

**Welcome to the
Covered Options Online Learning
Club**



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COOL_Club September 12, 2012

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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

Disclaimer about Options

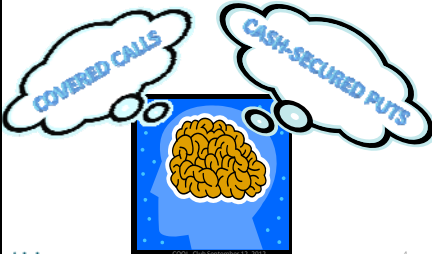
Options involve risk and are not suitable for all investors. All investment club members and individual investors should understand the risks of any form of trading or investing. To learn about options, we recommend visiting the Options Learning Center at the CBOE. To learn about stocks, please visit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

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What is COOL_Club?



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Reminder:

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

September Schedule		
• First Wednesday (Sep 5 th)	5 pm ET	<i>Closing Cash-Secured Puts – Cash-Secured PUT Cool Tool</i>
• Second Wednesday (Sep 12 th)	8 pm ET	<i>Opening Covered Options – Index ETF Cool Tool</i>
• Third Wednesday (Sep 19 th)	9 pm ET	<i>Closing Covered Options – Index ETF Cool Tool</i>
• Fourth Wednesday (Sep 26 th)	10pm ET	<i>Meet Mr. Volatility</i>

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Here is the September schedule along with projected Topics as well.

Next week will be around Closing Covered Options on the Index ETFs using the new Cool Tool. Then at the end of September we will introduce that rascally Mr. Volatility.

I wanted to mention that we had a technical glitch on the recording of last week’s session and so the recording will be the audio and a rebuilt video of the slides has been added back for the presentation piece but there just will not be any video for the live demonstration section. Remember there are slide handouts as well and last week those included some screen shots for using the Tool.



We are continuing to build out our COOL_Club home page

The link is 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 going to discuss tonight by clicking on “Resources and Tools”

And finally the schedule and registration links are here.

Tonight

- Refresher on Covered Options Index ETFs
- Some statistics OMG ... really?
(...relax you do not have to do them!)
- Index ETF COOL TOOL
- My Examples
- Closing out our COH Cash Secured Put
- Look at our homework
- Should be done around midnight

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

Going to delve into a bit of statisticsdon't worry you won't have to do any

Then we look at the new Index ETF COOL TOOL

Walk through some examples.

Look at closing out our Coach Cash Secured PUT that we sold in August.

Look at some our great Homework exercises that have been submitted

And when we get done with all that it should be around midnightjust joking

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



First some general reminders about Covered Options

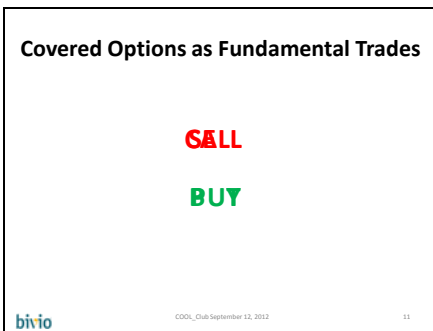
Something that is really hard for people when they start is the fact that your whole mindset is different.

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

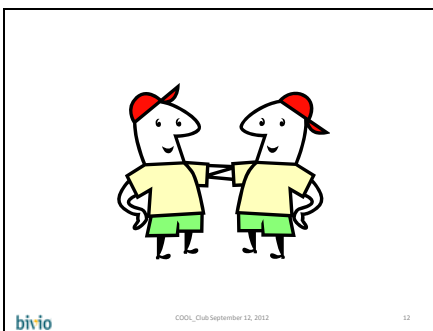


Just a reminder that the following little picture may help you remember that Selling Coverd CALLS

can turn into stock SELLS

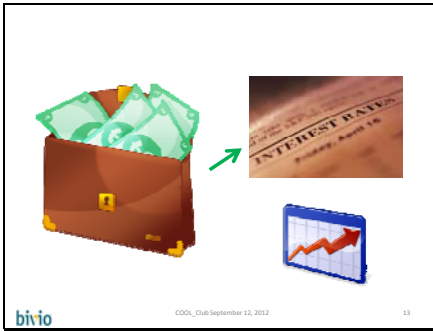
And Selling Cash Secured PUTs can

turn into stock BUYS



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

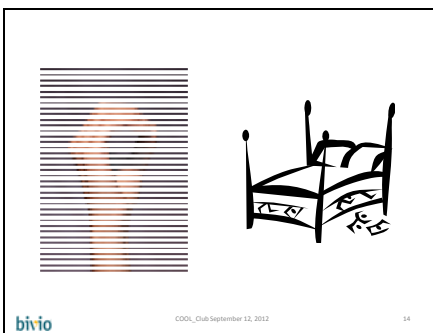
But for me it is how one plays them, and or what they use them for, that is where the difference lies.



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” 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, Europe is another story.

It would seem there might be a better place.

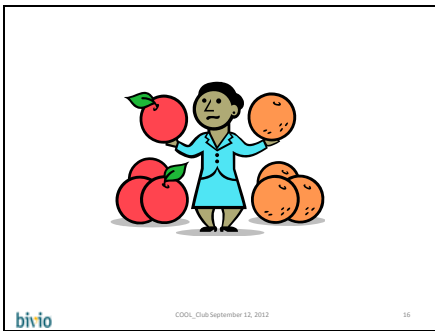


I believe done properly, Covered Options on Index ETFs can somewhat take the place of our low risk reasonable interest rate portion of our portfolio.

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 – I have misrepresented 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 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 want 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, for at least me, fundamental analysis is the key to stock investing AND on doing covered options on stocks.

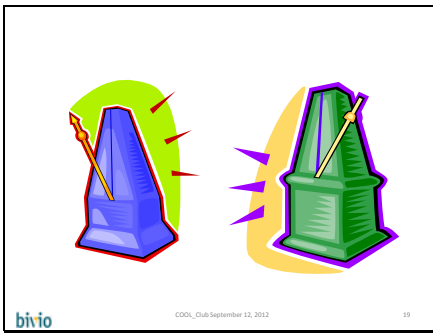


The way I approach Covered Options on Index ETFs is to focus more on making sure I am consistently collecting option premiums over and over and over and I am not trying to make significant amounts on price appreciation.

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

.....hmmmmmmmmmmmmmmmmmmmm

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

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

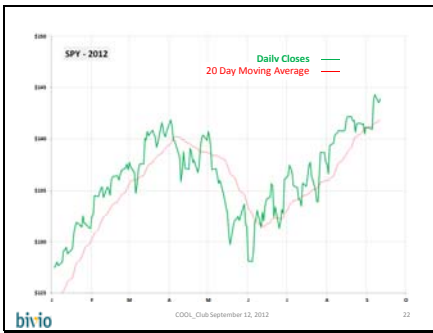


Last time I talked about the Index ETF I told you that you had to decide the trading range of the index you are looking at. But I have another approach I am going to throw out tonight that you might like even better.

I personally do use a gut approach to determining market ranges but that is not for everybody and 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. So tonight I am going to give you a bit more of a “recipe” to follow at least until you are ready to play with spicing it up.

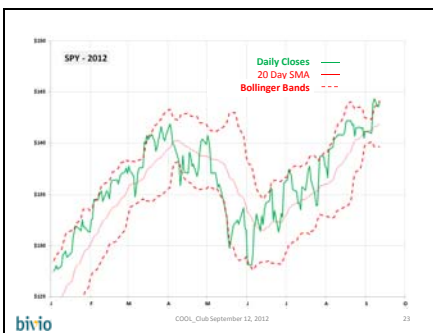


So here is a simple line graph of the daily closing prices of SPY for this year. The line connects the actual data points from each day.



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.

So what the computers do is to average the last 20 days of closing prices every day which gives us a new number that we can plot. We compare it to 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 the 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 Monday after a full weekend) 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).

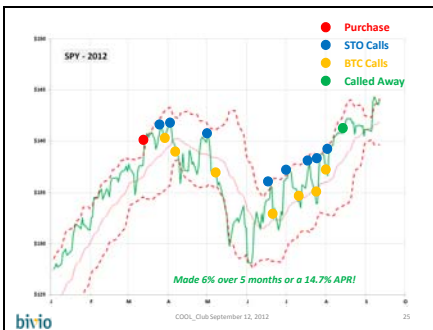
OK because some smart Cool Dude named John Bollinger was the first to realize that these bands had real meaning in stock prices we don't call these Standard Deviation Bands we call them Bollinger Bands. But as the Bard said "What's in a name? That which we call a standard deviation By any other name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

So you can see most of this year we have been trending up but you can see we have bumped the top band a number of times, about 6 or 7 in 9 months. And 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 and the same phenomenon once the band was hit the price bounced or rallied.



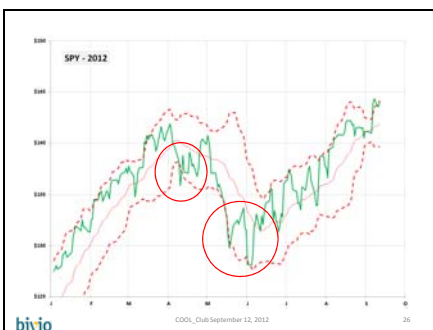
So let's see how this works. This is a series that I did in one of my portfolios this summer.

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 and 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 through out April, May, June, and July

Until 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.

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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Best time to sell puts is when the market has been trading down, is down on the day, and is close to a perceived trading bottom. The Bollinger Bands can help us see that. You also want that rascally Mr. Volatility going up. We will talk about him in just a couple weeks.

When an ETF PUT is Exercised

- Look to start selling CALLS

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If you sell a PUT and hold it to the 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 which 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.

Where can you download it?

COOL Club
Resources and Tools

COOL Tools 2.10
COOL Tools 2.09
COOL Tools 2.08

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

Here you will find the three COOL TOOLS and we also have links that go to the presentations on how to use the tools for the first two. Please note that the first two have been updated to fix a date issue so version for all three COOL TOOLS is 2.10.

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

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LET'S GO PLAY

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OLD TRADES

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NEXT SESSION Sep 19th 9:00pm EDT
**CLOSING COVERED OPTIONS WITH
INDEX ETF COOL TOOL**

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Next week, Sep. 19th at 9:00pm we will use the new Cool Tool to look at closing Index ETF Indexes.

Since we have mentioned SPYs so much lately, I decided I had better close in the following manner.

