

**Trading around a position
using covered calls**

Money and Investing

- Trading around a position using covered calls

Roger Manzolini

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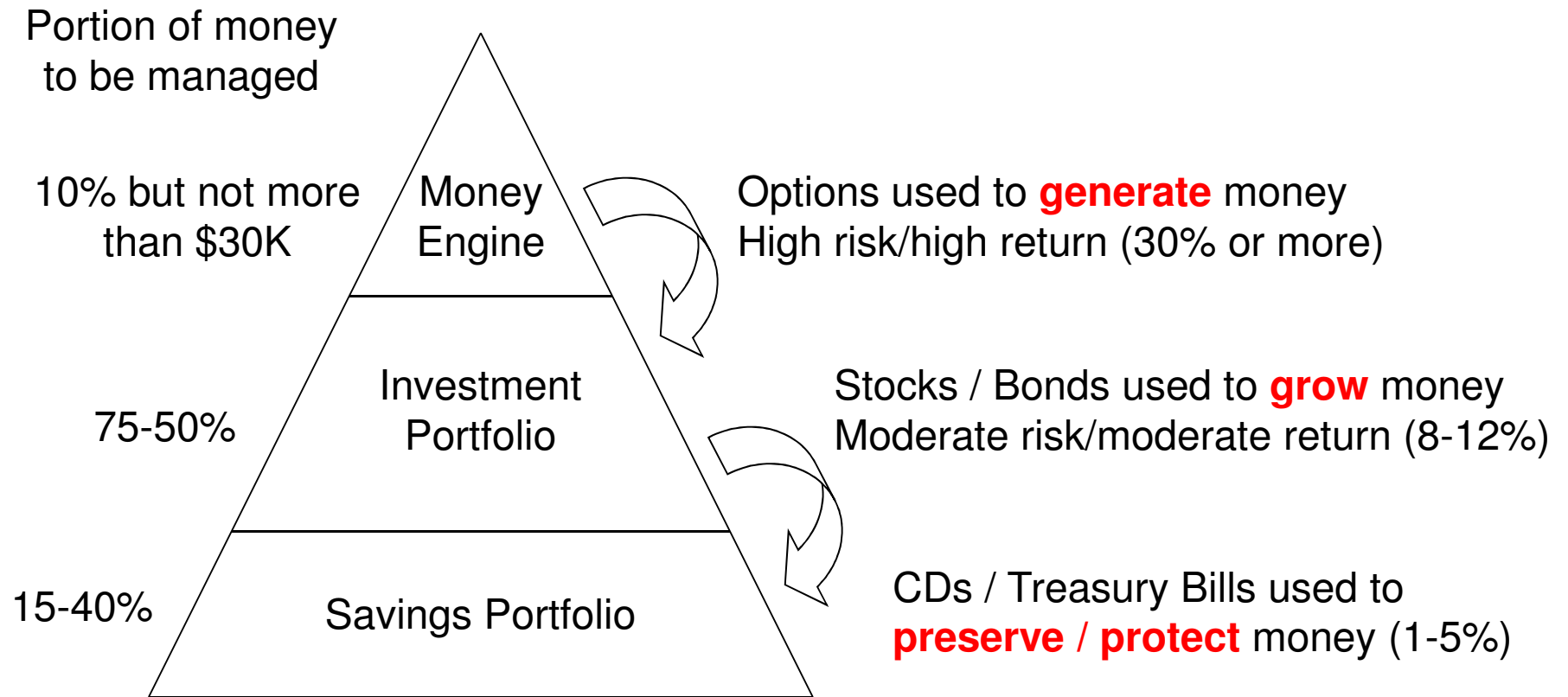
Additional caution: My peers call me Maddog

Agenda

- Introduction
- Option Basics
- Covered Calls
- Trading Examples
- Comparison of Approaches

Introduction

High Level Strategic View



Introduction

Market Composition

12	Sectors	Basic Materials	Capital Goods	Conglomerates	Consumer Cyclicals	Consumer Non-Cyclicals	Energy	Financial	Healthcare	Services	Technology	Transportation	Utilities
102	Industries	11	7	1	12	8	4	10	4	25	11	6	3
14,387	Stocks	2,032	635	90	479	406	1,054	3,674	1,243	2,296	1,990	226	262
1	# Stocks in each Industry	207	105	90	70	37	57	122	708	78	224	11	164
2		26	37		28	49	83	23	158	101	34	43	71
3		62	84		45	27	712	52	33	369	38	48	27
4		23	42		44	15	202	22	344	76	49	20	
5		23	159		91	175		127		296	347	38	
6		1,045	197		25	12		183		38	28	66	
7		48	11		43	79		2,252		66	266		
8		384			15	12		43		49	17		
9		81			12			649		75	129		
10		92			83			201		19	272		
11		41			15					345	586		
12					8					57			
13										41			
14										102			
15										65			
16										46			
17										33			
18										26			
19										50			
20										11			
21										119			
22										16			
23										62			
24										57			
25										99			

Introduction

Basic premise

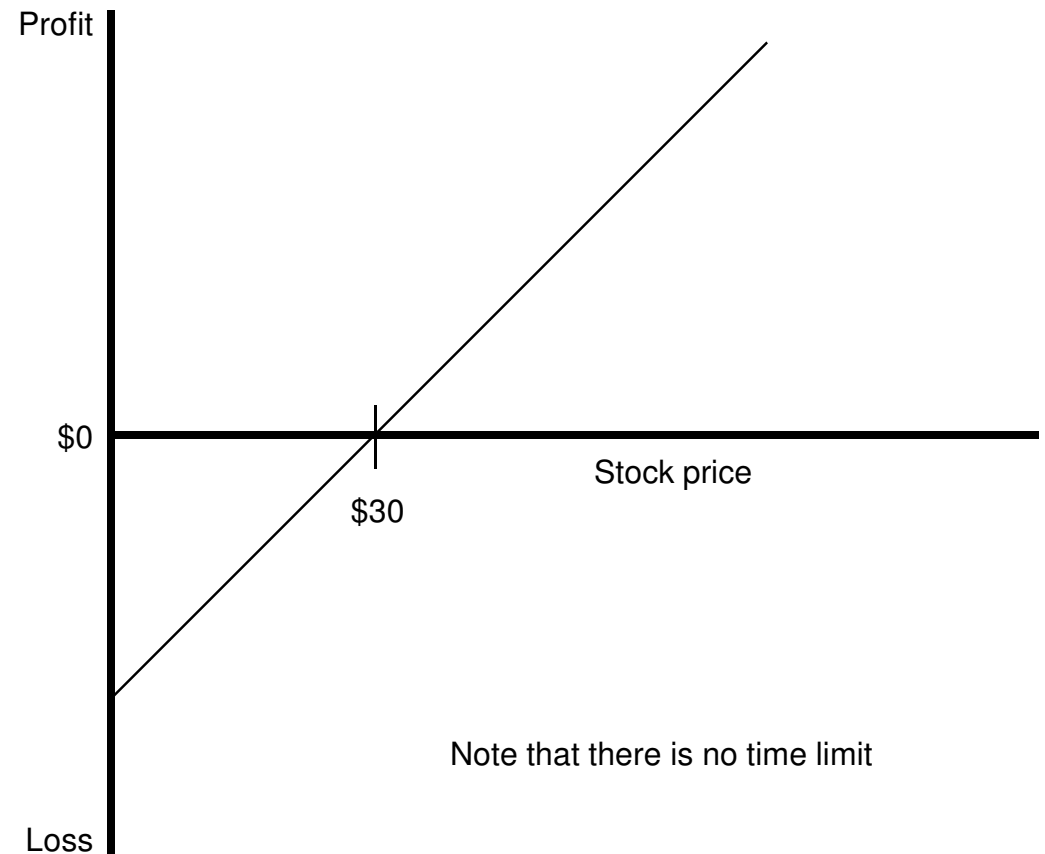
- You're familiar with typical buying, holding and selling stocks
- Portfolio performance can be improved over that typical approach through the use of options
- You can set up positions where you are paid to:
 - Hold your stock as you're accustomed to, or
 - Sell your stock at a profit
- The risk is that you give up the potential opportunity of making more money

Introduction

Understanding stock transactions

- Profit (loss) from a “buy stock” transaction
 - You’re “long stock”
 - i.e., you bought stock with the intent to sell it in the future at a higher price to make a profit

Buy low, sell high

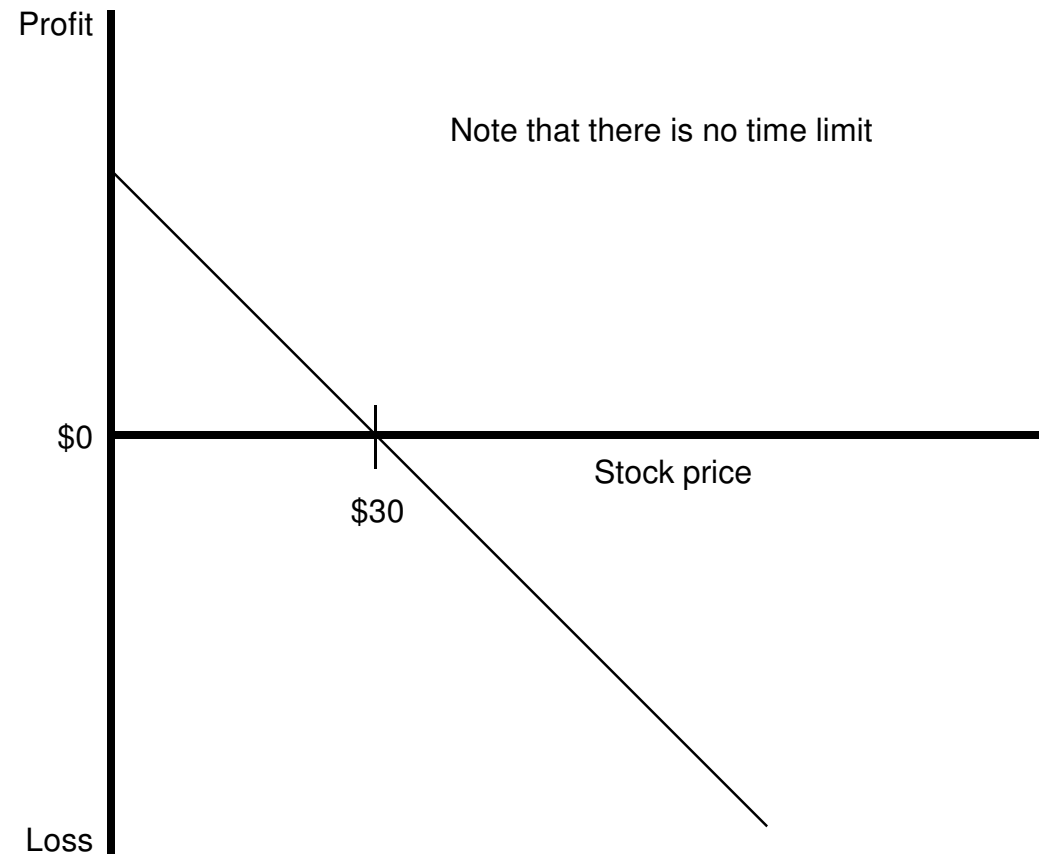


Introduction

Understanding stock transactions

- Profit (loss) from a “sell stock” transaction
 - You’re “short stock”
 - i.e., you sold stock that you didn’t have with the intent to buy it back in the future at a lower price to make a profit

Sell high, buy low



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Options

- What is an option?
 - An option is a contract that gives the holder of the option the *right*, but not the obligation, to buy or sell an asset at a specific price on or before a specific date
 - For example:
 - Option on a piece of property for sale
 - Not the focus of this discussion
 - Stock options
 - Subject of discussion today
 - with focus on selling calls

Money and Investing

Types of options

- American option
 - An option that can be exercised anytime up to and including expiration date
 - The type traded in our markets
- European option
 - An option that can only be exercised on the expiration date
- Bermuda options ...certain dates ...
- Asian options ...
- Exotic options ...
- ...all kinds of options; most of which we don't care about

Money and Investing

Option lingo

- Strike price; also called exercise price
 - The price the underlying stock may be bought or sold
- Premium
 - The cost of the option to the buyer
 - A credit to the seller
- Expiration date
 - The date the option expires. The last day the option can be exercised
 - Typically up to 9 months (longer out...leaps)
 - The 3rd Friday of the month
- Exercising the option (option is assigned)
 - When the underlying stock is bought or sold

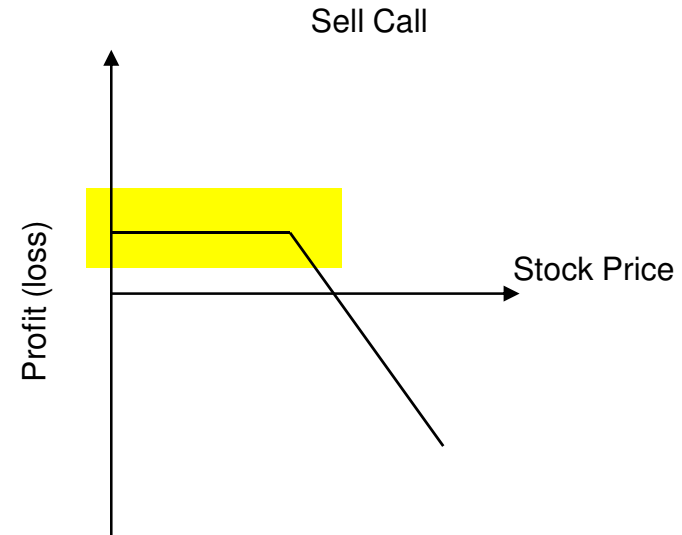
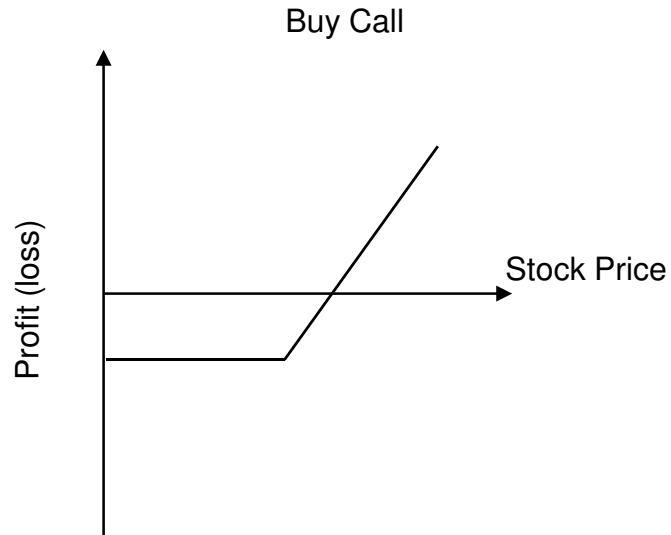
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Specific types

- Call option
 - Option that provides the buyer the right, but not the obligation, to buy at the strike price on or before the expiration date
 - Buyers of call options profit when the stock price rises above the strike price, plus the premium they paid for the option
 - Sellers of call options profit when the stock price remains below the strike price

Money and Investing

Call Options “hockey sticks”



Money and Investing

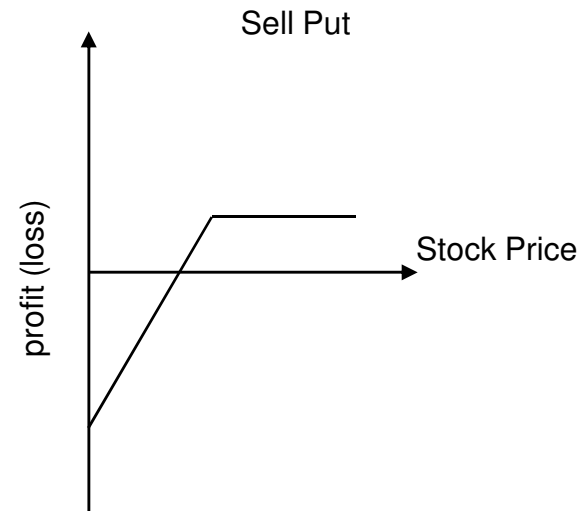
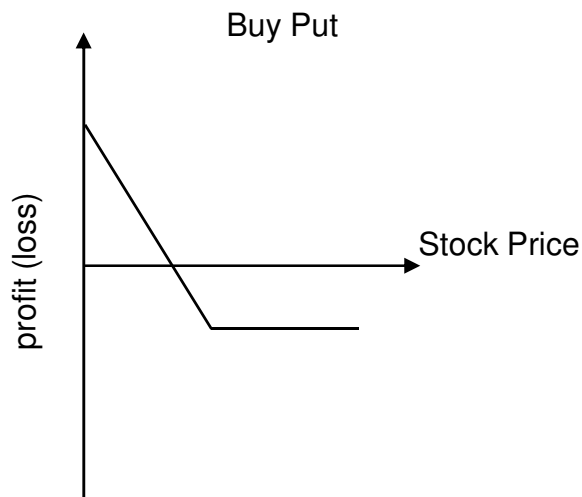
Specific types



- Put options
 - Options that provides the buyer the right, but not the obligation, to sell at the strike price on or before the expiration date
 - Buyers of put options profit when the stock price drops below the strike price, minus the price they paid for the option
 - Sellers of put options profit when the stock remains above the strike price

Money and Investing

Put Options “hockey sticks”



Money and Investing

Option Rights and Obligations

Initiator	Call option	Put option
Option buyer (holder, long in options)	Right to buy stock at strike price	Right to sell stock at strike price
Option seller (writer, short in options)	Obligation to sell stock at strike price	Obligation to buy stock at strike price

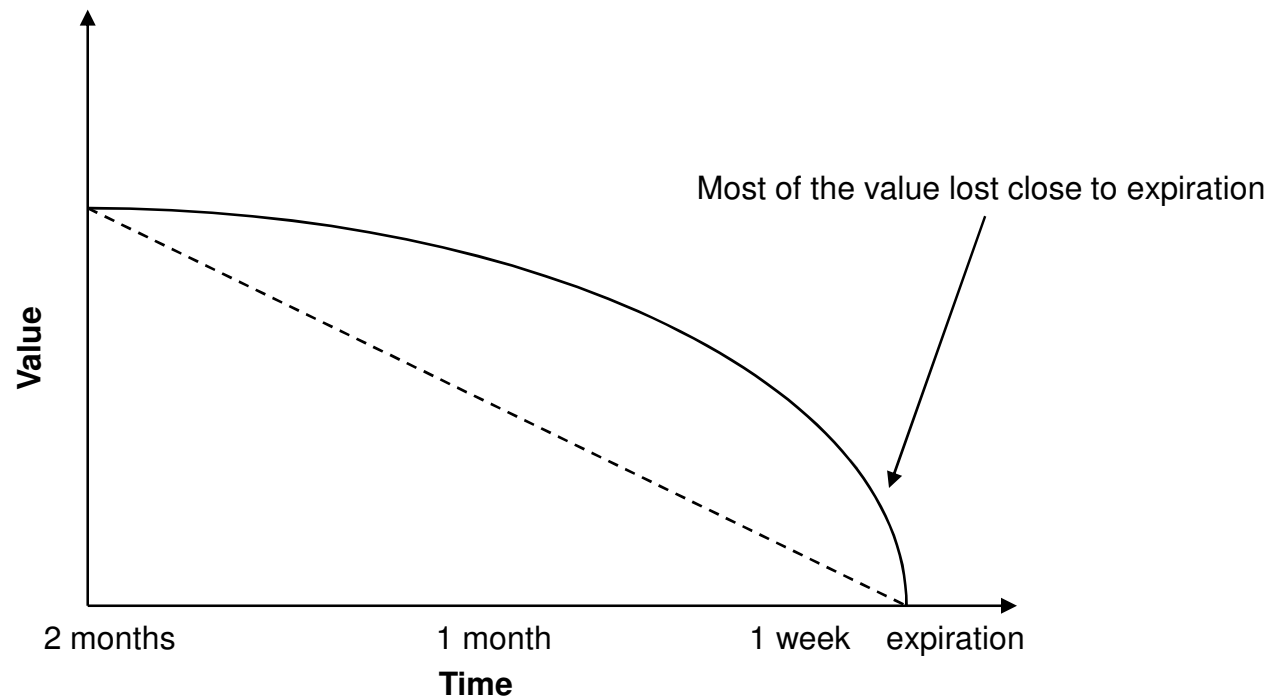
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Options

- Price
 - Price = intrinsic value + time value - fees
 - Intrinsic value = The amount by which an option is “in the money”
 - Call: stock price – strike price
 - Put: strike price – stock price
 - Time value = the portion of the option price that is in excess of the intrinsic value, due to the amount of volatility in the stock; sometime referred to as premium. Time value is positively related to the length of time remaining until expiration

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Time value decay



Money and Investing

Option Value

- The value of an option at expiration is a function of the stock price and the strike price
- Just the intrinsic value; there is no time value

Example - Option values given a strike price of \$85

Stock Price	\$60	\$70	\$80	\$85	\$90	\$100	\$110
Call Value	\$0	\$0	\$0	\$0	\$5	\$15	\$25
Put Value	\$25	\$15	\$5	\$0	\$0	\$0	\$0

Money and Investing

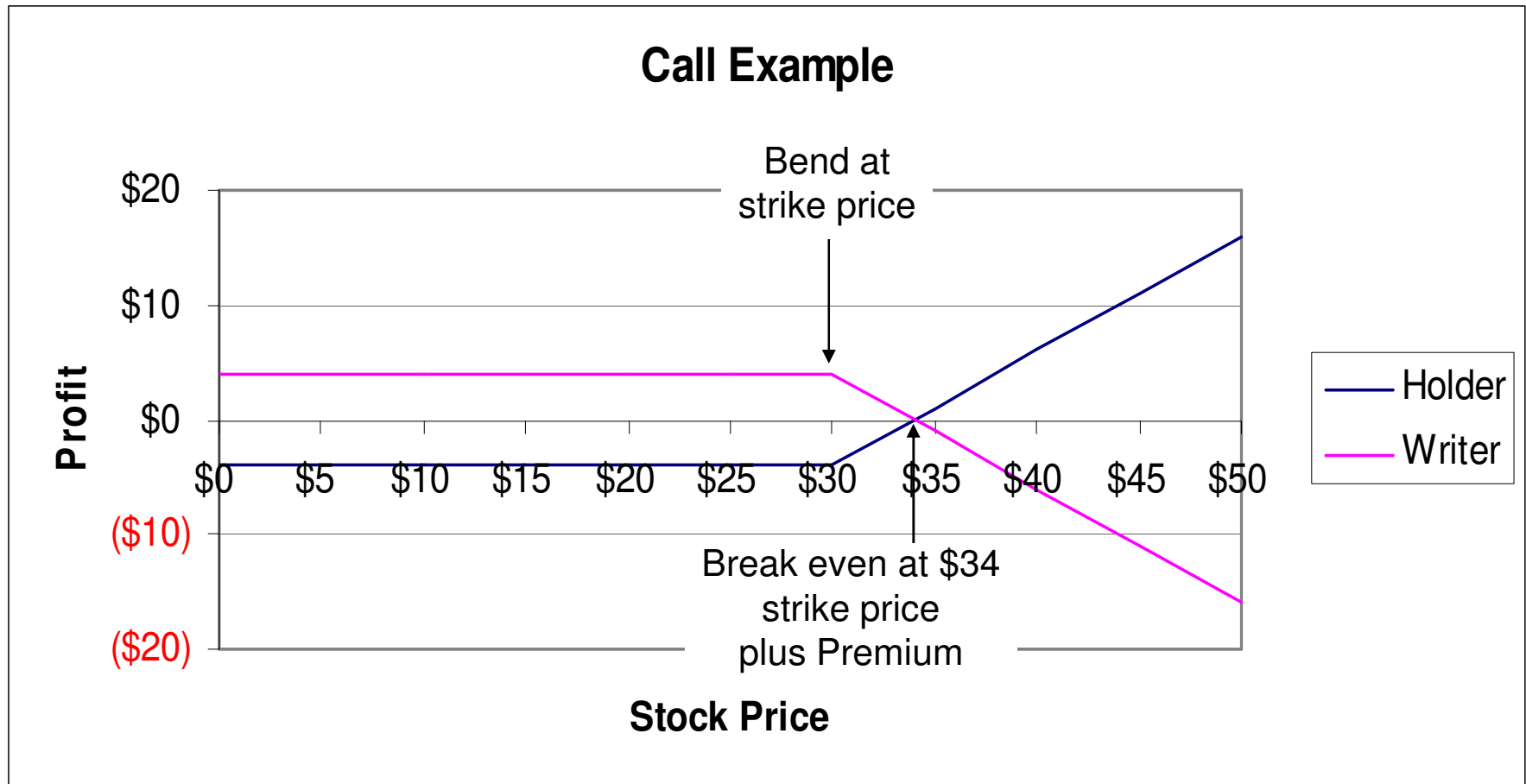
Example of a call option

- Suppose a call option has an strike price of \$30 and a premium of \$4 (no time value or fees)

Strike price	Premium	Stock price at expiration	Call holder's payoff	Holder	Writer
\$30	\$4	\$0	\$0	-\$4	\$4
\$30	\$4	\$10	\$0	-\$4	\$4
\$30	\$4	\$15	\$0	-\$4	\$4
\$30	\$4	\$20	\$0	-\$4	\$4
\$30	\$4	\$25	\$0	-\$4	\$4
\$30	\$4	\$30	\$0	-\$4	\$4
\$30	\$4	\$35	\$5	\$1	-\$1
\$30	\$4	\$40	\$10	\$6	-\$6
\$30	\$4	\$45	\$15	\$11	-\$11
\$30	\$4	\$50	\$20	\$16	-\$16

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profit (loss) of Call Option at Expiration



Money and Investing

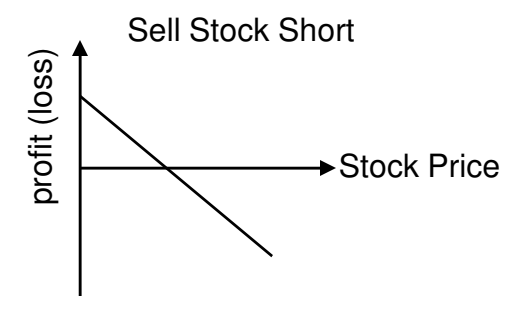
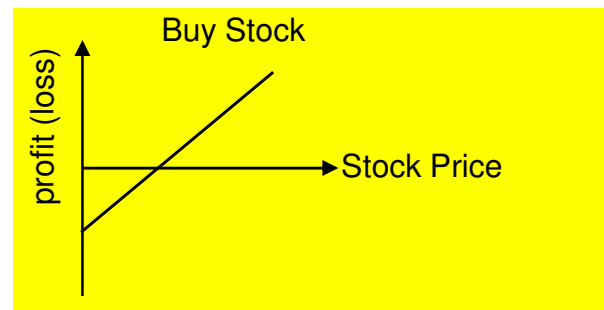
Trading Strategies with Options

- Protective Put
 - Strategy for “portfolio insurance”
- Covered Call
 - Strategy for “undisciplined sell, cash flow”
- Straddle
 - Strategy for “profiting from high volatility”
- Bull Spread
 - Like covered call but limits loss risk
- Butterfly Spread
 - Strategy for “profiting from low volatility”

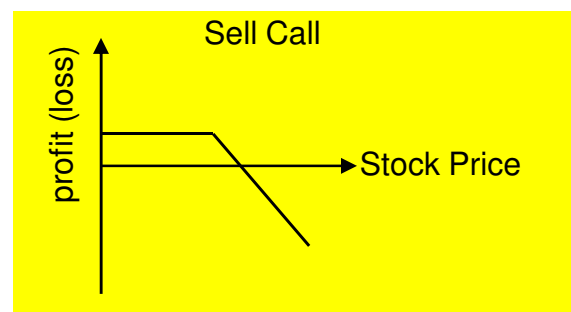
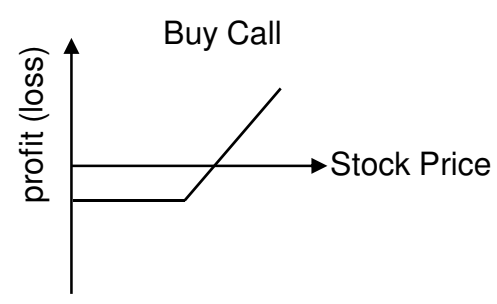
Money and Investing

Summary of profit (loss) Graphs

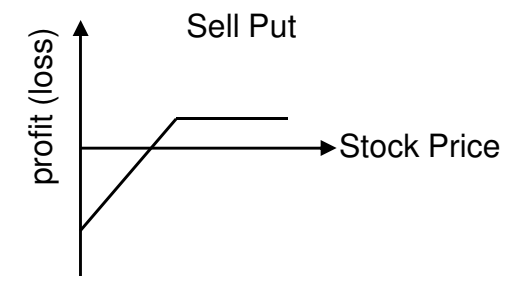
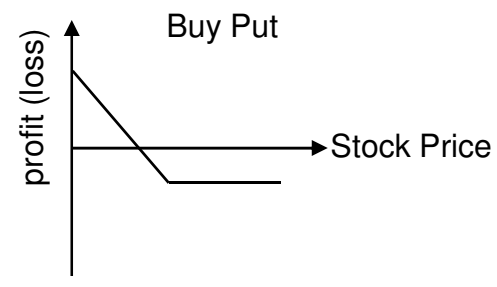
Stock Transactions



Call Option Transactions



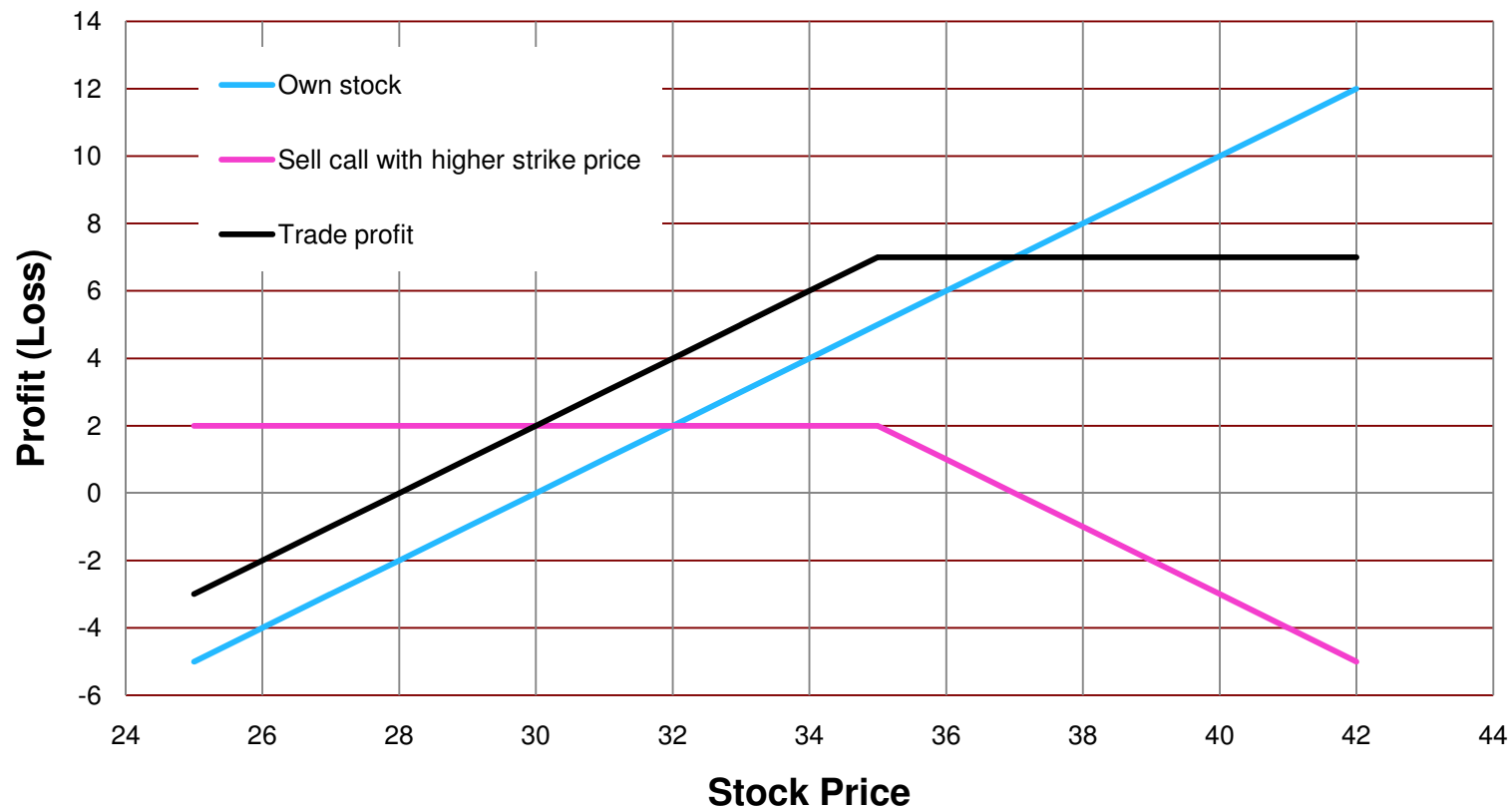
Put Option Transactions



Money and Investing

Covered Call - Strategy for “undisciplined sell”

Typical Covered Call Set-up Example



Possible Outcomes

- Stock goes down
 - Your loss is \$2 less than if you hadn't sold the call
- Stock remains the same (or goes up to just below the strike price of \$35)
 - Your gain is \$2 more than if you hadn't sold the call
- Stock goes up and exceeds the strike price of \$35
 - Option is assigned and you must sell your stock at \$35
 - Your gain is \$7 per share
 - \$2 premium from the sold option
 - \$5 from the stock sale

WIN

WIN

WIN

Other things to know

- Options can be traded just like stocks
- Options provide significant leverage and are volatile
 - Returns range from 100% loss to very significant gains (1,000%)
- Each option represents 100 shares of stock
 - E.g. selling 5 options grants the buyer the right to buy 500 shares of your stock at the strike price
- Most (~2/3) options expire worthless
 - This is very advantageous for option writers
 - I liken this to being the “house” at a casino
 - Many probable small gains
 - No probable large wins
- It has been my experience that whenever I’ve been forced to sell stock at a profit, I was able to buy it back later at a lower price

Trading examples

- Excel to show
 - Covered call trade setup
 - Buy stock
 - Sell call
 - 1 of 2 outcomes
 - Option expires
 - gain premium only
 - Option is exercised
 - gain premium and profit

Trading example 1

Trade set-up						
	qty	security	price	com	(cost) premium	
Buy stock	100	AEM	\$ 70.50	\$ 7	\$ (7,057)	
sell option	1	AEM Feb11 75.00 call	\$ 0.85	\$ 8	\$ 77	
Gain if option expires						
					Gain	
					\$ 77	1.1%
Gain if option is exercised						
	qty	security	price	com	receive	
Sell stock	100	AEM	\$ 75.00	\$ 36	\$ 7,464	
					Gain	
					\$ 484	6.9%

Trading example 2

Trade set-up					
	qty	security	price	com	(cost) premium
Buy stock	100	GOLD	\$ 79.50	\$ 7	\$ (7,957)
sell option	1	GOLD SEPT11 87.50 call	\$ 3.00	\$ 8	\$ 292
Gain if option expires					Gain
					\$ 292
					3.7%
Gain if option is exercised					
	qty	security	price	com	receive
Sell stock	100	GOLD	\$ 87.50	\$ 36	\$ 8,714
					Gain
					\$ 1,049
					13.2%

Trading example 3

Trade set-up					
	qty	security	price	com	(cost) premium
Buy stock	300	MRK	\$ 32.00	\$ 7	\$ (9,607)
sell option	3	MRK OCT11 35.00 call	\$ 1.09	\$ 11	\$ 316
Gain if option expires					Gain
					\$ 316
					3.3%
Gain if option is exercised					
	qty	security	price	com	receive
Sell stock	300	MRK	\$ 35.00	\$ 36	\$ 10,464
					Gain
					\$ 1,173
					12.2%

Trading example 4

Trade set-up						
	qty	security	price	com	(cost) premium	
Buy stock	2000	NAT	\$ 22.52	\$ 7	\$ (45,047)	
sell option	20	NAT OCT11 25.00 call	\$ 0.55	\$ 32	\$ 1,068	
Gain if option expires						
					Gain	
					\$ 1,068	2.4%
Gain if option is exercised						
	qty	security	price	com	receive	
Sell stock	2000	NAT	\$ 25.00	\$ 36	\$ 49,964	
					Gain	
					\$ 5,985	13.3%

Trading example 5

Trade set-up						
	qty	security	price	com	(cost) premium	
Buy stock	500	SLV	\$ 32.99	\$ 7	\$ (16,502)	
sell option	5	SLV JUN11 36.00 call	\$ 1.45	\$ 13	\$ 712	
Gain if option expires						
					Gain	
					\$ 712	4.3%
Gain if option is exercised						
	qty	security	price	com	receive	
Sell stock	500	SLV	\$ 36.00	\$ 36	\$ 17,964	
					Gain	
					\$ 2,174	13.2%

Trading examples

- Excel to show
 - Actual trades
 - Buy stock
 - Sell call
 - Buy back call
 - Option expires
 - Option is exercised (assigned)

Results with covered calls

Symbol	Description	Commission	Amount	comments
AEM	BOUGHT 150 SHARES OF AEM AT \$70.50	(\$7.00)	(\$10,582.00)	buy stock
AEM	BOUGHT 50 SHARES OF AEM AT \$61.98	(\$7.00)	(\$3,106.00)	buy stock
AEM 75.00 FEB 11 C	SOLD TO OPEN 1 CONTRACT OF OPTION AEM 110219C00075000 AT \$0.85	(\$8.26)	\$76.74	sell call
AEM 75.00 FEB 11 C	OPTION EXPIRED -1 CONTRACTS OF AEM 110219C00075000	\$0.00	\$0.00	option expired
ABX	BOUGHT 250 SHARES OF ABX AT \$46.1599	(\$7.00)	(\$11,546.98)	buy stock
ABX 50.00 FEB 11 C	SOLD TO OPEN 2 CONTRACTS OF OPTION ABX 110219C00050000 AT \$0.65	(\$9.51)	\$120.49	sell call
ABX	AS OF: SOLD 200 SHARES OF ABX AT \$50.00	(\$17.20)	\$9,982.80	forced to sell stock
ABX 50.00 FEB 11 C	OPTION ASSIGNED : 2 CONTRACTS OF ABX 110219C00050000	\$0.00	\$0.00	option assigned
ABX	BOUGHT 200 SHARES OF ABX AT \$49.86	(\$7.00)	(\$9,979.00)	bought back stock
ABX 60.00 JAN 12 C	SOLD TO OPEN 2 CONTRACTS OF OPTION ABX 120121C00060000 AT \$3.05	(\$9.52)	\$600.48	sell call
ABX 60.00 JAN 12 C	BOUGHT TO CLOSE 2 CONTRACTS OF OPTION ABX 120121C00060000 AT \$2.65	(\$9.50)	(\$539.50)	buy back call
NUE 43.00 JUL 11 C	Sold to Open 10c @ \$1.11 (9:30 AM)	(\$19.53)	\$1,090.47	sell call
NUE 43.00 JUL 11 C	Bought to Close 10c @ \$0.80 (1:30 PM)	(\$19.50)	(\$819.50)	buy back call
GOLD	BOUGHT 100 SHARES OF GOLD AT \$79.50	(\$7.00)	(\$7,957.00)	buy stock
GOLD 87.50 SEP 11 C	SOLD TO OPEN 1 CONTRACT OF OPTION GOLD SEP 11 87.50 C AT \$3.00	(\$8.26)	\$291.74	sell call
MRK	BOUGHT 300 SHARES OF MRK AT \$32.00	(\$7.00)	(\$9,607.00)	buy stock
MRK 35.00 OCT 11 C	SOLD TO OPEN 3 CONTRACT OF OPTION MRK OCT 11 35.00 C AT \$1.09	(\$10.76)	\$316.24	sell call
NAT	BOUGHT 2000 SHARES OF NAT AT \$22.52749	(\$7.00)	(\$45,058.48)	buy stock
NAT 25.00 OCT 11 C	SOLD TO OPEN 3 CONTRACT OF OPTION NAT OCT 11 25.00 C AT \$0.55	(\$10.76)	\$316.24	sell call
SLV	BOUGHT 500 SHARES OF SLV AT \$32.9999	(\$7.00)	(\$16,506.95)	buy stock
SLV 36.00 JUN 11 C	SOLD TO OPEN 5 CONTRACTS OF OPTION SLV JUN 11 \$36.00 C AT \$1.45	(\$13.27)	\$711.73	sell call
SLV 36.00 JUN 11 C	OPTION EXPIRED -3 CONTRACTS OF OPTION SLV JUN 11 \$36.00 C	\$0.00	\$0.00	option expired
		Amount sum	(\$102,195.48)	

Results without covered calls

Symbol	Description	Commission	Amount	comments
AEM	BOUGHT 150 SHARES OF AEM AT \$70.50	(\$7.00)	(\$10,582.00)	buy stock
AEM	BOUGHT 50 SHARES OF AEM AT \$61.98	(\$7.00)	(\$3,106.00)	buy stock
ABX	BOUGHT 250 SHARES OF ABX AT \$46.1599	(\$7.00)	(\$11,546.98)	buy stock
GOLD	BOUGHT 100 SHARES OF GOLD AT \$79.50	(\$7.00)	(\$7,957.00)	buy stock
MRK	BOUGHT 300 SHARES OF MRK AT \$32.00	(\$7.00)	(\$9,607.00)	buy stock
NAT	BOUGHT 2000 SHARES OF NAT AT \$22.52749	(\$7.00)	(\$45,058.48)	buy stock
SLV	BOUGHT 500 SHARES OF SLV AT \$32.9999	(\$7.00)	(\$16,506.95)	buy stock
		Amount sum	(\$104,364.41)	

Comparison of Approaches

- Results with Buy and Hold Approach

- Paid \$104,364.41 to own
 - 200 shares of AEM
 - 250 shares of ABX
 - 100 shares of GOLD
 - 2000 shares of NAT
 - 500 shares of SLV

- Results with Covered Call Options Approach

- Paid \$104,364.41 to own the same shares
 - 200 shares of AEM
 - 250 shares of ABX
 - 100 shares of GOLD
 - 2000 shares of NAT
 - 500 shares of SLV
- Collected \$2,168.93 in premiums

Comparison of Approaches

- Results with Buy and Hold Approach

- Paid \$104,364.41 to own
 - 200 shares of AEM
 - 250 shares of ABX
 - 100 shares of GOLD
 - 2000 shares of NAT
 - 500 shares of SLV

- Results with Covered Call Options Approach

- Paid \$104,364.41 to own the same shares
 - 200 shares of AEM
 - 250 shares of ABX
 - 100 shares of GOLD
 - 2000 shares of NAT
 - 500 shares of SLV
- Collected \$2,168.93 in premiums

Covered calls enhanced account by 2.1% over the same Buy and Hold account

Money and Investing

Parting Thoughts

- What does it take?
 - Time to continue to educate yourself
 - Time to manage your trades
 - Positive attitude
 - Belief in yourself that you can do it
 - Separation of emotion from trading decisions
 - Learning from your mistakes
 - Tenacity to continue

The End

Additional info and other strategies

Money and Investing



Option Intrinsic Value and profit (loss) Summary

	Call Option	Put Option
Intrinsic Value	$\text{Max}(0, S-X)$	$\text{Max}(0, X-S)$
Holder Profit	$\text{Max}(0, S-X) - \text{Premium}$	$\text{Max}(0, X-S) - \text{Premium}$
Writer Profit	$-(\text{Max}(0, S-X) - \text{Premium})$	$-(\text{Max}(0, X-S) - \text{Premium})$

Holder = Buyer
Writer = Seller

S = Sell Price
X = Strike Price

	Call Option	Put Option
In-the-money	$S > X$	$S < X$
At-the-money	$S = X$	$S = X$
Out of-the-money	$S < X$	$S > X$

Money and Investing

Components of the Option Price



- 1 - Underlying stock price
- 2 - Strike price
- 3 - Time to expiration
- 4 - Volatility of the stock return
- 5 - Risk-free rate of interest

Money and Investing

Determinants of Option Value



When there is an increase in:	Value of Call	Value of Put
Underlying stock price	increases	decreases
strike price	decreases	increases
Time to expiration	increases	increases
Volatility of stock return	increases	increases
Risk-free rate of interest*	increases	decreases

*** If interest rate increases, the present value of the strike price (that's what you're paying for when you buy an option) decreases; therefore value of call increases.**

Money and Investing

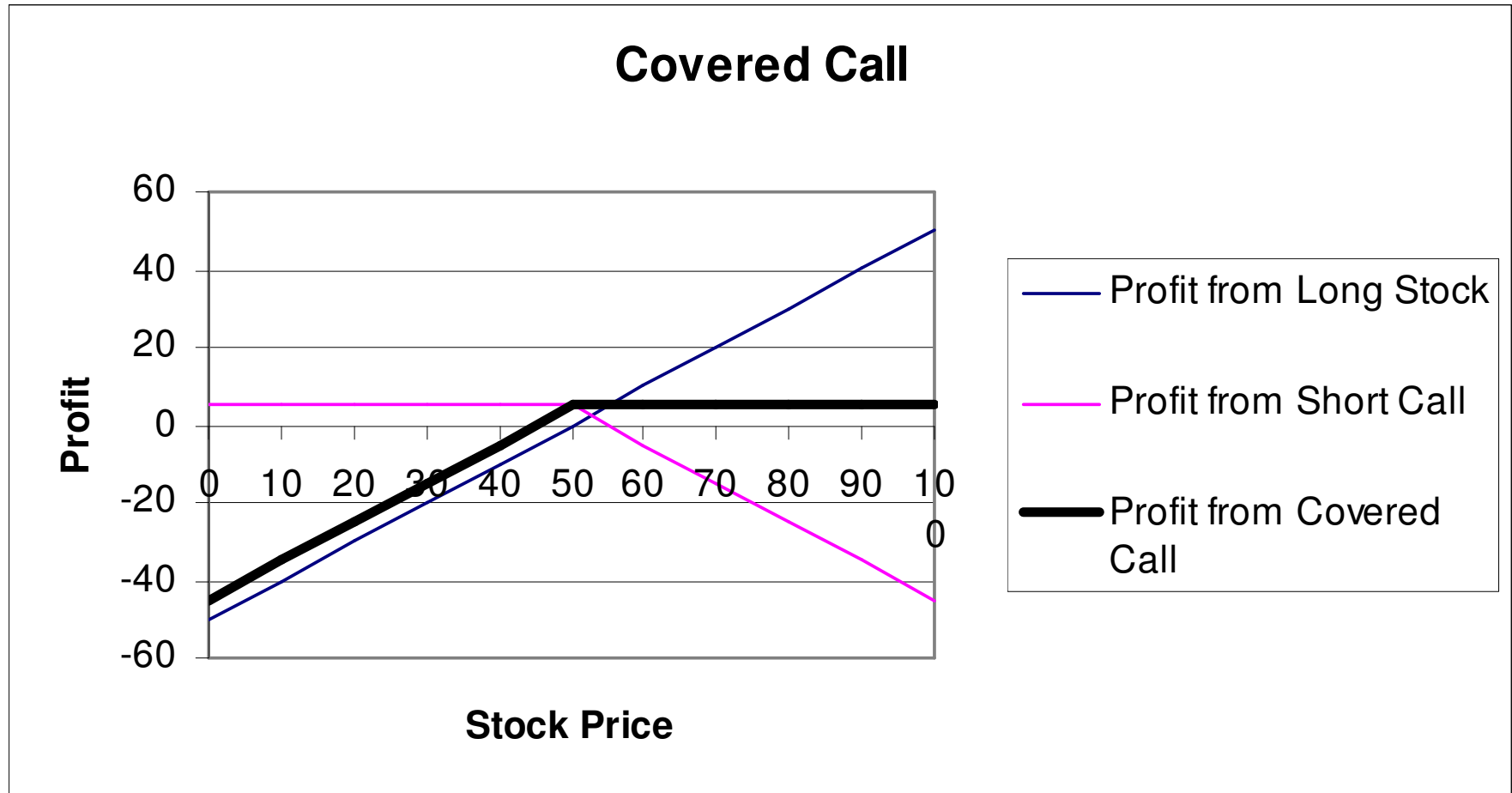
Covered Call - Strategy for “undisciplined sell, cash flow”

- buy (or already own) the stock
- Sell (write) call option on stock (collect premium)

Stock price	Profit from Long Stock	Profit from 50 Call Sold at \$5	Profit from Covered Call
\$25	(\$25)	\$5	(\$20)
\$30	(\$20)	\$5	(\$15)
\$35	(\$15)	\$5	(\$10)
\$40	(\$10)	\$5	(\$5)
\$45	(\$5)	\$5	\$0
\$50	\$0	\$5	\$5
\$55	\$5	\$0	\$5
\$60	\$10	(\$5)	\$5
\$65	\$15	(\$10)	\$5
\$70	\$20	(\$15)	\$5
\$75	\$25	(\$20)	\$5

Money and Investing

Covered Call - Strategy for “undisciplined sell”



Money and Investing

Example of a put option

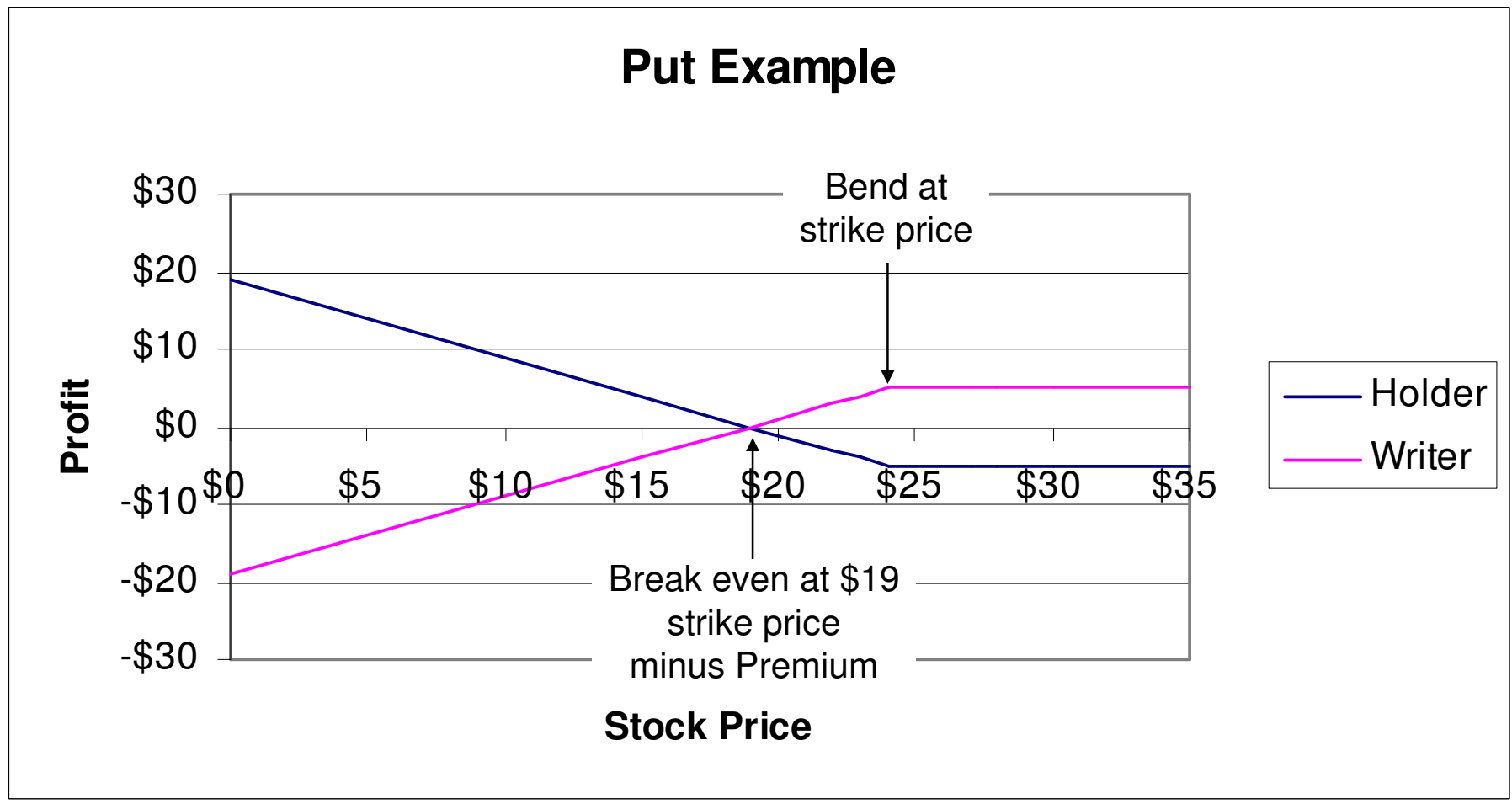


- Suppose a put option has an strike price of \$24 and a premium of \$5 (no time value or fees)

Strike price	Premium	Stock price at expiration	Call holder's payoff	Holder	Writer
\$30	\$4	\$0	\$0	-\$4	\$4
\$30	\$4	\$10	\$0	-\$4	\$4
\$30	\$4	\$15	\$0	-\$4	\$4
\$30	\$4	\$20	\$0	-\$4	\$4
\$30	\$4	\$25	\$0	-\$4	\$4
\$30	\$4	\$30	\$0	-\$4	\$4
\$30	\$4	\$35	\$5	\$1	-\$1
\$30	\$4	\$40	\$10	\$6	-\$6
\$30	\$4	\$45	\$15	\$11	-\$11
\$30	\$4	\$50	\$20	\$16	-\$16

Money and Investing

profit (loss) of Put Option at Expiration



Money and Investing



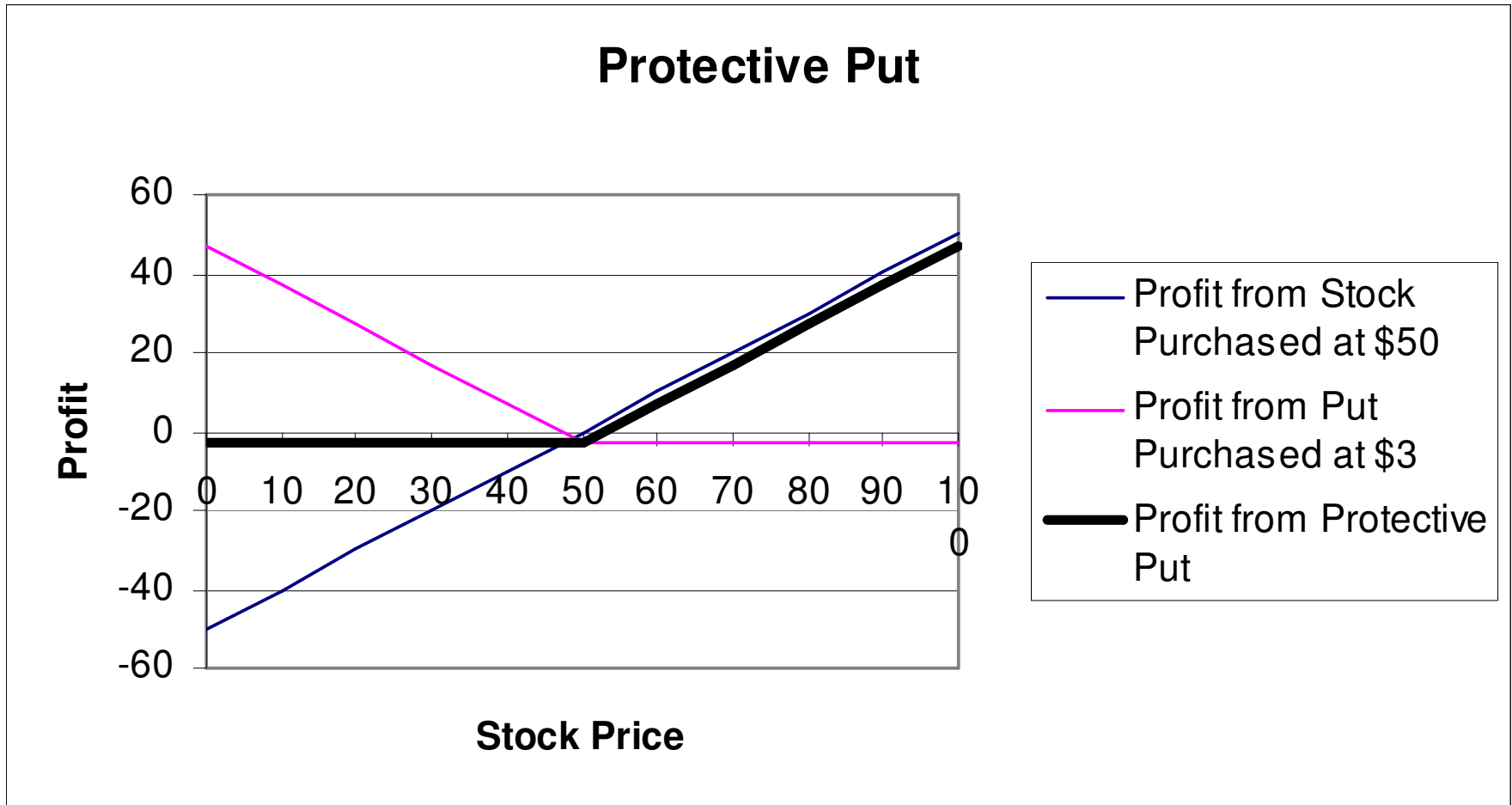
Protective Put - Strategy for “portfolio insurance”

- buy (or already own) the stock
- buy put option on stock

Stock price	Profit from Stock Purchased at \$50	Profit from 50 Put Purchased at \$3	Profit from Protective Put
\$25	(\$25)	\$22	(\$3)
\$30	(\$20)	\$17	(\$3)
\$35	(\$15)	\$12	(\$3)
\$40	(\$10)	\$7	(\$3)
\$45	(\$5)	\$2	(\$3)
\$50	\$0	(\$3)	(\$3)
\$55	\$5	(\$3)	\$2
\$60	\$10	(\$3)	\$7
\$65	\$15	(\$3)	\$12
\$70	\$20	(\$3)	\$17
\$75	\$25	(\$3)	\$22

Money and Investing

Protective Put - Strategy for “portfolio insurance”



Money and Investing



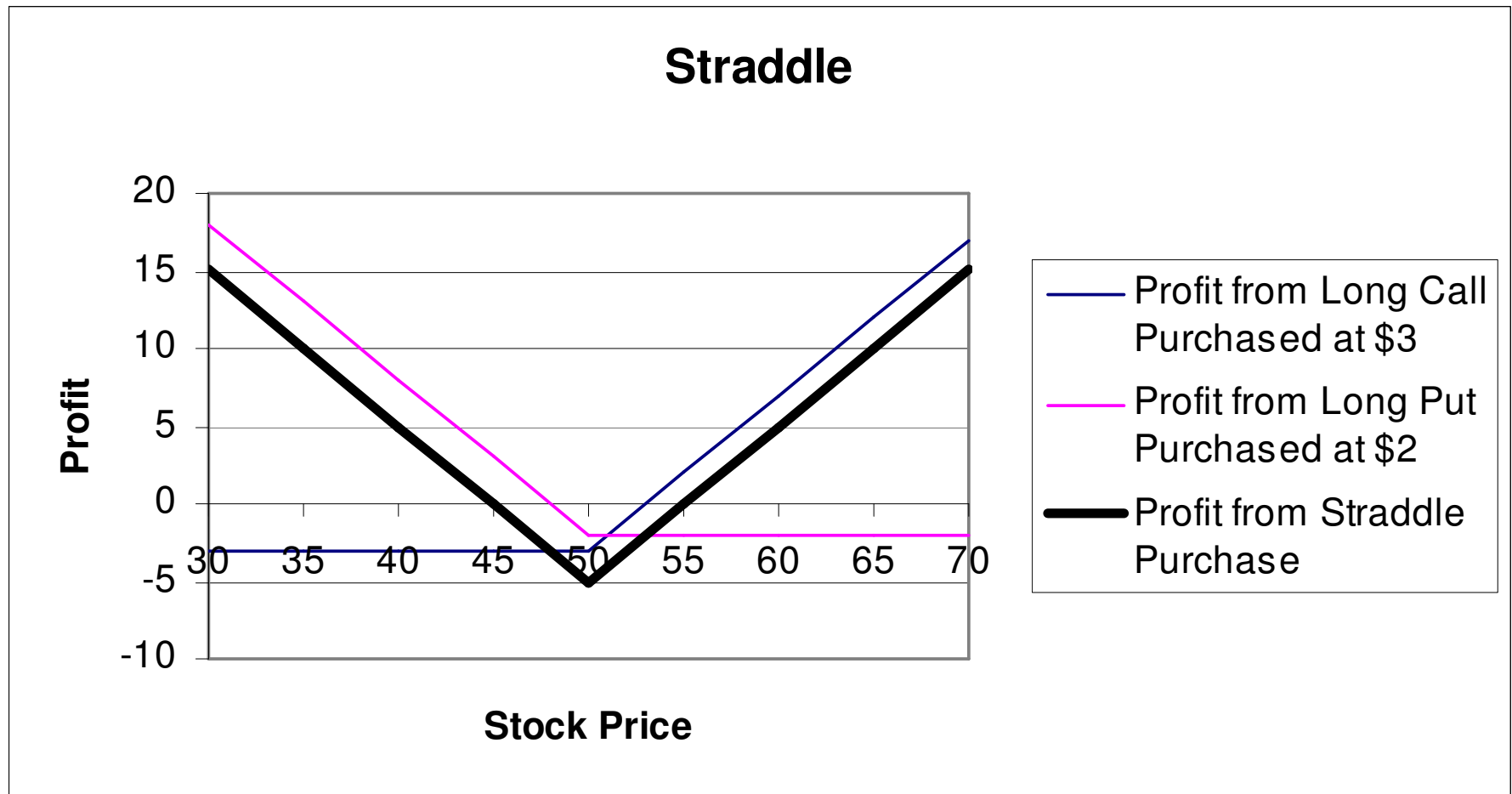
Straddle - Strategy for profiting from high volatility

- buy call, and
- buy put with the same strike price and expiration date as the call option

Stock price	Profit from 50 Call Purchased at \$3	Profit from 50 Put Purchased at \$2	Profit from Straddle Purchase
\$30	(\$3)	\$18	\$15
\$35	(\$3)	\$13	\$10
\$40	(\$3)	\$8	\$5
\$45	(\$3)	\$3	\$0
\$50	(\$3)	(\$2)	(\$5)
\$55	\$2	(\$2)	\$0
\$60	\$7	(\$2)	\$5
\$65	\$12	(\$2)	\$10
\$70	\$17	(\$2)	\$15

Money and Investing

Straddle - Strategy for profiting from high volatility



Money and Investing

Bull Spread

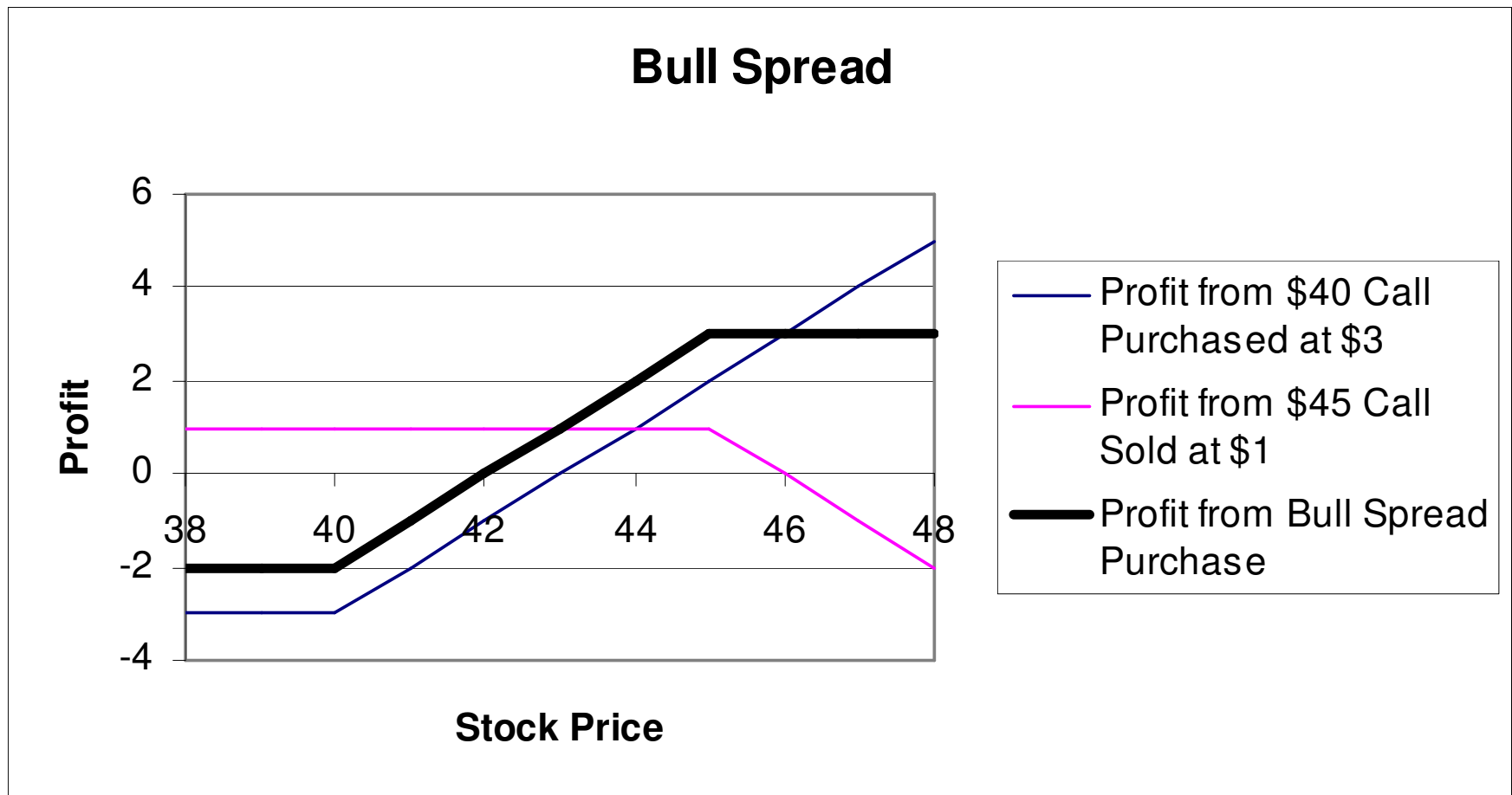


- buy call option with a certain strike price, and
- sell call option on the same stock with a higher strike price

Strike price	Profit from \$40 Call Purchased at \$3	Profit from \$45 Call Sold at \$1	Profit from Bull Spread Purchase
\$38	(\$3)	\$1	(\$2)
\$39	(\$3)	\$1	(\$2)
\$40	(\$3)	\$1	(\$2)
\$41	(\$2)	\$1	(\$1)
\$42	(\$1)	\$1	\$0
\$43	\$0	\$1	\$1
\$44	\$1	\$1	\$2
\$45	\$2	\$1	\$3
\$46	\$3	\$0	\$3
\$47	\$4	(\$1)	\$3
\$48	\$5	(\$2)	\$3

Money and Investing

Bull Spread



Money and Investing



Butterfly Spread - Strategy for profiting from low volatility

- buy call with relatively low strike price, x1;
- buy call with relatively high strike price, x3; and
- write two calls with strike price half way between x1 and x3

Stock price	Profit from \$40 Call Purchased at \$12	Profit from two \$50 Call Sold at \$6	Profit from \$60 Call Purchased at \$3	Profit from Straddle Purchase
\$30	(\$12)	\$12	(\$3)	(\$3)
\$35	(\$12)	\$12	(\$3)	(\$3)
\$40	(\$12)	\$12	(\$3)	(\$3)
\$45	(\$7)	\$12	(\$3)	\$2
\$50	(\$2)	\$12	(\$3)	\$7
\$55	\$3	\$2	(\$3)	\$2
\$60	\$8	(\$8)	(\$3)	(\$3)
\$65	\$13	(\$18)	\$2	(\$3)

Money and Investing



Butterfly Spread - Strategy for profiting from low volatility

