Welcome to the Covered Options Online Learning Club

COOL_Club

bivio

COOL_Club October 3, 2012 1

Good evening and welcome to tonight's session of the Covered Options Online Learning Club otherwise known as the COOL_Club. We are fairly laid back here in the COOL_Club and so if you have questions feel free to type them into the questions box and Laurie will get them to me. Hope you enjoy tonight and join us for other sessions.

Paul Madison

COOL_CLUB@bivio.com

bivio

COOL_Club October 3, 2012 2

I am your host Paul Madison and

resident COOL_Club Dude.

You can write to me at the COOL_Club Discussion List which is COOL_Club@bivio.com

Disclaimer about Options

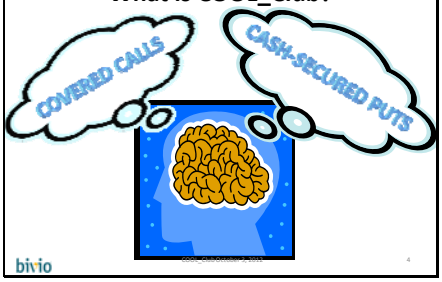
Options involve risk and are not suitable for all investors. All investment club members and individual investors should understand the risks of any form of trading or investing. To learn about options, we recommend visiting the Options Learning Center at the CBOE. To learn about stocks, please visit the Investor Education area of the NASD.

bivio

COOL_Club October 3, 2012 3

Our usual Disclaimer about Options... Options do involve risk and are not suitable for all investors. All club members or individual investors should understand the risks associated with options or any other investment instrument before investing. Also on the slide are places to go to help learn about options as well as stocks.

What is COOL_Club?



bivio

COOL_Club October 3, 2012 4

So what is COOL_Club

For those of you who are new, COOL_Club is a weekly 30 minute session where we explore the thought processes associated with doing Covered Options. Some nights, like tonight, we explore side topics that are related to selling covered options that I believe will help you better understand them.

October Schedule

- First Wednesday (Oct 3rd) 5 pm ET
  Why I Sell Rather Than Buy Options
- Second Wednesday (Oct 10th) 8 pm ET
  Covered Options: Getting started with your broker
- Third Wednesday (Oct 17th) 9 pm ET
  Selling Covered Calls
- Fourth Wednesday (Oct 24th) 10pm ET
  Selling Cash-Secured PUTs
- Fifth Wednesday (Oct 31st) Break
  Halloween - watch out for Mr. Volatility!

bivio COOL_Club October 3, 2012 5

An often asked question is "why does Paul only believe in selling options rather than buying options, isn't it just two sides of the same coin?" You are in luck because we will explore this topic at tonight's session.
Next week we will also do an extra topic about what you need to do with your broker to be able to start selling covered options.
By the way I would love people's experiences with brokers other than Fidelity, Schwab, & Optionshouse as these are the only three that I can speak about directly.
We will return to talking about Covered Calls on October 17th followed by Cash Secured Puts on October 24th. Depending on what the market is doing I might switch those two if it makes sense.

bivio www.bivio.com/COOL_Club

bivio COOL_Club October 3, 2012 6

Here is our COOL_Club home page
The link is www.bivio.com/COOL_Club
<Click>
Both Handouts and recordings are under the Presentations link
<Click>
Join the email discussion list by clicking here
<Click>
You can get to the Excel Spreadsheet COOL TOOLs by clicking on "Resources and Tools
<Click>
And finally the schedule and registration links are here.

Tonight

- Why I Sell Rather Than Buy Options
- Outstanding Trades
- Open forum

bivio COOL_Club October 3, 2012 7

So tonight
<Click>
We will spend most of our time on Why I sell rather than Buy Options<Click>
We have a few outstanding trades that have been discussed that we will do an update on and then if we have time
<Click>
We will have an open floor discussion around any questions on covered options, specific stocks, and or tool questions.

WHY I SELL RATHER THAN BUY OPTIONS

bivio COOL_Club October 3, 2012 8

Tonight we are going to explore both sides of buying and selling options. I hope it will help you understand why they are not just

bivio COOL_Club October 3, 2012 9

"two sides of the same coin".

bivio COOL_Club October 3, 2012 10

To help us understand this I want to explore something that we all deal with in our modern lives, Property and Casualty Insurance. We usually think of it as our homeowners insurance.

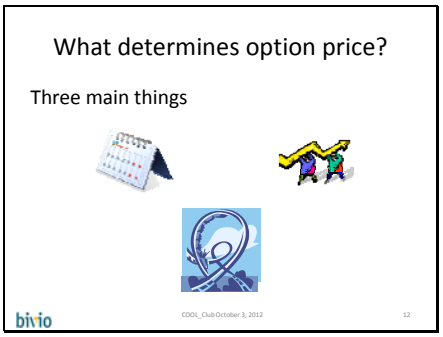
Buying Insurance

bivio COOL_Club October 3, 2012 11

So when you pay your insurance premium - Oh isn't that interesting they call it a premium just like options. Sorry, I digress,

so when you pay your insurance premium your Insurance policy has some value. That value can be calculated and is basically the amount of the coverage of the policy times the probability per day that you will sustain some type of loss times the days left on the policy. You pay the insurance company to take a risk. That's how they determine what to charge you.

When the policy expires, (in other words there is no time left on the policy) then the policy no longer has any value.



We will come back to our comparison with insurance in just a second but I want to do a little sidebar here.

Let's remind ourselves what drives option pricing.

There are three main things,

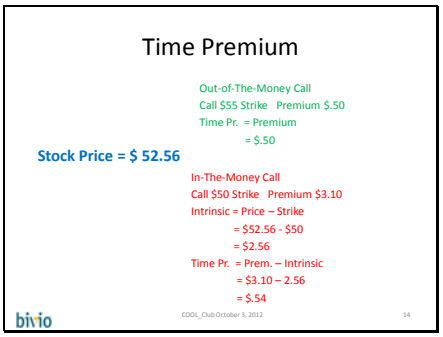
one is how long the option has to expiration ...in other words the longer time an option has to expire the more it is worth

The second is the underlying stock price

And the third component is Volatility which is another name for fear and greed and we learned about that last week.

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

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



The value of the Time premium is a bit different for Out-of-the-Money and In-the-Money so let's dig a little deeper.

For Out-of-The-Money options, which for Calls is strikes above the market price, all of the premium is viewed as Time Premium.

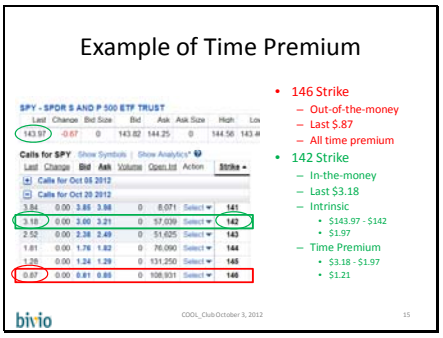
In our example. We have an out-of-the-money call. The Strike is $55 and the premium is $.50. As I said all the premium for an out-of-the-money is a time premium

For In-The-Money Options we have to first calculate what is called intrinsic value. This is the difference between the current price and the strike. The time premium is the amount of the premium over and above the intrinsic value.

We start with an In-the-Money Call with a Strike of $50 and a Premium of $3.10

The intrinsic value will be the Stock Price minus the Strike. In other words the $52.56 - $50 or $2.56.

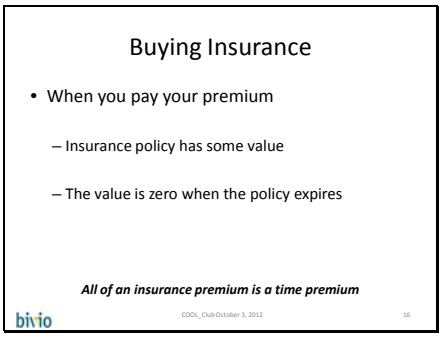
Our time premium will be the total premium of $3.10 less our intrinsic value of $2.56 which leaves a time premium of $.54.



Just to help drill this in a bit here are some examples looking at a CALL option chain on SPY when the SPY was just a little under $144.

Let's look first at a $146 Strike which is called out of the money because the strike price is higher than the current market price. The last premium that was traded was $.87. All of that would be considered Time Premium since it is out-of-the-money.

Next let's look at a $142 Strike
It is In-The-Money as the strike price is below the current market price. The last premium traded was $3.18. To determine how much of that is time premium we have to first calculate the intrinsic value. We get that by subtracting the Strike price from the Market Price. We see that is $1.97. Now we can determine the Time Premium by subtracting the Intrinsic value of $1.97 from Last Premium of $3.18 and we get a time premium value of $1.21

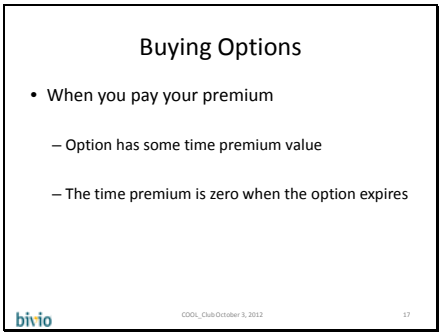


We have sidetracked long enough that we need to remind ourselves what the Buying insurance slide looked like.

When you pay your insurance premium your Insurance policy has some value.

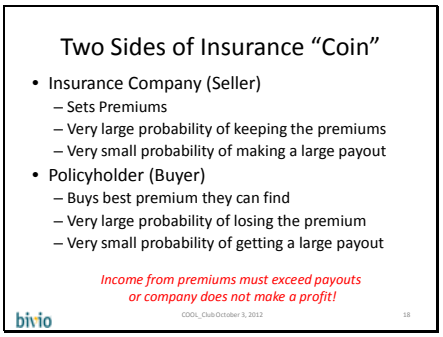
When the policy expire (in other words there is no time left on the policy) then the policy no longer has any value.

By the way, all of the insurance premium is a time premium.



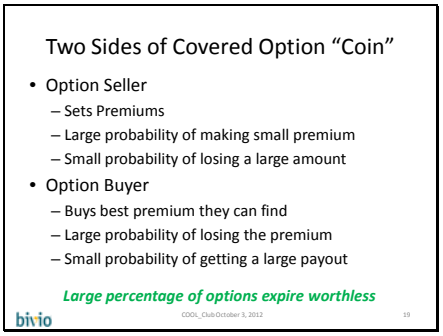
Now lets look at Buying options. When you buy an option some or all of the premium you pay will be a time premium. That time premium value can be calculated by looking at how much of a price gain the underlying stock would have to have to reach the strike, times the probability per day of reaching that level (assumed volatility would come in here) times the number of days left.

The calculation itself isn't as important right now as knowing that when the option expires, there is no time premium left. It is zero. If stock prices haven't moved like you thought, you have not been able to use your option to purchase or sell shares. You have just paid to protect yourself in case the price moved in a direction you didn't like. Just like you don't get anything from the insurance company if your house doesn't burn down.



So with both options and insurance there are two sides to the "Coin".
First there is the Insurance Company (or seller). They get to set Premiums. They select premiums where they think there will be a very large probability that they will get to keep them. They want to know there is very small probability that their insurance will be used and they will have to make a large payout. An Insurance Company's income from premiums must exceed their payouts or the company will not make a profit.

On the other side of the coin is the insurance Policyholder or buyer. They strive to buy at the lowest premium they can find. They know that there is a very large probability of spending their premium and not getting anything in return.



How does that relate to Covered Options?
As option sellers we get to set our premiums. Of course, we are not guaranteed that there will be any buyers at our premium. If we have made good option selections, once we have sold we know there is a large probability of keeping the small premium and a small probability of losing a large amount (we will come back to this).

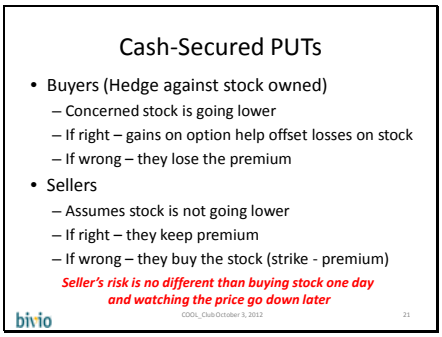
Option Buyers go out and buy the best premium they can find. They know (or should know) that there is a large probability that they will lose the premium they paid. They also know there is a small probability of a getting a large payout.

So what does a large probability mean? Of the options that are still open by the time they reach expiration something like over 75% expire worthless. That means they are never used. The sellers never have to do anything and the buyers never get a payout.

Let's delve in a little deeper to the two sides of the specific option types. First on Calls.
A buyer of a CALL is speculating that the stock is going higher.
If right, buying the option allows them enjoy a significant amount of the price increase without having to buy the underlying stock. Their cost to do this is the price of the premium which is a fraction of the cost of the stock itself.
If wrong, they lose the premium.

Now the Seller of the Covered Call... That is what I am and I hope you are as well.
When I sell a covered call I making the assumption the price of my stock is not going much, if any higher. In fact, I'd be happy selling it at the strike price. But, I'm not sure it will get there, so I'm trying to earn a little money in the meantime.
If I am right then I get to keep the premium.
If I am wrong and the price does go up significantly, then I get called away and sell my stock for the Strike price plus the premium (net of commissions). The philosophy that I operate under and I teach in Cool_Club is that I only sell Covered Calls at strike levels that I am more than comfortable letting the stock go at. If you cannot honestly let the stock go at the strike price then you should not be selling a Covered Call. This is an extremely important thing you need to keep reminding yourself of.

I believe my risk as an option seller is absolutely no different than when I sell my stock outright and shortly after that the price takes off. It is a loss of opportunity and nothing more.



A reason someone can buy a PUT is because they own a stock and they want to provide some downside protection. This protection is called a hedge. If they are right and the stock goes down then the option will go up and gains on the option help offset losses on their underlying stock.

If they are wrong they lose their premium but their stock has gone up in value.

Notice how similar this scenario is with Insurance.

I don't like to pay money for insurance so I sell PUT's rather than buy them. As a Seller of a Cash-Secured PUT, I believe a stock is not going significantly lower. I'm going to sell the insurance to the guy who wants to protect his price.

If I am right I get to keep the premium and don't have any other obligation.

If I am wrong then I will buy his stock with the cash I have used to secure the PUT. My price will be the strike price defrayed by the premium I collected (all net of commissions of course). This is not a problem to me because I decided I would be happy with this outcome when I sold the option in the first place.

My only risk from being exercised on a cash-secured put is no different than when I buy a stock one day and shortly thereafter watch the price go down. At least if it does go down, the fact that I collected an option premium means my purchase was made at a slightly lower price than if I had just bought the stock outright at the strike price.

Let's Recap
I hope you can see the Buying and Selling options are very different
I hope that the analogy of insurance helps you better understand options.
A large advantage for the sellers is that they collect Time premiums. As we discussed, they are an amount that wastes away to zero at expiration.
Finally a large percentage of options that are open to expiration expire worthless.

QUESTIONS

OUTSTANDING TRADES

COOL Examples

REMINDER!

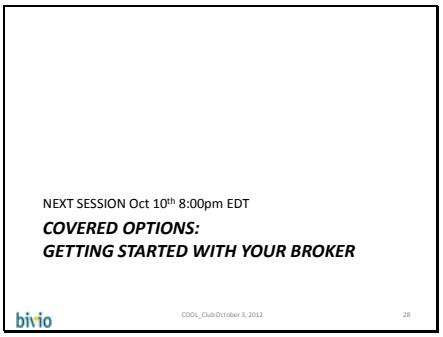
- Education purposes only!
- No recommendations to:
  - Buy or sell stock
  - Sell or buy options
- Before investing in anything:
  - Consult a professional
  - Or do your own research

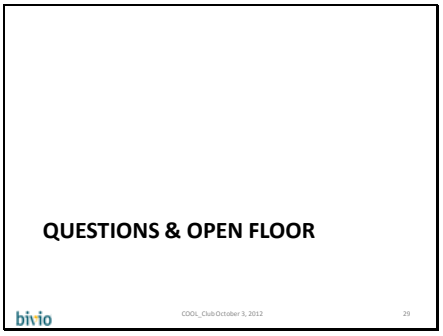
Recent Trade

- MCD
  - Sep 20
    - MCD $93.05
    - STO $92.50 Call for 10/20 Exp. (30 days)
    - Collected $1.77
    - APR 22%
  - Oct 3
    - MCD $90.93
    - BTC @ $.50 after 13 days
    - APR 32%

Open Trades From Last Week's Posts

- COH
  - STO on 9/25 $55 PUT for 10/20 Exp.
    - Collected $1.80 APR 45+%
  - Waiting to BTC or Buy COH @ $55 - $1.80
  - Currently @ $.85 (over 50% down after 8 days)
- QSII
  - STO on 9/26 $17.50 PUT for 10/20 Exp.
    - Collected .55 APR 45+%
  - Waiting to BTC or Buy QSII @ $17.50 - .55
  - Currently @ $.55 (flat over the period – QSII ~ $17.75)





As Homework, I like what is going on where people are sharing some things they are doing or trying. I think it would be good to make sure you spell out, this is in a Virtual account so people can take that in to account.