack of good fixed income opportunities in today's market. And he is starting to agree that Conservative Options can play a role in generating an income stream to supplement our underlying portfolio returns.

Yes Malcolm we are all in this conundrum and no it is not just your echo chamber.

Your strategy is certainly is what I have found as well and I believe I am stressing here in the COOL\_Club.

I would say that Malcolm and I would both love it if others, who have some different strategies to crack the same problem, will share them via the discussion list.

Kudos to Malcolm for another excellent post.

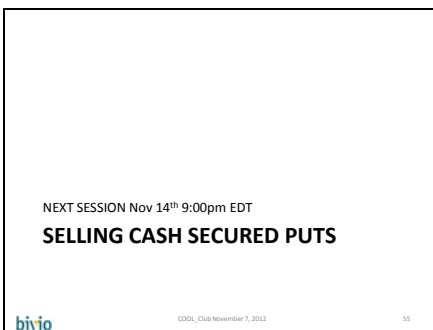


No homework to look at so it must be time for another assignment.



Seems like a great time to try selling a Cash-Secured PUT on an Index ETF. Obviously I favor SPY and IWM but you are free to go further afield if you want to try something different.

As always, it does not matter whether it is real or virtual as both are great for learning. After you try it, take a couple minutes to write-up what you did on the discussion list. This helps not only others but it also helps cement what you did for yourself. Details on the trade are great but including your thought process as well is even better.



Next week, Nov 14<sup>th</sup> at 9:00pm we will talk about Selling Cash Secured PUTs on stocks.



**GOOD NIGHT AND GOOD SELLING**