BOOMER'S GUIDEBOOK TO DOUBLE-DIGIT INVESTMENT INCOME

- ✓ Earn Two Incomes on Your Stocks from Dividends & Option Writing
- ✓ Guidelines for Stock/ETF Selection
- ✓ Small Investment Requirement
- ✓ Only One Hour of Time Per Month
- ✓ Complete Turnkey Method Provided
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Arrow Publications

ARROW PUBLICATIONS
Fountain Hills, Arizona 85268
E-Mail: arrowpublicationsUSA@gmail.com
Web site: www.arrowpublications.net

Manufactured in the United States of America
Library of Congress Control Number: 2010914257

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QUESTIONS FOR THE AUTHOR

Mr. Kadavy maintains a question and answer section on the Arrow Publications Web site. Readers who would like to ask him a question regarding one of his books or about implementation of the strategies contained within them can go to the Web page and review the questions and answers that have been previously posted. If the question is new, the reader should click on the "E-mail Me" button and submit the question. A personal response will be provided. If the question would be of broader use to the reading audience, Mr. Kadavy's response may be posted on the Web site. These questions and answers can be a valuable tool for additional learning.

For questions, go to:

www.arrowpublications.net/Questions.html

OPTIONS BLOGS

A list is provided of Internet blogs on the practice of option writing as an investment strategy. To keep up with the latest ideas on option writing, visit:

www.arrowpublications.net/Blog.html

CONTENTS

PREFACE

Members of the "Baby Boomer" generation are defined as those Americans who were born during the post World War II baby boom, specifically from 1946 through 1964. I consider myself part of that generation even though I arrived a bit before, reaching retirement in just enough time to get a preview of what was ahead for all of the rest of you. I was one of the lucky ones…in a position to retire early from my principal career and take up other things that I always wanted to do but seldom had the time to do, like writing.

Looking back at life over earlier, simpler decades, who among us could have ever imagined we would experience the wars, political and societal changes, and economic hardships that came to pass as we approached retirement? The point of this guidebook is to help Boomers pick up the financial pieces and get a decent return on our retirement investments in a climate where such an achievement is anything but certain.

The principal asset classes we think of as our investments for retirement have frequently become nothing short of a train wreck. The stock market a few years ago was trading where it was twelve years previously (with the Dot-Com Crash and the Great Recession providing the bookends). Interest rates are at historic lows thanks to easing by the Federal Reserve, depriving seniors of almost all of the returns they have been used to in the past from such traditional sources as bank CDs. The ten-year U.S. Treasury bond yield has ranged from 1 ½% to 2 ½%. Enormous wealth has been lost in residential and commercial real estate in recent years following the implosion of the debt bubble in which most of us were involved. One out of every four homes in the United States today was underwater…worth less than the mortgage(s) on them. And the rapidly increasing federal debt does not bode well for our future financial security as individuals, or as a country. Our problems go well beyond the excessive borrowing that brought on this financial maelstrom. For decades, financial security at retirement could be compared to a three-legged stool…the legs representing Social Security, a pension and personal investments. Is that stool still standing today?

We continue to hear about the looming insolvency of the Social Security system. In 1940 there were 42 workers to support benefit payments for each retiree. By 1950 it had declined to 16. Today the number is 3.3, and by 2030 projections indicate that there will only be 2.2 workers for every recipient of Social Security.

In addition to the huge number of people in the baby boom generation (it's own "bubble"), also contributing to the problem is the fact that in 1940 the life expectancy of men was 61.4 years and 65.7 years for women. Today the life

expectancy for men is 74.2 years and 79.5 years for women…and growing. And, even though we hear the term "Social Security trust fund" from politicians, in reality no such fund exists beyond intergovernmental IOUs. The money has been spent, making the ability of our government to pay for benefits in the future solely dependent on future revenues from taxes we pay to the government.

We have also seen pensions, the second leg of the stool, start to wither away. Increasingly, large American companies have converted existing pension plans to so-called "cash balance" plans because they require smaller company contributions. They also favor younger workers, to the detriment of those who are about to retire. Other companies are terminating their defined benefit pension plans altogether and fewer companies are starting new ones, choosing instead to establish retirement plans such as the 401(K) that does not require contributions by the employer (some plans are even structured not to include employer contributions) and will not pay a specific benefit to retirees, as does a defined benefit pension plan. Today only about 20% of private sector employees are covered by traditional pension plans.

The third leg seems to be in trouble too. At a time when it is more important than ever for individuals to save and invest for themselves, studies indicate that, until the aftermath of the recent Great Recession, Americans were saving less and less for their own financial security and retirement. In a broad survey by the Employee Benefit Research Institute (EBRI), 54% of the respondents said they had not even tried to calculate how much money they would need for retirement. A national survey commissioned by the Del Webb Corporation indicated that 60% of "baby boomers" polled believe they will not have enough money to retire on time. When asked how much money boomers thought they needed to retire, half claimed they did not know.

Added to this are the downbeat predictions of financial experts such as Bill Gross and Mohamed El-Erian, formerly of highly respected PIMCO, Warren Buffett (arguably the most successful stock market investor for many decades) and the late John Templeton (a pioneer in the mutual fund industry and the founder of the Templeton Funds). These experts, among many others, have been predicting that we may see more modest investment returns in the stock market for perhaps decades to come. Further impacting our investment returns are the lowest interest rates since the Great Depression in the 1930s, expected to last well into the future. Bill Gross paints a dire picture for those of us who need to obtain something more than just a few percent investment return: "The unmistakable fact is that future investment returns will be far lower than historical averages. Investors are faced with 2.5% yielding bonds and stocks staring straight into new normal real growth rates of 2% or less. There is no 8% there for pension funds. There are no stocks for the long run at 12% returns. And the most likely consequence of stimulative government policies that strain to get us there will be a declining dollar and a lower standard of living. A future of low investment

returns, and a heap of trouble for those expecting more, is what lies ahead." (*Investment Outlook* by Bill Gross.)

The big issue for us Boomers is this: even assuming that we can step up our savings significantly for retirement, how can we generate sufficient income on investments in our retirement given the prospects for a slow-growth stock market and the low interest rate environment that may persist for many years to come?

All of these major issues affecting our financial lives are now converging on our ability to retire early, or on time, or at all. The long-term prospect of low returns from both equity and fixed-income investments demands of us more than ever that we devote significant energy to planning our earnings, expenses, asset accumulation, debt creation/elimination and investment decisions so we have a personal roadmap leading us to success, and so we can make adjustments along the way.

While each of us needs a broad-based financial plan (and as the author I provide you with a means of creating one that comes with this guidebook), clearly one of our greatest challenges is how we can achieve a reasonable rate of return on our investments for the long term, especially given the trends of stock market investments in recent years and the current pathetic yield on fixed income investments.

This book will narrowly focus on what I believe to likely be the single best opportunity to achieve consistent double-digit income returns that provide the potential to outpace other alternatives now and into the future.

The strategies detailed in this guidebook are readily understood, easy to implement yourself in the convenience of your own home without further advice, and will work as a permanent program for the rest of your life. The program involves (1) the selection of high dividend paying common stocks of very large, highly recognizable companies and Exchange Traded Funds (ETFs) to provide substantial dividend income and (2) writing covered call options on the shares selected to provide a secondary source of premium income in addition to the dividends. The book details a second strategy of writing put options on such shares as an alternative to writing covered calls. Put writing can generate consistent, predictable income, but also provide an opportunity to purchase these shares at a price below current market value. I have successfully utilized both strategies of writing covered calls and put options for almost thirty years myself. The fact that I used these strategies was one of the reasons I was able to retire early and continue to enjoy double-digit returns on my investments.

I realize that you may not know anything about these strategies and that some of the terms mentioned here may already be totally unfamiliar to you. For now, trust that everything you need to know is in this guidebook. By the time you have finished the book, you will be very knowledgeable about the entire process…even comfortable with it. Best of all, if you want to practice option writing on paper before committing real investment dollars, you can see for

yourself how it works for as long as you like until you are ready to allocate your investment dollars at the time of your choosing. The strategies outlined in this guidebook can be used equally successfully with the largest of investment portfolios or with as little as 100 shares of an Exchange Traded Fund or individual stock.

The program provided in this book to assist you in achieving double-digit compounded annual returns might be more conservative or more aggressive than your current investment approaches. Suffice it to say for now that the program involves more risk than placing your money in an FDIC insured bank, but less risk than simply being invested in the stock market. If you are willing to take some risk to significantly increase your retirement income, but not as much risk as just being in the stock market alone, then this book is for you. By using the tools in this guidebook, you will have a viable means of working towards this worthwhile objective.

Let's start then from the very beginning to lay out the program that will soon be providing you that opportunity for consistent double-digit returns and a growing stream of income.

Paul D. Kadavy

NOTE REGARDING THE MICROSOFT EXCEL® TEMPLATES DISCUSSED IN THIS BOOK

In this book several Excel® file templates are utilized that will facilitate your use of the covered call and put option writing programs. Your own use of these templates will greatly assist you with the calculations necessary to make quality decisions using the programs. Now, or when you are ready to use these Excel® templates, please send an e-mail requesting the "Boomer files" addressed to arrowpublicationsUSA@gmail.com. We will promptly provide the files to you that contain these templates by return e-mail. We will also send you a copy of the eBook *Finding Financial Freedom* in PDF format along with the file templates that go with this book, as described in Chapter 13 of this guidebook. If you limit access to approved users of your e-mail account, please be sure you list arrowpublicationsUSA@gmail.com as an approved user so you will receive our files. For your protection, it is our commitment that your e-mail address will *never* be sold or given to anyone.

If you do not have a computer, many libraries have them available for your use at no charge. Their computers often have Excel® software installed on them which will enable you to run the above-mentioned templates.

If you have a computer but do not have Microsoft Excel®, you may download the Apache OpenOffice software for free at www.openoffice.org. This software includes Calc, a worksheet program with which you can fully utilize the Excel® file templates.

THE SELECTION OF HIGH YIELDING DIVIDEND STOCKS AND/OR EXCHANGE TRADED FUNDS (ETFS)

The question is not at what age I want to retire, it's at what income.

The ability of a company to pay a dividend is one of the most visibly apparent ways the company can communicate its financial strength, as dividend payments are made each quarter based upon the company's ongoing earnings capability. Thus, a company with a long-term track record of paying consistent and growing dividends can not only give us a level of comfort as investors by demonstrating that its earnings are stable, but it can also provide somewhat of a cushion to the price of the company's shares during periods of declining markets. For Boomers approaching retirement, or in retirement, the dividend component of share ownership should be an important consideration in our search to achieve desired investment returns. The dividend yield on a stock is calculated by dividing the amount of a company's annual dividend by the current share price.

While many investors purchase shares in common stocks for long-term capital appreciation (growth in value) of the shares, the fact is that statistical data over the past seventy-five years shows that about half of the total return from ownership of common stocks comes from the dividends paid by companies, the other half coming from appreciation in the value of the shares over time. Also, contrary to conventional wisdom, the share prices of stocks that pay dividends tend to outperform their brethren that don't pay dividends and with much less volatility in share price.

In short, even though all common stocks involve potential risk, ownership of shares in companies with a long track record of paying dividends should be an important component of a Boomer's investment securities portfolio, along with fixed income securities such as bonds and cash reserves. So, the selection of appropriate dividend paying stocks is step one in the Boomer's Guidebook. There are two different ways we can accomplish this, both of which will work very well.

A BRIEF PRIMER ON EXCHANGE TRADED FUNDS (ETFs)

All of us are familiar with individual stocks to one degree or another, but not all of us are aware of the broad proliferation of Exchange Traded Funds that

have hit the market in recent years. We will begin with a brief general discussion on that subject, with specific reference to ETFs that focus on dividend paying stocks, and then proceed to a discussion on individual stocks that pay large dividends.

What exactly are Exchange Traded Funds? They are a hybrid between listed corporate common stocks and mutual funds that are open-ended (continually offering new shares). ETFs are investment companies under the U.S. Tax Code and are regulated by the Securities and Exchange Commission. ETFs consist of a broad spectrum of securities (typically stocks, although bond and currency ETFs also exist) designed to correspond to the price and yield performance of the underlying portfolio of securities. ETFs have been created to mirror many different themes, including a couple of ETFs that specialize in ownership of high dividend paying stocks. Those are the ones that are of particular interest to us for purposes of this guidebook. Specific features of ETFs, including those that focus on high dividend stocks, are as follows:

DIVERSIFICATION:

Exchange Traded Funds: A buyer of ETF shares gets instant exposure to a market or sector portfolio of his or her choice (such as a portfolio of high dividend paying stocks). By participating in a portfolio of a large number of securities, an investor has ownership in a broad number of companies or issues within one security. This provides a degree of protection in the event that the price of a company in the index or sector should decline significantly.

Mutual Funds: Similar to ETFs in regard to diversification.

Individual Stocks: Unless you have time and knowhow to research and pick individual securities and you can afford a portfolio of at least 10 and perhaps up to 20 issues in different industries, you will not be fully diversified.

TRADING:

Exchange Traded Funds: ETFs can be bought or sold as easily as a share of an individual stock. Shares may be bought and sold at any time during the trading day when markets are open. Pricing is continuously updated. Funding of purchases and sales settle three days after the transaction is completed, as with individual stocks.

Mutual Funds: Typically only bought and sold at the end of the trading day after the market is closed, not intra-day, and are priced at net asset value. Purchases and sales settle immediately.

Individual Stocks: Same process as with ETFs.

AVAILABILITY OF LIMIT AND STOP ORDERS:

Exchange Traded Funds: Both limit and stop orders are available, as with individual stocks.
Mutual Funds: Shares purchased directly from the offerer of the fund are bought and redeemed at the net asset value established by the fund at the end of the day. Therefore, limit and stop orders do not apply to mutual funds.
Individual Stocks: Both limit and stop orders are available, as with ETFs.

DIVIDEND REINVESTMENT:

Exchange Traded Funds: Each ETF establishes its own dividend policy. Some reinvest dividends immediately on an ongoing basis, while others reinvest quarterly. Some pay shareholders in cash.
Mutual Funds: Dividends may be reinvested in shares at the time of payment by the fund (typically quarterly) or may be paid out to shareholders.
Individual Stocks: Companies that pay dividends make payment in cash on a quarterly basis. Some companies offer dividend reinvestment programs (so-called DRIPs) where a shareholder can elect to receive shares in lieu of cash dividends.

AVAILABILITY OF MARGIN:

Exchange Traded Funds: ETFs may generally be purchased on margin under the same rules as for individual stocks.
Mutual Funds: Margin purchase of mutual funds is not permitted for a period of time after the account is opened.
Individual Stocks: Many, but not all, individual stocks may generally be purchased on margin under the same rules as for ETFs.

SHORT SELLING:

Exchange Traded Funds: ETFs are eligible for short trading (the investor borrows shares from the broker in anticipation of declining market prices--the investor hopes the shares can be bought back at a lower price).
Mutual Funds: Short selling is not available with mutual funds.
Individual Stocks: Short selling is available on most stocks.

TAX EFFICIENCY:

Exchange Traded Funds: Investors do not experience the tax consequences that occur when stocks in a mutual fund are frequently bought and sold. There are other factors that generally result in no tax consequences to ETF investors until they actually sell their shares.
Mutual Funds: Funds with a high degree of purchase and sale activity can generate significant tax consequences for shareholders while they are held for investment.
Individual Stocks: Tax consequences are realized only when an individual stock is sold.

COST:

Exchange Traded Funds: One of the most cost-effective means of investing in a market or an index. Annual management fees typically range from 0.1% to 0.65%. ETFs generally charge fees similar to or even lower in cost than no-load index-based mutual funds. Brokerage commissions are also paid to buy and sell ETFs.
Mutual Funds: Some mutual funds charge a sales load or fee, often as high as 4 ½%, in addition to the management fee that all mutual funds charge. For many mutual funds the management fee is considerably higher than for ETFs, with some professionally managed fund portfolios charging as much as 2% annually.
Individual Stocks: The cost of ownership is the brokerage commissions to buy and sell the individual stocks. There are no annual management fees.

AVAILABILITY THROUGH BROKERAGES:

Exchange Traded Funds: All ETFs can be purchased through any broker, whether full-service or discount.
Mutual Funds: Most no-load mutual funds can only be purchased through the company offering the fund. Load funds, those with the largest fees, are available from most brokers.
Individual Stocks: Individual stocks, as with ETFs, are available through any broker, whether full-service or discount.

AVAILABILITY OF OPTIONS (INCLUDING COVERED CALLS AND PUTS):

Exchange Traded Funds: There are a fast growing number of ETFs that offer options, which would allow the investor to write covered calls and puts. This trend will no doubt continue in the future. There are two

significant ETFs that specialize in high paying dividend stocks on which covered calls and puts may be written. This will be discussed in detail in a later chapter of this guidebook as a second source of investment income.
Mutual Funds: Options are not available on mutual funds.
Individual Stocks: Many individual stocks offer options, which would include the availability of covered call and put writing.

TIME REQUIRED FOR THE INVESTOR TO RESEARCH AND MANAGE:

Exchange Traded Funds: ETFs are perfect for investors who do not have the time or lack the inclination to research and select individual securities.
Mutual Funds: Mutual funds are also ideal for investors short on time or who do not have the desire to research and select individual securities.
Individual Stocks: The most time consuming and potentially risky strategy for an investor, especially one who does not diversify holdings adequately.

INVESTMENT TRANSPARENCY:

Exchange Traded Funds: With an ETF you always know what securities comprise the portfolio in which you participate.
Mutual Funds: Almost all mutual funds report their actual holdings only twice per year, which means that fund investors seldom can determine exactly what they own.
Individual Stocks: Investors who purchase individual stocks obviously always know what they own.

SUITABILITY FOR DOLLAR COST AVERAGING:

Exchange Traded Funds: For investors desiring to invest a small amount on a regular basis (dollar cost averaging), ETFs would not be the best choice. Each trade incurs a brokerage commission. For covered call or put option writing, purchases of ETFs should always be in 100 share increments.
Mutual Funds: Mutual funds represent the best opportunity for investors making small, multiple purchases. For no-load funds, brokerage commissions would not come into play if the shares are purchased directly from the fund offerer.
Individual Stocks: The same comments regarding ETFs apply to individual stocks.

THE PRINCIPAL HIGH DIVIDEND YIELDING ETFs

There are two ETFs of substantial size specializing in ownership of high dividend yielding stocks that also offer the opportunity to write covered calls

and put options (which will be of great interest to us later in this book). Those ETFs are the SPDR® S&P® Dividend ETF (ticker symbol SDY) and the iShares® Dow Jones® Select Dividend Fund ETF (ticker symbol DVY). For investors who wish to utilize ETFs rather than select individual common stocks, either of these ETFs will work acceptably well. Below are the key features of each:

SPDR® S&P® Dividend ETF (SDY)

Objective: To closely match the returns and characteristics, before fees and expenses, of the S&P High Yield Dividend Aristocrats™ Index (ticker: SPHYDATR) *
Net Assets: $46.185 billion
Gross Expense Ratio (Management Fees): .35%
Dividend Distribution Frequency: Quarterly
Number of Holdings: 100
Current Dividend Yield: 2.75%
Current Top ETF Holdings and Percent of Fund:

HCP Inc. (2.59%)
AT&T Inc. (2.30%)
Consolidated Edison Inc. (2.23%)
National Retail Properties Inc. (1.91%)
Target Corporation (1.87%)
People's United Financial Inc. 1.81%)
McDonald's Corporation (1.64%)
Leggett & Platt Incorporated (1.61%)
Chevron Corporation (1.59%)
Kimberly-Clark Corporation (1.56%)

Sector Breakdown:

Financials	21.09%
Consumer Staples	15.37%
Industrials	14.41%
Utilities	11.07%
Materials	11.03%
Consumer Discretionary	9.65%
Health Care	7.47%
Information Technology	3.50%
Energy	3.31%
Telecommunication Services	3.09%

For the most current information regarding this ETF, go to the following website: https://www.spdrs.com/product/fund.seam?ticker=sdy

* The S&P High Yield Dividend Aristocrats™ Index is comprised of the 50 highest dividend yielding stocks of the S&P Composite 1500® Index that have increased dividends every year for at least 25 consecutive years. These stocks have both capital growth and dividend income characteristics, as opposed to stocks that are pure yield, or pure capital oriented.

iShares® Dow Jones® Select Dividend Fund ETF (DVY)

Objective: Seeks investment results that correspond generally to the price and yield performance, before fees and expenses, of the Dow Jones U.S. Select Dividend Index (ticker symbol DJDVY) *
Net Assets: $15.000 billion
Gross Expense Ratio (Management Fees): .39%
Dividend Distribution Frequency: Quarterly
Number of Holdings: 100
Current Dividend Yield: 3.06%
Current Top ETF Holdings and Percent of Fund:

Lockheed Martin Corporation (4.19%)
Entergy Corporation (2.26%)
Integrys Energy Group Inc. (2.00%)
Northrop Grumman Corporation (1.98%)
Philip Morris International Inc. (1.88%)
Chevron Corporation (1.83%)
General Dynamics Corporation (1.82%)
Clorox (1.79%)
McDonald's Corporation (1.78%)
Kimberly-Clark Corporation (1.77%)

Sector Breakdown:

Utilities	34.28%
Industrials	14.56%
Consumer Staples	11.36%
Consumer Discretionary	9.95%
Financials	9.10%
Energy	6.31%
Materials	5.36%
Health Care	4.44%
Telecommunications	2.30%
Information Technology	1.65%
Cash and/or Derivatives	0.49%

For the most current information regarding this ETF, go to the following website:

http://us.ishares.com/product_info/fund/overview/DVY.htm

* The objective of the Dow Jones U.S. Select Dividend Index ™ is to represent the country's leading stocks by dividend yield. One hundred stocks are selected to the index by dividend yield, subject to screens for dividend-per-share growth rate, dividend payout ratio and average daily dollar trading volume. Components are weighted by indicated annual dividend.

As stated earlier, the use of ETFs rather than individual stocks provides us with an opportunity to achieve broad diversification through the ownership of a single security, since the ETF owns a large number of securities within the fund. These ETFs can be bought and sold through brokers just as an individual stock. The expense ratio (management fee charged to the income of the fund) is quite low and can be considered as an offset to the brokerage charges you would incur by acquiring individual stocks (and the brokerage charges for writing options on multiple individual stocks as opposed to one or two ETFs, as we will discuss later). The simplicity, diversification and cost effectiveness of utilizing either or both of these ETFs should be evaluated by each investor as opposed to the alternative of acquiring individual high yielding stocks. We will now discuss the latter approach.

SELECTION OF INDIVIDUAL HIGH YIELDING DIVIDEND STOCKS

Instead of acquiring an ETF with a portfolio of stocks in a sector the investor desires to own (e.g., high yield dividend paying stocks), the investor may consider doing his or her own research on individual stocks to achieve the objective of maximizing income through dividends (and later by writing options for additional income). While this involves more work on the part of the investor, it can be rewarding to the investor who wants to be more involved in decision making and can allow the investor to focus on special situation stocks where opportunities may be greater in the future for capital appreciation, dividend growth, acquisition or other factors.

While there are literally thousands of stocks that pay dividends and on which options can be written, for purposes of this book we will now focus on some of the stocks that are currently yielding the most through dividend income and which also are among the largest companies in the country. Included on the following list are fifty such companies ranked by dividend yield. While this does not necessarily represent an all-inclusive list from which an investor in individual dividend paying stocks should choose, it is a good start to begin a screening process for candidates.

Company Name	Ticker Symbol	Current Stock Price	Current Dividend Yield	Dividends Paid Since
AT&T	T	$32.76	5.7%	1984
HCP	HCP	$40.19	5.6%	1985
UNIVERSAL HEALTH REALTY TRUST	UHT	$51.70	4.9%	1987
CONSOLIDATED EDISON	ED	$60.84	4.3%	1885
CHEVRON	CVX	$101.62	4.2%	1912
CINCINNATI FINANCIAL	CINF	$53.11	3.5%	1954
McDONALD'S	MCD	$96.35	3.5%	1976
EMERSON ELECTRIC	EMR	$55.26	3.4%	1947
COCA-COLA	KO	$39.91	3.3%	1893
EXXON MOBIL	XOM	$83.87	3.3%	1882
KIMBERLY-CLARK	KMB	$105.79	3.3%	1935
NUCOR	NUE	$46.79	3.2%	1973
PROCTOR & GAMBLE	PG	$81.83	3.1%	1891
SYSCO	SYY	$38.57	3.1%	1970
ATMOS ENERGY	ATO	$53.09	2.9%	1984
JOHNSON & JOHNSON	JNJ	$99.21	2.8%	1944
PEPSICO	PEP	$94.32	2.8%	1952
CLOROX	CLX	$108.77	2.7%	1968
LEGGETT & PLATT	LEG	$45.47	2.7%	1939
UGI CORPORATION	UGI	$31.78	2.7%	1885
GENUINE PARTS	GPC	$94.47	2.6%	1948
TARGET	TGT	$98.18	2.6%	1965
3M	MMM	$162.74	2.5%	1916
AFLAC	AFL	$61.13	2.5%	1973
T. ROWE PRICE	TROW	$82.18	2.5%	1986
ARCHER DANIELS MIDLAND	ADM	$46.30	2.4%	1927
BEMIS COMPANY	BMS	$46.73	2.4%	1922
WALMART	WMT	$81.90	2.4%	1973
AUTOMATIC DATA PROCESSING	ADP	$85.88	2.3%	1974
CHUBB CORPORATION	CB	$100.31	2.3%	1902
COLGATE-PALMOLIVE	CL	$68.46	2.2%	1895
DOVER CORPORATION	DOV	$71.25	2.2%	1947
McCORMICK & CO	MKC	$71.98	2.2%	1925
STANLEY BLACK & DECKER	SWK	$96.18	2.2%	1877
ABBOTT LABORATORIES	ABT	$46.88	2.0%	1926
AIR PRODUCTS & CHEMICALS	APD	$152.00	2.0%	1954

ILLINOIS TOOL WORKS	ITW	$97.66	2.0%	1933
W.W. GRAINGER	GWW	$230.72	1.9%	1965
HORMEL	HRL	$55.25	1.8%	1928
V.F. CORPORATION	VFC	$72.93	1.8%	1941
BECTON, DICKINSON & CO.	BDX	$141.85	1.7%	1926
CARDINAL HEALTH	CAH	$88.12	1.6%	1983
FAMILY DOLLAR	FDO	$79.30	1.6%	1976
MEDTRONIC	MDT	$76.47	1.6%	1977
ECOLAB	ECL	$114.47	1.2%	1936
LOWE'S	LOW	$74.16	1.2%	1961
PPG INDUSTRIES	PPG	$227.91	1.2%	1899
FRANKLIN RESOURCES	BEN	$52.52	1.1%	1981
CINTAS	CTAS	$82.56	1.0%	1984
SHERWIN-WILLIAMS	SHW	$285.24	0.9%	1979

Most online brokers offer research capabilities that will provide you with the information you need about companies such as these to make informed decisions. Many offer screening tools that allow you to establish desired parameters (e.g., minimum yield, market capitalization, number of shares outstanding and many other factors). As we will discuss in a future chapter, I recommend using an online discount broker for all of your trades and also for your research. There are other online resources for information and research. You will find a number of them listed at the end of this guidebook. In short, you will be able to get all of the information you need from your computer by going online in the convenience of your own home. This list of fifty is a worthy starting place.

2

THE FUNDAMENTALS OF COVERED CALL WRITING

> The measure of success is not how much money you have in the bank, but rather how much money the bank will lend you.

As previously discussed, a core element of the Boomer's Guidebook is (1) the utilization of Exchange Traded Funds with the sector focus of high dividend yielding stocks, (2) the selection of individual stocks that pay high yielding dividends, or (3) a combination of both.

After those decisions have been made, the next step is to initiate a covered call option writing program, which, when added to the dividend income received from the selected ETFs and individual stocks, will fulfill the objective of providing double-digit investment returns. (Note: Instead of purchasing shares and writing covered calls, the investor may wish instead to initiate a put option writing program as described in Chapters 5-9, or initiate a combination of both strategies simultaneously.)

This chapter will explore an investment opportunity widely known and used by savvy "institutional investors"…pension funds, insurance companies, hedge funds, trust departments and some mutual funds. It's little known and often misunderstood by individual investors…covered call option writing on securities that you already own or may acquire at any time in the future.

Using standardized, exchange-traded options for covered call writing on ETFs and individual stocks, the combined return to the investor from dividends, the additional income an investor receives from writing covered calls, and also in some cases potential capital appreciation in the shares owned, can result in double-digit yields…more predictably and conservatively than with individual common stocks alone. Covered call writing is a new subject for most individual investors, especially of the Boomer Generation, and is misunderstood by many others. It is misunderstood, as many investors think of "options" and "calls" as being high risk, speculative strategies where large losses can be incurred. While that can be the case with *buying* calls, covered call *writing*, which is *selling* calls, is more conservative than investing in stocks or ETFs alone, can provide significant protection in a down market, and can be a key component for an investor to achieve double-digit returns in a flat, slow-growth or even a slightly declining market.

The program outlined in this chapter, a combination of prudent ownership of high dividend paying ETFs or individual stocks, coupled with writing covered

call options on them, provides what may be one of the best opportunities to achieve double-digit investment returns in the future. I will give you all of the theoretical and practical tools necessary to develop an investment discipline that will help you achieve double-digit investment returns on your ETF and stock investments.

What comes to your mind with the words "call" or "option"? Many investors would say they think of high risk, where a person might lose their entire investment. Actually, that can be very true for some types of option investors. But that has nothing to do with the investment program provided in this chapter. Quite the opposite. In fact, the covered call option writing program outlined here can take big losses by others and turn them into your profits! The investment *for them may be high risk*, but *your investment is very conservative* as you will soon see.

What is meant by the term "covered"? This simply means that you own shares of the ETF or stock that stand behind the options…that you have the shares to deliver if they are sold. There is also such a thing as "uncovered," but that will only come into play in our discussion later on put writing, which we will utilize in a way that is equally as conservative as covered call writing.

The term "writing" when used in conjunction with covered calls simply means selling…you are selling calls on ETFs or stocks you own.

THE KEY DISCUSSION TOPICS

Our program will revolve around these subjects: what covered call options are and how they work; how and where they are traded; how to decide which covered calls to write; how to use an Excel® worksheet template included with this book to assist you in those decisions; how to select and use a broker to execute your transactions; how to evaluate your success in meeting your investment program goals; and some information on tax matters.

The program involves the use of an investment referred to as an "option contract," which defines the rights and obligations of the parties involved. There are only three actions you as an investor need to take with this program to achieve your investment objectives using covered call option contracts:

- Select from the high dividend yielding ETFs and/or individual stocks on which you wish to write call options.
- Select the specific covered call option contracts to be written.
- Initiate the trades.

This cycle is then repeated over and over.

This program requires that you already have some knowledge of the equity markets and can determine which of the ETFs and/or individual stocks you want to own or have the ability to do some research and make those decisions. If

you feel you are in need of an education or a refresher on the markets and ETFs, please refer to the appropriate Investment Related Internet Web sites listed at the end of the book.

This program, covered call option writing, has been available for decades. Nobody talks much about it though, and most people aren't involved in it. But it is widely accepted by many knowledgeable individual and institutional investors. Any reputable full-service or discount brokerage firm can verify the validity and usefulness of writing covered calls. They provide brokerage services not only for stocks and ETFs, but also for options as part of what they do for their customers.

COVERED CALL WRITING IN A NUTSHELL

Here is a highly abridged version of what this is all about. You will not be *buying* call options, which is a potentially high-risk strategy, but rather you will be *selling* call options on ETFs and/or individual stocks you already own or will acquire, also known as *writing*. This is a very conservative, yet potentially lucrative option investing strategy. When you sell an option on shares that you own you are selling a window of time in which the buyer has the right to buy your shares at a set price. The buyer is hoping that the price of your shares is going to go up significantly during this window of time that the option is active…in other words, before the option expires. When you sell a call option, you are performing a transaction known as "writing a covered call," or, more simply "writing calls," or just "call writing." By writing covered calls, you can reduce the downside risk on your investment, you can predict with greater accuracy how much money you will make, and you can help stabilize your profits. Selling the right to buy your shares to others gives you the ability to make consistent and significant returns on your investments, and the buyer immediately pays you money to do this.

That's a mouthful, but it's the essence of it. You may not understand much about it now, but by the time some definitions, examples and calculations are reviewed, you will become much more comfortable with how it works. It will become second nature to you and you'll be ready to start making money with the program.

Before advancing to that level, however, it is time to answer some questions and also introduce additional important terms and provide their definitions. These terms will be used frequently going forward. (Note: An alphabetical listing of terms used throughout this book and their definitions is located in the Glossary.)

WHAT IS AN OPTION?

The *buyer* of an option has the right, but not the obligation, to buy or sell shares of an ETF or individual stock for a specified price on or before a specific date. A "call" is the right to *buy* the shares…like calling them away from you…while a "put" is the right of a share owner to *sell* the shares…like putting them into your hands. The investor who purchases an option, whether it is a call or a put, is the option buyer. Conversely, the person who initiates a transaction by selling a call is the call option *seller* or *writer*. The buyer of the option is *not* obligated to buy the shares, but the seller *is* obligated to sell if the buyer decides to "exercise" his right of purchase under the option. When the buyer of a call exercises the option, the seller's shares are said to be "assigned," meaning they will be sold. In the case of our investment program, you will *always* be the seller of options. And with the program described in this chapter you will only be dealing with calls, not puts. The subject of puts and put writing is a separate strategy that will be discussed in detail later in this guidebook.

WHERE ARE COVERED CALL OPTIONS TRADED?

Option contracts are considered to be securities. As such, they are bought and sold through a brokerage firm. Either a full-service brokerage or a discount brokerage can be used, although option trades through a discount broker are usually much less expensive. Option contracts trade on U.S. securities exchanges, such as the Chicago Board Options Exchange (CBOE), the New York Stock Exchange (NYSE) and other qualified exchanges. The contracts traded on all of the exchanges are issued, guaranteed and cleared, that is to say settled or finalized, by the Options Clearing Corporation (OCC). The OCC is a registered clearing corporation with the Securities & Exchange Commission (SEC). It's not necessary to understand any more than that, except that this provides you with needed protection to assure your transactions fit certain common standards and that they all are handled through an independent and unbiased third party.

HOW IS MONEY MADE WRITING COVERED CALLS?

An investor can potentially make money three ways. First, you are always paid cash, called a "premium," for giving someone the right to buy your shares from you at a specific price, which is called the "strike price," on or before the "expiration date" when the option expires. You get to keep the premium money whether or not the shares are actually bought from you later. There are typically a variety of strike prices available, some of which will be below the current market price of the ETF or stock and some of which will be above it. There are also a variety of option expiration dates available that extend out as short as the current and the next month to as long as three years for options on some ETFs

and stocks. These very long-term options, whose expirations range from one to about three years, are referred to as "LEAPS," which stands for "Long-Term Equity Anticipation Securities." They are traded through your broker the same as other options. There are also a growing number of stocks on which weekly options are available.

Second, the strike price on the options you write may at times be *higher* than the current market value of the shares on which you are writing options. This is referred to as being "out-of-the-money." For example, if the current price of the shares on which you are writing options is $28 and you write an option with a $30 strike price, the option is said to be out-of-the-money by $2. This means, in addition to the premium income, you can also potentially realize additional "capital appreciation." That's the difference between the price of your shares when a call option is written and the strike price of the call option. Your shares would be sold, that is to say "called away from you," or "assigned," if the price is above $30 per share on the option expiration date. You would get to keep your option premium, plus your shares would be called away at $30 per share, which is $2 per share greater than it was when you wrote the call option.

Third, since we are targeting high dividend yielding ETFs and individual stocks to maximize income, you have that source of income as well. You are the owner of the shares during the option period, so any dividends that are declared with an "ex-dividend date" taking place when you own the shares means the dividends belong to you…and that obviously enhances your yield as you combine it with the option writing income and any capital appreciation to calculate your total yield.

If you were to write an option with a strike price *lower* than the current price of your shares, the option is said to be "in-the-money." For example, if the current share price is $32 and you write an option with a $30 strike price, the option is said to be in-the-money by $2. As we will see later, you would receive a higher premium by writing an in-the-money option when compared to an out-of-the-money option, but you could actually incur a loss on your shares compared with its price on the date you wrote the option if you write the in-the-money option. If the price in this example remained the same, you would receive only $30 per share for shares that were worth $32 at the time you wrote the option, or a loss of $2 per share from the market price at the time the option was written. We will discuss the circumstances under which you might want to consider doing this.

Finally, when the market price of your shares is exactly the same as the strike price of an option, or very close, the option is said to be "at-the-money." An example of this would be if you were interested in a call option with a strike price of $25 and your "underlying shares," that is to say the ETF or individual stock you own on which you would be writing the call options, was selling at exactly or very close to $25 per share. We will see that an at-the-money covered

call can provide maximum assured income for you as an investor and therefore will be a tactic that I will highly recommend to you.

All of this will be simplified shortly with more detailed examples.

WHAT IS A STRIKE PRICE AND HOW IS IT DETERMINED?

A strike price is the actual price at which the buyer of the option has the right to purchase the shares covered by the option. Typically each ETF and individual stock that trades options offers at least several different strike prices for each expiration date. Strike prices are established when the underlying shares either advance or decline to a certain price level and trade consistently around that level. If, for example, the SPDR® S&P® Dividend ETF was trading at $49, hit a price of $50 and traded consistently at this level, a new and higher strike price may be added by the exchange where the option is traded. Volatile ETFs or stocks that trade in a broader range of prices would have more strike prices available for selection, some of which would be above the current market price for the shares and some of which would be below. Strike prices are typically established in $2 ½ or $5 increments, especially for individual stocks. Both of the high dividend yielding ETFs discussed in Chapter 1, however, offer strike prices set in $1 increments above and below the current market prices. This provides for maximum flexibility in option writing tactics as we will soon see. Some high volume individual stocks, especially those that are lower priced, may also offer strike prices in $1 increments.

WHEN DOES THE CALL WRITER RECEIVE THE PREMIUM INCOME MONEY?

Once you've written a call, the cash premium is deposited into your brokerage account THE NEXT BUSINESS DAY, even though you have not earned it yet. That's one of the many attractive benefits of option writing. No waiting! The premium is paid to you in cash…and, it is yours to use or invest *now* to earn even more money for yourself. Obviously this represents a big difference from waiting around for your interest to be paid on a bank CD or a bond.

WHAT IS THE EXPIRATION DATE?

The expiration date is the last day on which an option may be exercised by the option buyer. For most options, this date is officially the third Friday of the expiration month. The third Friday is the last trading day. If Friday is a holiday, the last trading day will be the preceding Thursday. Recently some of the exchanges have begun offering options that also expire at the end of the month or on a weekly basis. For purposes of this guidebook we will deal only with the

options where the last trading day is the third Friday of the expiration month, as these will generally be the expiration dates that are most actively traded and therefore provide the most liquidity.

WHAT IF THE ETF OR STOCK A CALL IS WRITTEN ON DROPS SIGNIFICANTLY IN PRICE?

Obviously a decline in share prices can happen in a bad market. If it couldn't, everyone in the world would invest everything they have in ETFs and the stock market. When you sell (write) call options on an ETF or individual stock and the share price goes down, the price of the options go down too. You could then buy the options back at a lower price than you sold them for to close out the position and realize a profit on the difference. Or you can wait until expiration when the calls would be worthless. Then you've realized the entire premium income as gain. That's how the downside protection comes into play when you write covered calls.

Just like ETFs and stocks, call options are traded continuously on the exchanges. This is because option contracts, like the underlying shares, are "fungible" assets. That means you can buy and sell the same option contract at any time prior to expiration, because the contracts are identical and are interchangeable with other investors on the exchanges where they are traded.

The bid and ask prices of the option change too, even from minute to minute, as the price of the underlying shares change and as the time to expiration becomes shorter so there is less time remaining. Strategies for a declining share price will be discussed in more detail later. Just keep in mind that if an ETF or individual stock declines in price you will *always* be better off if you have written call options on it than if you just owned the shares alone, because the premium you receive gives you some "downside protection."

WHAT IF THE SHARES A CALL IS WRITTEN ON RISE SIGNIFICANTLY IN PRICE?

There is a downside. A declining share price should not be considered a negative to writing covered calls, because the premium you receive gives you some downside protection. In other words, you are better off than if you just owned the ETF or stock alone. The downside for the option writer occurs when the share price shoots up way above your strike price plus the option premium received and is in that position on the expiration date. In such a case, the option writer would have been better off just owning the shares and not writing the options.

But, while the option writer may have lost in the sense that the call writing transaction didn't capture the entire rise in the share price, by receiving the premium income, dividends, plus the gain (if any) up to the strike price, the

investor has obtained the maximum objective sought when the calls were initially written. That's a downside with an upside!

If your share price goes way up, there are some choices, which will be covered in more detail. You can wait to see if your shares get called away from you at expiration. Another choice is to buy back the call at what could be a higher price than you initially sold it for. By doing this you release your obligation to sell the shares, but that strategy is rarely recommended, as will be discussed later.

WHAT IF THE ETF OR INDIVIDUAL STOCK SHARES DON'T GET CALLED AWAY AT EXPIRATION?

Options experts suggest that as much as eighty-percent of the time options written out-of-the-money or at-the-money expire without being exercised. If the expiration date comes and goes and your shares were not called away, this means you still own the shares and you have earned the premium. You can then sell the ETF or stock shares at their current market value, just continue to hold them, or write another call and collect another premium.

UNDER WHAT CIRCUMSTANCES WILL SHARES LIKELY BE CALLED AWAY?

You can anticipate having your shares called away, referred to as being "assigned," any time your option becomes in-the-money. This almost always occurs at expiration if the market price of the shares is greater than the strike price, although it could possibly happen at any time during the term of the option contract if the buyer of the option wanted to exercise the right earlier.

IF THE CALLS I WRITE EXPIRE WITHOUT BEING EXERCISED AND I KEEP ALL OF THE PREMIUM INCOME, DO I HAVE TO PAY A COMMISSION AT EXPIRATION?

No. As a writer of call options, the only time you pay an option commission is when you initiate the transaction or close out your position by buying it back. Closing it out is generally not recommended. If the option expires worthless, as a call writer you keep the entire option premium and pay no additional commission at expiration.

Let's summarize the key benefits, features and risks of covered call writing:

THE BENEFITS AND FEATURES OF COVERED CALL WRITING

1. **Additional income –** Writing covered call options can provide you with an ongoing stream of income from your ETFs and/or individual stocks. This is particularly important at a time when most common stocks, mutual funds and ETFs either pay no dividends at all or they provide a very meager return on investment by themselves. The call writing income can also significantly enhance total returns in a flat, slower growth stock market or slightly declining stock market.

2. **Income paid up front -** The income received from covered call writing is credited to your account the next day, creating immediate cash flow that can be reinvested to produce more income or can be withdrawn from your brokerage account for any purpose, including paying your bills. Since the call writing income is paid up front, if the income is reinvested it can enhance the overall yield on your original investment.

3. **Predetermined return –** The immediate and annualized returns from call writing can all be evaluated prior to initiating the investment position. You will know what the call writing income will be and the maximum additional capital appreciation opportunity, if any, you will have on your shares.

4. **Risk reduction -** If an ETF or a stock declines in price, the call writing income you received helps to offset some, or all, of the decline in the share value. Writing covered calls acts like an insurance policy, offering some downside protection when your shares decline in price.

5. **Cash dividends –** As a writer of covered calls, you will continue to be entitled to any cash dividends for as long as you own your shares of either a dividend paying ETF or an individual stock.

6. **Fungibility –** Exchange-listed options, as is true of individual stocks and ETFs, are fungible. That is, each listed option is interchangeable with any similar listed option. This enables investors to initiate and close out a position in the open market through their brokerage account. Fungible option contracts became available in 1973.

7. **Ease of trading -** Since options are actively traded on the open market, call option transactions can easily be executed, similar to trading stocks and ETFs. With the assistance of this guidebook, it is readily accomplished yourself with online or phone trading through a discount brokerage account or through a full-service broker.

8. **Diversification of ETFs and individual stocks for option writing -** There is a growing list of ETFs and common stocks of all types that offer covered call writing. Unquestionably the number that offer this will continue to become even more widely available in the future.

9. **Cash or margin account -** Covered call options may be written on shares either in a cash or a margin account (cash only for retirement accounts).

10. **Options listed in daily newspapers, brokerages, and online -** A table of actively traded listed options, their closing prices from the previous day, and other relevant data is available on a current basis in most daily newspapers. A detailed quote for any option is always available through online brokerage accounts. Many brokerages also have automated quotation systems for customer use over the phone. Extensive online options quotations are also available through the Yahoo! Finance section on the Internet (www.yahoo.com), BigCharts.com (www.bigcharts.com), the Chicago Board Options Exchange Web site (www.cboe.com) and other similar sources.

THE RISKS OF COVERED CALL WRITING

1. **Investing in the stock market –** Writing covered call options requires that the investor own stocks or Exchange Traded Funds, which are stock market investments that are subject to market risk. Writing covered calls, however, provides some downside protection in declining markets. Therefore, the investor in stocks or ETFs on which covered call options have been written is always better off if they decline in value than the investor who owns the same stocks or ETFs but does not write covered call options.

2. **Limited gains in a rising market –** An option writer's potential gain is limited to the amount of dividend income and call writing income received plus any gain in the price of the underlying shares from the time the option was written up to the dollar amount of the strike price. Depending on the strike price and the extent of a rise in the underlying shares prior to the expiration date, in a rapidly rising market the option writer may not benefit from all of the rise in the price of the shares. While still profitable, an option writer faces the risk that it might have been better financially to have simply held the shares and not written covered call options in a rapidly rising market.

3. **Unanticipated exercise of call options –** The holder (buyer) of a call option has the right, but not the obligation, to buy (exercise) the option writer's shares at the strike price at any time through the expiration date. A writer can expect that his shares will not be subject to exercise if the market price of the

shares is less than the strike price of the call option written. If, however, the market price rises above the strike price before expiration, it is possible that the holder could exercise the call option at any time, thus requiring the option writer to sell the underlying shares at the strike price. Exercise of options generally occurs at the expiration date, and then usually only if the market price exceeds the strike price. On occasion, however, a holder will exercise an option prior to the expiration date, especially if a dividend is payable soon before the expiration date of the option contract. This is beneficial in some respects for the option writer, as the writer is paid the strike price early and can decide how to deploy the funds immediately instead of having to wait until the expiration date.

4. **Potential lack of option market liquidity –** Options generally trade in much smaller quantities than common stock or ETF shares. Options for some ETFs and stocks are very actively traded. For others there are usually fewer option contracts traded. This may cause the bid and ask price spread to widen significantly. For this reason, investors are encouraged to always place limit orders (see Glossary) with their brokers on option trades instead of market orders to eliminate the risk of an order being filled at a different price than what a current quote might indicate.

5. **Possibility of a decrease in option premiums –** The price of a covered call writing option premium is determined by market forces and mathematical models. During periods of market volatility, option premiums tend to be greater than during periods of stable markets. It is not possible to predict future volatility. Should markets become less volatile, or should markets be less attractive to investors in the future, it is possible that option premiums may not be as large as they have been in the past. Such an occurrence would tend to make the returns on covered call writing less attractive than they have been during periods of larger option premiums.

6. **Commissions on option trades –** The commissions charged by full-service brokers and discount brokers vary significantly. It is important to the investor to find a brokerage, whether discount or full-service, where commission costs can be reasonably managed.

If any of the preceding is confusing at this point, do not lose heart. The following chapters outline in detail the particular usages of ETFs and individual stocks in a covered call writing program.

HOW COVERED CALL WRITING WORKS

> Investing is weird. Every time one guy sells, another one buys, and they both think they are smart.

Now that we have discussed the fundamental knowledge behind covered call writing and introduced some terms and definitions, it's time to get into the application of that knowledge.

To really understand what *you* will be doing through covered call option writing we need to start by looking first at a typical call transaction from the *buyer's* perspective. That side of the transaction has absolutely nothing directly to do with what you will be doing, but understanding the "buy" side of the transaction will greatly help you understand the "sell" side, which is *your* side. For purposes of simplicity, commissions will not be included in any of the following examples. Later we will discuss how you can keep commissions down to a reasonable minimum. But for now, just remember that there will be some commissions involved that will affect these numbers a bit.

THE CALL BUYER'S (SPECULATOR'S) SIDE OF THE TRANSACTION

Let's work with the shares of Proctor & Gamble (ticker symbol PG), one of the high dividend paying stocks on our earlier list, for our example. As a Boomer, you are likely to want to maximize the combination of your dividend and option writing income to provide for the expenses in your approaching or current retirement. Since an at-the-money call will provide the greatest return, we will begin our example with an at-the-money call, which may likely be the most common option writing approach you will take when you begin to write calls.

So, let's say PG is selling for $60 per share on options expiration date in August. "John," as we will call the buyer, thinks PG may be poised to rise, so on the Monday following option expiration he buys ten PG call contracts with an October expiration and with a strike price of $60 per share. For this he pays a premium of $1.50 per contract. Each call contract covers 100 shares of the underlying shares, unless later adjusted for a stock split or stock dividend. So during the term of this option John controls 1,000 shares of PG. The price he pays for this, the option premium, is $1,500 ($1.50 premium per contract x 10 contracts x 100 shares per contract).

The price of the option is based on mathematical models, but largely revolves around the price volatility of the underlying shares, the distance between the strike price of the option from the current price of the underlying shares, and how much time exists between now and the time the option will expire.

The more volatile a given ETF's or company's recent share price history in the marketplace, the higher the premium a call will command. For example, all other things being equal, a call on many of the high-flying tech stocks and ETFs, which experience substantial price swings, would typically have a premium greater than PG's options. But, since we are Boomers who want to maximize our income and also do so without taking on undue risk, we are satisfied with the significant dividend that PG regularly pays, plus a smaller call option premium than we could otherwise get by purchasing a more risky, volatile stock or ETF.

Second, the price of the underlying shares relative to the strike price of the option is a major factor. If the price of PG is $60 per share, it is already trading at the $60 strike price of the call option. Since the likelihood is obviously much greater of the price of PG shares reaching $60 by the end of the October expiration period than rising to, say, a strike price of $62 ½, the price of the option for a $60 strike will be significantly higher than the $62 ½ strike option contract, which is trading at $.50. In other words, for at-the-money and out-of-the-money calls, the closer the strike price is to the current market price of the underlying shares, the greater the call option premium will be.

Third, if it is now August and an investor is buying an option, he will pay a larger premium for a call that will expire in October than one that will expire in September. By purchasing an option giving him the right to buy shares at a specific price until October, the buyer has an additional month more time for the price to go up than if the option expires in September. For that reason, the PG option buyer will have to pay about $1 more per call for the October expiration than for the September expiration.

Mathematical formulas are the framework behind the pricing of options traded between buyers and sellers. Ultimately, actual trading prices are established by what a willing buyer and willing seller agree upon through their brokerage orders.

Another factor that can affect the level of option premiums is the economic environment. For example, let's say there is a rough market where prices have declined, recovered a bit, declined, and so on. There isn't much "visibility" going forward regarding when the economy will improve and equity prices will recover. That scenario is reflected not only in ETF and stock prices, but also in option premiums. Option premiums for the same shares, strike prices and expirations, when compared with different economic times, have sometimes trended either higher or lower during these times of market uncertainty.

Getting back to the PG example, how does this work for John? The buyer of a call is a speculator. In this case John is speculating that the price of PG shares

will rise fairly quickly so he can take his profit. The price of the call he has purchased will go up and down with the price of PG.

These option contracts, just like the underlying shares, both continue to be traded on the open market. In the short run, if the price of PG would rise, then the price of the call contract should rise as well. And the price of the option would rise at a higher percentage rate than the stock itself, because the purchase of an option provides "leverage"…100 shares for each contract. In this case, for a price of $1,500 John has control, for a limited period of time, of 1,000 shares of PG worth $60,000. If PG would rise to $63 the next day after the trade, the owner of the shares would have a gain for that day of 5%. The call option, however, might in turn rise to $4 or a gain of 167% above the option purchase price. The buyer, if he wished to, could then sell his option contracts on the open market and pocket his gain on the transaction. This does not affect you, the option seller, and your option strategy. You will typically just sit on your covered call options and wait for the expiration date to pass. Specific buyers and sellers of calls aren't matched together unless calls are assigned at expiration. Either party can get out of their call position through their broker, just like a trade for the underlying shares. That's what makes options fungible.

John's purchase of calls demonstrates why a speculator might choose to buy an option rather than buy the underlying shares. Had John purchased 1,000 shares of PG at $60 and sold it at $63 his investment would have been $60,000 and his profit $3,000 for a return of 5%. By buying the option contracts instead, he realized a 167% profit on his investment but tied up only $1,500 of his capital in the process. This sounds terrific, but what's the downside? If PG had declined from $60 to $57 the value of his options would also decline, perhaps going from $1.50 to $.50. This would represent a loss of $1,000 or 67% of his investment. Had he bought the shares and had they declined to $57, the percentage loss would only be 5%.

By comparing ownership of shares with ownership of options one can begin to see the highly speculative nature of *buying* calls. Using options, a person can control a very large number of shares with very little money when compared with ownership of the actual underlying shares. This means the potential for big gains and big losses. There's another major difference between buying an option versus buying the shares. Options expire, but shares do not. If an option buyer continues to hold the option, and if the price of the shares do not exceed the option "strike price" at expiration, the options will always be completely worthless. So, if an investor is a buyer of call options, he not only has to be right about the share price going up, he has to be right about *when* it goes up!

This is a good time to introduce two more terms…"intrinsic value" and "time value" of options. The terms "in-the-money," "out-of-the-money" and "at-the-money" were discussed previously, which have to do with the relationship between the option strike price and the current market value of the underlying shares on which options are being written. The "intrinsic value" portion of an

option's price is the dollar amount by which the strike price is less than the market price of the shares. For example, if shares are trading at $62 ½ per share and the strike price of an option is $60, then the intrinsic value of the option is $2 ½. If the share price and the strike price are the same, then the intrinsic value is $0. It is also $0 if the strike price is any amount greater than the market price. Obviously this can change at any given moment as the price of the underlying shares moves up or down in trading. The strike price of a specific option is fixed until its expiration, but the market price of the shares and the option normally change constantly as trading takes place. So, a given option premium can have intrinsic value at times when the market price of the shares goes above the strike price and have no intrinsic value when it is below the strike price. As we will soon see, I recommend for you to generally write options where the strike price is about the same or slightly greater than the market price of the underlying shares at the time of the trade, so there will be no intrinsic value when the option contracts are written. There is a time and a place for writing in-the-money calls too, which we will also discuss.

The "time value" of an option premium is the market price of the option less the amount of intrinsic value. In other words, it is the value of the time remaining until the option expires. The longer the time between the current date and the expiration date the greater the time value of the option. This can be best understood through examples.

Assume the following facts. The strike price for an option on shares of a stock is $55, the current market value of the shares is $57 and the current price of the option is $4 ¼ . Since the market value is higher than the strike price, the intrinsic value is determined by subtracting the strike price from the market price, which gives an intrinsic value of $2 for the premium. The time value is then determined by taking the current option price of $4 ¼ and subtracting the intrinsic value. The time value is therefore $4 ¼ minus $2 or $2 ¼. Another way to say this is that the *intrinsic value is the amount by which the shares are in-the-money*. The *time value is the rest of the price of the option*.

Let's look at a second example. The strike price for an option on an ETF is $80, the current market value of the ETF is $76 and the current price of the option is $3. The option is out-of-the-money, so there is no intrinsic value. Thus, the entire market price of the option premium of $3 is regarded as time value. Obviously this changes as the price of the ETF and the option go up and down.

Back to PG again. John stands to realize a substantial percentage profit or loss on his call option investment if there are short-term swings up or down in the market value of PG shares. Let's examine what will happen if John continues to hold his option until the expiration date in October. You will recall that the strike price of the option contract John bought was $60. This means that on the expiration date if the price of PG is less than $60 the options expire with no value. John has lost his entire investment. Why? John's option contracts give him the right, but not the obligation, to buy 1,000 shares of PG for $60 per share at

any time through the October expiration date. Most options expire on the third Friday of the expiration month, although some are configured to expire at the end of the month or even weekly. Generally options are not exercised until immediately after the expiration date. The reason for that is simple. Option buyers are often speculators who really don't want to own the underlying shares on a long-term basis or at all. Therefore, if the buyer of the option wants to close out his option position before the expiration, the buyer will almost always sell the contracts on the open market rather than exercise the options and then wait to sell the shares after they are delivered to his broker.

But, in this case we are assuming John has not sold his option contracts and the October expiration date has just passed. We have said that if the price of PG is below $60 he has lost his entire investment. What happens if after the expiration date the share price is above $60 per share? As we just said, John would have typically sold his contracts before expiration, but if the expiration date passes and the underlying share market price is greater than the strike price, John's broker will automatically exercise his options and buy the shares because the options have intrinsic value. Let's say the price of PG is $61 ¼ at the close of the market on the expiration date. If John exercises his options he will pay $60,000 for his 1,000 shares of PG. By exercising his options he will have $61,250 worth of shares which he can sell for a $1,250 profit.

But didn't John pay $1,500 for the options and won't he still have a net loss by exercising the options and selling the shares? Yes…but the gain on the sale of the shares will partially offset the loss of the premium he paid ($1,250 investment gain - $1,500 premium loss = $250 net loss).

Again, if John had held his options until around the expiration date he would have most likely sold the contracts themselves rather than exercise the options and then sell the shares. Why? It is a much simpler transaction. By the time he could take delivery of the shares and sell them, the market price of PG could possibly go down. If the shares were trading at $61 ¼ towards the end of the day on the last day of trading before expiration, the $60 PG call option would be trading at about $1 ¼ per contract (time is up, so there is only the $1 ¼ intrinsic value and no time value is left). He would receive about $1,250 when he sold his ten contracts ($1.25 x 10 x 100), for the same result (except for commissions).

When you remember that up to eighty-percent of all options contracts that are out-of-the-money or at-the-money when the transaction is initiated expire worthless, it becomes clear that buying options is highly speculative. It requires significant price movement occurring rather quickly in the underlying shares if the buyer is to make a profit, especially if there isn't much time remaining to expiration.

It is also clear that in many cases much or all of the option buyer's investment can be lost, even if the price of the underlying shares rises somewhat before the expiration date.

Let's use the example of John's PG options again. We'll say the price of PG goes up and down during the two months he owns the call contract, but the share price remains at $60 after expiration and John still holds his options. Even though the price of PG has not increased or decreased after two months has passed, John has still lost his entire investment. He would not exercise his option to buy shares at $60 that can be bought on the open market for the same price. He has lost the premium he paid for the options. What is John's breakeven point on the expiration date? If he paid $1.50 per share premium to buy each contract, and if the strike price is $60, then John's breakeven is $61.50 per share ($1.50 + $60 = $61.50). In other words, if John holds the options through the expiration date, unless the price of PG is at least $61.50 per share, or 2 ½% higher than when he bought the options, he lost money. Of course, he could have sold the contracts well before the expiration date and made or lost money, depending on what the price of PG and his options were and also how much of his time had run out before expiration.

It should be apparent why the opposite, mirror side of this transaction, fortunately the side in which you will be involved as a covered call writer, is the more attractive proposition.

THE CALL WRITER'S (YOUR) SIDE OF THE TRANSACTION

Let's look at the same transaction from YOUR side now. You are the owner of 1,000 shares of Proctor & Gamble. You would like to increase your income by writing some call options on the shares you own. While you like the company's long-term prospects, your principal objective is to increase your retirement income through dividends and the maximum amount of premium that you can obtain from covered call writing on the stocks and ETFs you own. PG is currently trading at a share price of $60. It is the weekend following August options expiration and you start checking out the premiums for PG options contracts with various strike prices and expiration dates. One of them that looks attractive to you is the October $60 PG at-the-money call. It is trading $1.50 per contract. For receiving a premium of $1.50 per share you decide you would be willing to let go of your 1,000 shares of PG at $60 per share if the price should be greater than $60 on the expiration date. Remember that the option buyer could call your shares away from you at any time up to and including the expiration date, but this rarely ever happens before the expiration date, even if the market price of the shares goes above the strike price. An exception to this may occur if the company has declared a dividend and the ex-dividend date occurs shortly before expiration. If the shares are trading in-the-money, the buyer may be tempted to exercise the shares to capture the dividend. This will be discussed in more detail later.

Using your computer, you plug all the data into the Excel® option worksheet mentioned earlier and read the information as follows (note: the

formatting below appears in two separate segments due to the constraints of space, whereas on the Excel® template the same data appears on one continuous line):

At-the-Money Call @ $60 Strike Price

DATE-------->		23-Aug						
X	X	X		X	X	X		X
CO. SYM.	# SHS.	SHARE PRICE	MARKET VALUE	ANN. DIV.	OPTION EXPIR.	STRIKE	DAYS	OPTION SYMBOL
PG	1,000	$60.00	$60,000	$1.93	15-Oct	$60.00	53	PG101016C60

X	X				CAPITAL		ANNUAL	BREAK-
CO. SYM.	PREM.	$ PREM. INC.	PREM. $ PER DAY	CONT. YIELD	APPR. OR (DEPR.) AT STRIKE	ANNUAL YIELD	YIELD W/ CAP. APPR. OR (DEPR.)	EVEN PRICE OF SHARES
PG	$1.50	$1,500	$28.30	2.50%	$0	20.43%	20.43%	$58.50

From this transaction you will collect $1,500 in option writing income ($1.50 premium per share x 10 contracts x 100 shares per contract, not including commissions). You see that, on an annualized basis, the premium income and dividends at the current market price of PG shares will yield 20.43%. Not bad! And the return rate from the premium income will be locked in for 53 days until October 15 (the third Friday in October) based upon that premium and the market price of the shares on the day of the transaction. The annualized yield is used for comparison purposes, as investors are used to thinking in annual terms. When you buy a six-month CD at the bank at a 2% rate of interest, for example, the rate quoted is on an annual basis. If they quoted you 1% for the six months, that would be comparable to what we are calling the contract yield of 2.50% in this example.

In this example it is assumed you wish to maximize your premium income by writing an at-the-money call. Therefore there is no potential for additional capital appreciation, as the call strike price and the market price of the shares are the same when the transaction is initiated. You can see that the total return on an annualized basis, which is the premium income, plus dividends, (plus additional capital appreciation…which doesn't apply in this case…if you had written an out-of-the-money call and if the shares are called away from you at expiration) is 20.43%.

Now the downside. If the price of PG shares were at, say, $63 ½ before the expiration date, you would probably feel pretty bad that you had lost out on some additional capital appreciation. You would only receive $60 per share plus your option premium of $1.50, or a total of $61.50 per share, so you would have missed out on receiving $2 per share that your PG shares would have been worth

had you done nothing but hold them. Yet you realized an annualized return well into double digits. You also had $1.50 per share of downside protection if PG's price had headed south. Some transactions will turn out like that. Just remember that as a covered call writer you are no longer in the business of maximizing capital appreciation on the shares of any given company or ETF. You are in the business of earnings dividends and using covered call options to provide you with a rate of return that will meet or exceed your objective. If you keep that in mind, you will not be overly disappointed, even if your shares are called away from you at times. An even more frequent occurrence would be that your shares are called away, but the strike price plus the premium you receive is greater than the market value of the shares at expiration. This means you are better off than if you had just held the shares. I have always said that I would like to have my shares called away from me every time I write covered calls. That would assure that I achieved my maximum return objective every time and never experienced a loss!

This points out that we can't just look at the call option premium income in isolation. We have to consider what happens to the share price as well in figuring the overall return. Obviously it can go down too, which will be addressed shortly.

So, you decide to go ahead and place an order to "sell-to-open" ten contracts of the PG October $60 calls at $1 ½. You are not buying the calls, you are selling to someone (such as John) the right to buy your shares at a specific price and over a specific time period. And this is the opening of the transaction for you, so it is referred to as "sell-to-open," or your broker may call it "sell covered call." If you decided later that you wanted to close out the transaction rather than wait for the options to expire or be exercised on the expiration date, you would then do the opposite and enter an order to "buy-to-close." That would close out the transaction. This is not generally recommended, but will be discussed in more detail later.

When you have entered your order, John or some other buyer buys your contracts through his broker and pays $1,500. The deal is settled and you get the money placed into your brokerage account *the next business day*. The reason you receive the premium income now is that the buyer obviously has to pay for the buy side of the transaction immediately, and you are the lucky beneficiary of immediate cash when you are on the sell side of the transaction. You are free to immediately withdraw that money, let it sit, or invest it in something else that will also produce more income and capital gain opportunity.

So what do you do after you have sold your calls? Almost always, you will just sit on them and wait for the expiration date to occur. Some other alternatives will be discussed later, but mostly you will just wait it out until expiration. You can look forward to each passing day, as time is the best friend of an option writer. Every day that ticks off toward the expiration date means you are closer to the time you can either write a new option on your shares or you will receive

cash for your shares at the strike price if your call contracts are exercised and assigned.

Let's assume for a moment that the market price of PG remains at $60 on the expiration date. What happens? Since a buyer would not pay the same price for shares that he could buy at the same price on the open market, the options expire unexercised. You have previously pocketed the buyer's $1,500 and you get to keep your PG shares. Now you can write more call options. With the stock price the same, if you write another one to expire in about the same time period later, you will likely receive a similar amount of option writing income as the previous transaction. In fact, if you were to do that for an entire year and the price of PG shares would remain at $60 at the end of the year, you would have received a return of over 20% from your dividend and premium income…a fantastic gain in a flat market. An owner of PG shares who did not write options would have no gain at all other than from dividend income. Hopefully you are able to see what is meant about option writing working its magic in a flat to slowly rising or slightly declining market.

And if PG shares closed above $60 on the October expiration date you would receive $60,000 and could then use the proceeds as you please. A serious option writer would probably buy shares in the same or another attractive high dividend yielding stock or ETF and then write more call option contracts. The cycle goes on and on.

But what occurs if the price of PG went down. That's when "bad" is really "not quite so bad." Let's say at the October expiration PG shares are trading at $59. You have the premium income of $1,500 to keep and obviously you get to keep your shares, because the buyer of the call would not pay you $60 for PG shares that could be bought on the open market for $59. Since you received $1.50 per share in premium income, you have a $.50 net gain per share in the transaction from the date the contracts were written ($59 + $1.50 - $60). You have fared better than a shareholder that simply owned the shares and did not write options on them. You have had $1.50 per share of downside protection, which is somewhat like insurance, during the entire term of the contract until expiration. Of course, if PG went down even further than that, you could experience an overall loss, but a loss that would be less than if you hadn't written the option contracts.

What would you do then after the expiration of the options with your $59 PG shares? There are several things you could do, depending on how you feel about the company's prospects and what is going on in the market and the economy in general. These are your choices:

If you believe your PG shares have a good deal of near-term recovery potential:

- Simply hold the shares and do not write options for awhile, hopefully allowing the shares to rise.

or

- Write calls that are out-of-the-money…that is, write calls with a strike price that is significantly higher than the current market price. You won't get a huge premium, but you will get some. And the likelihood of your shares being called away is greatly reduced if the price of the shares goes up.

If you believe your shares have significant further near-term loss potential:

- Sell your shares now and wait for a better investment climate for PG or another stock or ETF.

or

- Write calls that have a strike price that is somewhat below the current market price…the in-the-money option contracts. This will provide you with much better premium income (although the portion that represents intrinsic value should be regarded as a return of your capital) and therefore a lot more downside protection. Again, it is not often recommended that you write in-the-money calls, where the strike price is below the market price. If you are wrong and the price of the shares goes up, they will be called away at a price that may not be acceptable to you. So, this is one of only a few occasions when you should consider such a strategy…and be sure you really believe that your shares have a strong chance of declining in value below the strike price of your options.

If you believe your share price will meander about where it is or go up a bit:

- Treat this as a normal option writing opportunity, because this is when option writing works its best magic. You may wish to write call contracts with a shorter-term expiration and also try to ratchet the strike price up at expiration if the shares are gradually increasing in value so you get back to the position you were in originally if there was a significant loss.

Remember…it is still possible to lose money buying ETFs or individual stocks and writing call options if the price of your shares declines. But if you are caught in a declining market where your shares are going down in price, you will *always* be better off if you have written calls on your shares compared with just owning the stock or ETF alone, because the premium income gives you the added downside price protection "insurance."

AN OUT-OF-THE-MONEY EXAMPLE

Let's make a different assumption about your investment return objective. We assumed for purposes of the previous example that you wanted to maximize your dividend and option writing income, to the point where you were willing to sacrifice any additional opportunity for capital gain by writing an at-the-money call. If you were willing to accept a smaller premium income return in exchange for giving yourself some room for additional capital appreciation, you could have written an out-of-the money call. This would be an appropriate tactic if your immediate income needs were not as great and you are willing to accept a smaller premium in exchange for the potential opportunity to realize some capital appreciation in the value of your shares. We'll take a peek at what such a trade might have looked like assuming you chose a strike price at $62 ½.

You can see that under this scenario your call premium is $0.50, compared with $1.50 for the at-the-money $60 strike price. Your contract yield is .83% (compared with 2.50%) and your annual yield is 8.96% (compared with 20.43%). In this case, however, since you are writing a $62 ½ strike price, you have the opportunity to realize an additional $2,500 of capital appreciation in the event the price of the shares rise to $62.50 or beyond.

Out-of-the-Money Call @ $62 ½ Strike Price

DATE-------->		23-Aug						
X	X	X		X	X	X		X
CO. SYM.	# SHS.	SHARE PRICE	MARKET VALUE	ANN. DIV.	OPTION EXPIR.	STRIKE	DAYS	OPTION SYMBOL
PG	1,000	$60.00	$60,000	$1.93	15-Oct	$62.50	53	PG101016C62.5

X	X							
CO. SYM.	PREM.	$ PREM. INC.	PREM. $ PER DAY	CONT. YIELD	CAPITAL APPR. OR (DEPR.) AT STRIKE	ANNUAL YIELD	ANNUAL YIELD W/ CAP. APPR. OR (DEPR.)	BREAK-EVEN PRICE OF SHARES
PG	$0.50	$500	$9.43	0.83%	$2,500	8.96%	37.65%	$59.50

In the event that occurs, your annual yield with capital appreciation would be 37.65% (compared with 20.43% in the at-the-money writing example). The fundamental question that has arisen between these two examples is this: Are you willing to sacrifice $1 of premium income to potentially capture an additional $2 ½ per share of capital appreciation? That decision would be driven by a number of factors, not the least including your need for current income, the outlook for PG shares in particular, and the overall economic outlook and market outlook in general. Only you can make that decision. Once you begin writing

covered call options, the use of the Excel® templates provided with this guidebook and the dictates of your personal needs and market analysis will drive decisions on whether you write at-the-money calls, out-of-the-money calls, and perhaps on occasion even in-the-money calls. It will also drive what specific strike prices you select as well as the expiration dates for your option contracts.

Using this example at the $62 ½ strike price, if your PG shares closed between $60 and $62 ½…say $62…you still get to keep your entire option premium *and* your PG shares, as the share price was not above the strike price on the expiration date. The nice thing about this is that you have kept your shares, but they are now worth more than when you wrote your option in August ($62 vs. $60). Not only do you have your premium income and a gain in the shares, but when you write your next option contracts, say the December contract, you will find that the $62 ½ strike price contracts will be trading at a higher relative price …perhaps $1. This is because the market price is closer to the strike price now than it was the last time you wrote the option contracts. Remember that for at-the-money and out-of-the-money calls, the closer the market price is to the strike price, the higher the option premium will be. This time your ten contracts would give you about $1,000 of premium income.

Instead of writing new calls at the same $62 ½ strike price, an alternative strategy that might be effectively used would be to write contracts at an even higher strike price…for example the $65 contract instead of the $62 ½ contract. This would reduce your premium income again because the strike price is higher, but it would allow for more room for the price to increase in PG shares by the next selected expiration date. Again, the strike price you select will largely be based on your personal income needs as well as what you think may happen to PG's price by the next selected expiration date. Of course, that is very difficult to know, but the investor usually has some informed thoughts on the subject from what is heard and read.

A CALL OPTION WRITER'S DREAM

What would be the optimum situation for an option writer to maximize gain opportunities? This is difficult to achieve, but if you choose to be a writer of out-of-the-money calls you will have this happen to you on occasion to some degree or another with some of your shares. The optimum situation is to write calls so that on the expiration date the market value of the shares is just under the strike price. In addition to the premium income, you keep your shares, so you can write new options at a higher strike price and continue to do this over and over again at each expiration date if the share price keeps slowly rising. In this perfect world you would receive steady premium income, but by keeping your shares as they go up to a price just below your strike price at each writing opportunity, your shares become increasingly worth more too.

Let's consider a highly embellished example. You buy PG shares at $60 and write contracts on them at a strike price of $62 ½ and receive a premium of $0.50. On expiration your shares are trading at $62.25, so you write new call options at a $65 strike price and receive $0.40 in premium income. At the next expiration the shares are trading at $64.90. You write more options at a $67 ½ strike price, and this time you get $0.45 in premium income per share. One more time. At this expiration your shares are trading at $66.95, so you write the $70 strike price and get $0.35 in option premium income. At the expiration your PG shares are trading right at $70. How did you do? Well, you paid $60 for shares that are now worth $70. In addition, you have collected $1.70 in premium income. You total gain from start to finish is $11.70 per share. You are ahead of your colleagues who have only bought PG shares and held onto them. Of course, they have never had to worry about having their shares called away from them. But don't forget, you've had a degree of cumulative downside price protection too in case the shares started heading south, and more predictability in your overall return as you collected all of those option premiums.

Should you be concerned when the price of your shares moves above the strike price or when your shares get called away from you at expiration? Don't worry about having your shares called away from you. As an investor who owns shares in solid companies and/or ETFs, your goal is to achieve an above average return on a consistent basis by writing call option contract premiums on your shares. That's your game…that's the business you are in as an investor. You should be very happy if all the shares you write options on were called away from you at every option expiration date. That way you wouldn't have any losses and you would be achieving your most optimistic objective, premium income and capital appreciation (if any) too, every time. Between your premium income, dividends and capital appreciation, you would be doing extremely well. Returns well into double digits…Warren Buffett-like returns!

Is there a risk that you end up having all of your best performing shares called away from you with only the losers remaining in your portfolio? That has not been my experience. Whether you are writing covered call options or just buying shares to hold, you should never buy an ETF or company that you aren't comfortable holding for the long term. And you should never buy shares of any ETF or company just because it would give you an excessive amount of premium income. That implies it's a volatile ETF or company, meaning that it has more downside potential in a bad market as it does upside potential in a good market. If you stick to large capitalization, high quality, high dividend paying stocks and ETFs, you should be able to sleep at night with no concerns. If you can't, then you need to reduce the risk you are taking.

You also have to keep in mind that when you write call options you are dealing with a rather short time horizon for the option. In most cases you won't be writing three-year LEAPS on your shares that would provide a lot of time for the price to go up significantly. You could write a long-term option in an isolated

case for diversification, but that would probably be the exception rather than the rule. For shorter-term options, there usually just isn't enough time for the share price to go way beyond the strike price, particularly if you leave some room for capital appreciation by writing out-of-the-money calls. That's not to say that it can't happen. It will, on occasion. Of course, when the shares are called away from you, you can simply buy them back again and either hold them or write more calls on them. It will cost you more to buy it back the second time than it did the first time, but you will have the premium income to help too. On occasion you will find the opposite happen, where you have your shares called away from you and then the price goes down so that you can buy it back for less than the strike price at which it was earlier called away. Obviously there are a lot of different ways this can go. And, keep in mind that if you are writing at-the-money calls your shares are more likely to be called away from you at expiration (or perhaps even earlier) than if you are writing out-of-the-money calls. Even though this will increase your commission expense, I do not regard this as a negative in view of the fact that you are collecting larger premiums with at-the-money calls.

The most important thing is that you buy shares that you feel comfortable owning and you stick with them until there is a reason to sell them or until the shares are assigned and called away. And if the shares of one of your ETFs or companies are called away, you should always ask yourself if you should buy the same shares back again, or if there is another company or ETF on your working list that better meets your criteria for investment.

The possibility of missing out on a good sized gain from upward price movement in a share holding isn't too much of a price to pay when you consider all of the advantages that writing covered calls offer.

The hypothetical scenarios discussed here will obviously not happen to you in the way they were described. They have simply been included for purposes of illustrating some very positive possibilities. But with common sense in your ETF and company stock picking and the tools this program provides, you will soon find yourself well on your way to selecting option writing opportunities that will give you solid double-digit returns…and some good cocktail party conversation material!

4

SELECTING FROM COVERED CALL WRITING ALTERNATIVES

A long-term investment is defined as a short-term investment that failed.

Have you sent us an e-mail message yet requesting your Excel® file templates to assist you with your option writing decision making and record keeping? Their use will greatly assist you with the calculations necessary to make quality decisions using the covered call writing program. If you have not already done so, please send an e-mail now to arrowpublicationsUSA@gmail.com requesting the "Boomer files."

When you bring up this Excel® file named "Boomer files" you fill find a number of tabs at the bottom. Click on the tab named "Calls." You will find it a useful resource to assist in making decisions on which call options to write for the ETFs and individual stocks you own or are considering buying. It provides information to simplify decision-making and saves a lot of time in "crunching the numbers."

CALCULATING COVERED CALL WRITING OPPORTUNITIES

On the next page you will find an example of the use of the "Calls" template format using a covered call writing opportunity on Proctor & Gamble shares (note: again, the template appears a bit different in this book because of formatting, but the information is the same as what you will be inputting into the "Calls" template).

Let's discuss this worksheet in detail, because you will use this same format over and over again in making your option writing decisions.

Note the row towards the top with the small "**x**"s. In any vertical column where there is an "**x**," that means you need to fill in the information yourself. If there isn't an "**x**" in a column, the information in that column is automatically calculated for you on the Excel® template.

Many of the columns are obvious. The first column is the ETF or stock ticker symbol. There are three rows for each symbol on the Excel® template because it is always wise to consider multiple expiration dates and strike prices. The next column is the number of shares you own and then the current market price of the shares. In this example, we entered 1,000 shares for convenience sake. Any number of shares can be used as long as it is in multiples of one-hundred shares,

since an option contract always applies to one-hundred shares, also called a "round lot." You can't write options on an "odd lot," which is less than one hundred shares.

DATE-------->	23-Aug							
X	X	X		X	X	X		X
CO. SYM.	# SHS.	SHARE PRICE	MARKET VALUE	ANN. DIV.	OPTION EXPIR.	STRIKE	DAYS	OPTION SYMBOL
PG	1,000	$60.00	$60,000	$1.93	17-Sep	$60.00	25	PG100918C60

X	X				CAPITAL		ANNUAL	BREAK-
CO. SYM.	PREM.	$ PREM. INC.	PREM. $ PER DAY	CONT. YIELD	APPR. OR (DEPR.) AT STRIKE	ANNUAL YIELD	YIELD W/ CAP. APPR. OR (DEPR.)	EVEN PRICE OF SHARES
PG	$1.00	$1,000	$40.00	1.67%	$0	27.55%	27.55%	$59.00

The total dollar amount invested in an ETF or stock for covered call writing is not particularly material. The most important thing is that you purchase in round lots, regardless of the amount you are investing. The more round lots you purchase, the more cost efficiency there is in brokerage commissions on option trades, which will be discussed in detail in another chapter. Other than commissions, the returns will be the same, both for a large investment and a small one.

The market value column doesn't have an "**x**," so that means the calculation there is automatic if you have entered the other information. Next you would enter the annual dividend payment per share. Many ETFs and individual stocks don't pay any or only a small dividend. But to maximize income we are focusing on high dividend paying securities, so it will be an important component of our overall investment return and is therefore very important to enter when analyzing alternatives between ETFs and companies. Just enter the annual dividends per share and the template will include them with the other information to figure your total investment yields.

The column "option expiration" deserves more detailed discussion. We've briefly said that there are hundreds of ETFs and companies at this time on which you are able to write covered call options. For any given one, there is typically a variety of option expiration dates to choose from. Let's continue with Proctor & Gamble as an example. As of the new option month beginning on the Monday following the third Friday in August, there were options available expiring in September, October, January, April and the LEAPS a year from January…expending over a period of one year and four months. This gives investors quite a few choices to suit their own unique call writing needs. More detail will be provided on how those selections are made, but at this point suffice

it to say that you would often have quite a selection to choose from in making your option writing decisions. Some LEAPS extend out for as long as three years. For any given ETF, there is an "option cycle," which means that generally there are options expiring on the same four months every year plus the current and the next following month. Some offer LEAPS as well. Not all ETFs and stocks, however, offer this many choices in their option cycle.

There are three different cycles. All ETFs and individual stocks will follow one of these cycles:

Cycle 1:	January	April	July	October
Cycle 2:	February	May	August	November
Cycle 3:	March	June	September	December

In the chapter on brokerage accounts, details will be provided about how to determine what option expiration dates are available on different shares and how you get quotes on them and other information to plug into the worksheet.

One thing that is always true, however, is that all ETFs and stocks on which options can be traded offer an expiration for the current month and the next month. Proctor & Gamble is included in Cycle 1. So, the December options would not be available for PG if it were only August, because the month of December is part of Cycle 3. But when we are in the month of November, there will be a November and a December option for PG, even though those two months are not included in Cycle 1…simply because there is always an option created with an expiration for the current and the following month.

The next column also deserves some extensive discussion… the "strike price." The strike price is the part of the option contract that specifies the price at which the option buyer has the right to buy your shares up through the expiration date. When the market price of any given security goes up and down, the exchange where the option contracts are traded will open up new strike prices if they have not already been opened previously. So if shares of a given company have traded recently from a low of $30 per share to a high of $80, there would be strike prices offered at least in $5 increments from $30 through $80. Some of the more actively traded ETFs offer strike price increments of $2 ½, while select ones, such as DVY and SDY, are offered in $1 increments (especially at strike prices that are close to the current market price, which are generally the strike prices you will be utilizing). This provides you with maximum choice.

As you know by now, what is typically recommended for Boomer investors to maximize your premium income is to select a strike price at about the same price or slightly above the price where your shares are currently trading…the at-the-money or slightly out-of-the-money calls. That will hopefully insure receipt of an option premium that will fulfill your yield objective and may also provide you with some limited opportunity for capital appreciation if the shares go up in value. You should usually consider at least two different strike prices, and add

more as needed, at and above the current market value of the shares and put those numbers onto the worksheet with the other information to help determine which is the one that works best for you considering the rate of return, the capital appreciation potential and the time until expiration.

The column titled "Days," which shows the number of days from the current date through the date of expiration, is automatically calculated. When you enter the option expiration date, the number of days from the current date is subtracted from the expiration date with the resulting number of days placed into this column. So, for example, for the PG option expiring September 17 there are 25 days remaining from the date the worksheet was prepared through the expiration date.

The "option symbol" is the next column. You get that information from the broker you are using. It can readily be retrieved online or by a phone call through your broker or from other online resources, as we will discuss in detail later.

Finally, you plug in the current quote in the "premium" column for the option, which you will get from the broker as well. Sometimes there can be quite a bit of spread, or variance, between the "bid" and "ask" prices that are quoted for options. The bid price is what a buyer is currently bidding or willing to pay to buy the contract. The ask price is what a seller is currently asking or willing to sell the contract for. Actual trading will usually take place between those two figures. Generally it is best to take the bid and ask prices, add them together and divide by two to get the approximate midpoint. So, if the bid is $0.90 and the ask is $1.10, use the midpoint of $1.00, or perhaps even a little less to be conservative. This is the premium per share that you could reasonably expect to receive if you placed an order. You need to be aware that for option contracts quoted under $3.00 the contracts generally trade in increments of 5 cents. For contracts priced over $3.00 the increment is 10 cents. Very actively traded and some lower priced contracts trade in penny increments for many of the strike prices, particularly those close to the current share market price. You will be able to determine the amount of the increment for each option as you review the broker's "option chain" that lists all available options for the security you are researching and place orders online.

You will see the total premium income you would collect under the next column marked "$ Prem. Inc." The commissions obviously vary from broker to broker, so you will be able to customize your own template to accommodate the charges for your brokerage accounts.

The next column, "Prem. $ Per Day" is simply the premium income you would receive on a given transaction divided by the number of days from the current date to the expiration date. This information might not be important to all option writing investors, but it is useful to compare it with other option writing opportunities for relative attractiveness.

Next is "Contract Yield," which gives you the percentage return from the premium for this transaction only, and it is not annualized. In other words, it just tells you what percent return on your current option contract you would be getting now. Again, another comparison technique.

"Capital Appr. Or (Depr.) At Strike" is the next column. The number under this column lets you know the amount of additional potential growth or depreciation in value that could potentially occur based upon the strike price that you have selected and considering the current market price of the underlying shares. In this example, the share price and the strike price are the same, namely $60, so there is no upside or downside at this particular slice in time. We will see in future examples that for out-of-the-money writes, the amount in this column will be a positive number (appreciation potential in share value) whereas for in-the-money writes, the amount in this column will be a negative number (depreciation potential in share value). More on this will come later.

The next column, "Annual Yield," combines the dividend income and also the premium income for the transaction and calculates the *yield on an annualized basis*. It's annualized because investors are used to thinking about their returns that way. For example, if you are seeking a 12% annual return you don't say you want a one-percent return per month, because people just don't think that way. So take the example of the PG option expiring on September 17. What this means is that if you could continue to write the same option at the same premium price and with the same frequency…days to expiration…, and collect the dividends each quarter when they are paid, you would realize an annualized yield on your investment, based on its current value, of 27.55%, not including commissions. In other words, at the September expiration date you would need to do the exact same deal again and again to get that precise yield. Obviously it isn't going to happen that way, because the price of the shares will change, and that means the price of the options in the future will change too. But it is the best information we have at a given point in time, so that's why it's used. Obviously we can't predict where prices will be in the future, so we use the measurements we have now. That gives us the ability to compare one option opportunity with another in an "apples to apples" manner.

The next to the last column is a calculation of the annual yield after including the opportunity for capital appreciation or capital depreciation that can potentially occur on the transaction…that would be if the shares are called away. Let's use the example again of the PG options expiring in September. A writer sells 10 contracts of PG on the 1,000 shares owned (10 times 100 = 1,000 shares) at a strike price of $60 per share. Since the price of the shares is also $60 at the time the option is written, that leaves no possible additional appreciation if the shares are called away. Therefore, in this example the preceding "Annual Yield" and the "Annual Yield W/Cap. App. Or (Depr.)" are the same. Later you will see

examples of out-of-the-money and in-the-money sample calculations where additional capital appreciation/depreciation may come into play.

The final column calculates the breakeven price of the shares considering the amount of premium collected. In this example, the investor has collected $1 per share in premium income. With the initial share price at $60, the investor will achieve breakeven at $59 ($60 - $1 = $59). A close of the stock price above $59 will mean some level of overall profit on the trade, whereas a close below $59 will mean some level of loss.

This is a real example of a call option available at the time of this writing and the market price for it. It represents an actual trade that an investor might consider when the time comes to start writing options.

THE OPTION WRITING STRATEGY

What your goal should be is to take the shares you acquire for your portfolio, including those you already own and new ones you are considering buying, and select option writing opportunities on them that will average out to an overall return at least as great as the investment return objective you establish for yourself. You will exceed that return in some cases, but in others you won't…especially if you try to leave room for significant additional capital appreciation. So, don't lose sight of the forest because of the trees. It's your *overall return* in a diversified, well-balanced portfolio that counts.

Let's look at the figures on the first worksheet and use these as a means of strategizing about approaches to call option writing. The selection of option expirations is narrowed down to just three and for only one strike price per ETF or stock, but you need to remember that there are of lot more choices than those.

DIFFERENT EXPIRATIONS

Remember that there are always call options that expire in the current and next following month for every optionable ETF and stock. Those are the shortest-term standard options available and sometimes they are the best choice, especially in a rising market if you write out-of-the-money calls. If you select options that will expire in about one month, there isn't a whole lot of time between now and the expiration. If you decide to leave room for at least a several point rise between the current share price and the strike price of the call option, the chance is less that the price will rise above the strike price to where the options would be exercised and your shares called away from you. If there is, say, $3 between the current share price and the strike price, the chance of the shares going up that much is a lot less for an option expiring in one month than it would be for one expiring in three months, six months or a year. It is also less likely to be called away than an at-the-money call, but a significant amount of premium would be sacrificed.

There's a logical progression in the price of the call option premium as the length of the time to expiration increases, as you can see in all of the examples that follow shortly. As the days to expiration become greater, the amount of the premium per contract increases. This will always be the case. The reason is this: if you are comparing options with various expirations using the same strike price, it makes sense that if you were a buyer of a call option you would be willing to pay more for one expiring in October than you would for one expiring two months earlier in August. That's because with the October contract the buyer has two more months for the shares to possibly go up so he can profitably sell his option contract or exercise it at expiration.

In the sample template that follows you will find examples of different option writing choices on the iShares® Dow Jones® Select Dividend Fund ETF (DVY) and on several individual stocks from the list provided in Chapter 1, including Proctor & Gamble (PG), Abbott Laboratories (ABT) and ConocoPhillips (COP). The "Calls" template format is used. In the example each security assumes the use of the same strike price but three differing expiration dates for the call options. These examples will clearly point out how returns vary depending on the expiration dates selected.

SAME STRIKE PRICE,
DIFFERENT EXPIRATION DATES

DATE--------> 23-Aug

X	X	X		X	X	X		X
CO. SYM.	# SHS.	SHARE PRICE	MARKET VALUE	ANN. DIV.	OPTION EXPIR.	STRIKE	DAYS	OPTION SYMBOL
DVY	1,000	$44.52	$44,520	$1.70	17-Sep	$45.00	25	
DVY	1,000	$44.52	$44,520	$1.70	15-Oct	$45.00	53	
DVY	1,000	$44.52	$44,520	$1.70	17-Dec	$45.00	116	
PG	1,000	$60.00	$60,000	$1.93	17-Sep	$60.00	25	
PG	1,000	$60.00	$60,000	$1.93	15-Oct	$60.00	53	
PG	1,000	$60.00	$60,000	$1.93	21-Jan	$60.00	151	
ABT	1,000	$49.55	$49,550	$1.76	17-Sep	$50.00	25	
ABT	1,000	$49.55	$49,550	$1.76	15-Oct	$50.00	53	
ABT	1,000	$49.55	$49,550	$1.76	19-Nov	$50.00	88	
COP	1,000	$54.10	$54,100	$2.20	17-Sep	$55.00	25	
COP	1,000	$54.10	$54,100	$2.20	15-Oct	$55.00	53	
COP	1,000	$54.10	$54,100	$2.20	19-Nov	$55.00	88	

X CO. SYM.	X PREM.	$ PREM. INC.	PREM. $ PER DAY	CONT. YIELD	CAPITAL APPR. OR (DEPR.) AT STRIKE	ANNUAL YIELD	ANNUAL YIELD W/ CAP. APPR. OR (DEPR.)	BREAK-EVEN PRICE OF SHARES
DVY	$0.60	$600	$24.00	1.35%	$480	23.50%	39.24%	$43.92
DVY	$0.90	$900	$16.98	2.02%	$480	17.74%	25.17%	$43.62
DVY	$1.80	$1,800	$15.52	4.04%	$480	16.54%	19.93%	$42.72
PG	$1.00	$1,000	$40.00	1.67%	$0	27.55%	27.55%	$59.00
PG	$1.60	$1,600	$30.19	2.67%	$0	21.58%	21.58%	$58.40
PG	$3.30	$3,300	$21.85	5.50%	$0	16.51%	16.51%	$56.70
ABT	$0.70	$700	$28.00	1.41%	$450	24.18%	37.44%	$48.85
ABT	$1.20	$1,200	$22.64	2.42%	$450	20.23%	26.48%	$48.35
ABT	$1.60	$1,600	$18.18	3.23%	$450	16.95%	20.71%	$47.95
COP	$1.00	$1,000	$40.00	1.85%	$900	31.05%	55.34%	$53.10
COP	$1.70	$1,700	$32.08	3.14%	$900	25.71%	37.16%	$52.40
COP	$2.35	$2,350	$26.70	4.34%	$900	22.08%	28.98%	$51.75

Let's discuss these worksheets in detail, because you will use this same format over and over again in making your option writing decisions.

As the number of days increases to expiration, *the rate of increase* in the amount of the premium tends to slow down. This phenomenon causes many option writers to stick more to the shorter term writing opportunities. Doing so generally makes sense, although an option writer should usually try to have diversification in the expiration dates written on different shares in the portfolio. Shorter-term call options won't give you as much downside protection as longer-term calls. So, the proper selection is dependent on your beliefs about what the near-term future holds for the market.

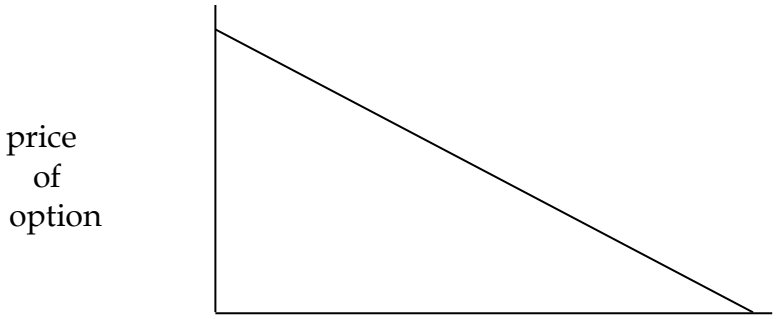
As you can see from the previous worksheet, the premium for the PG September call contract is well less than that of the October contract. Yet the premium per day, the annual yield, and the annual yield with capital appreciation/depreciation are all larger for the September contract. That is simply a function of the shorter time period until expiration. The same is true in comparing the October contract with the following January contract.

The subject of diversification was touched upon briefly and the fact that some ETFs and stocks are riskier than others, which means their prices are more volatile. That volatility is reflected in call option prices too and the yield that an investor can expect from writing call options. For example, of the stocks and ETF profiled on this worksheet, the greatest annualized yield would be for the COP September $55 calls. The premium and dividend you would receive for this transaction would give you an annualized return of 31.05%. An observer of this sheet might ask why an investor should buy any of the others when that kind of a return can be obtained writing COP options. The answer is that COP has more upward and downward price movements than the other shares, and risk

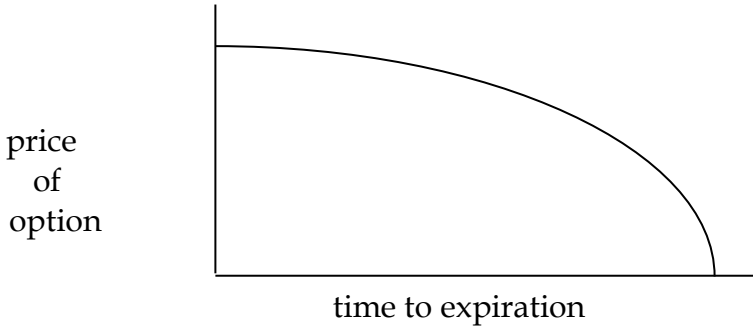
moderation is needed by buying other securities for broader equity diversification.

It is important to remember that as a retired, or prospectively retired, Boomer you are in the business of achieving your return objective through a combination of dividends and premiums received by call option writing. If your shares were called away from you at every expiration, you might be missing some upside capital appreciation in certain cases, yet you would be meeting or exceeding your objective all the time, which is what you set out to do in the first place. That's the business you are in with your ETF and individual stock investments and option writing program…and you should stick to it.

Let's say you have just written an at-the-money or out-of-the-money covered call on some of your shares. And let's further say that the price of the underlying shares remains exactly the same during the entire period until the option expires (this obviously won't ever happen, but will help make an important point). One might expect that the price of the option would decline in a straight line progression over its life until it expires worthless on the expiration date…like this.



That's not typically the way things work, however. Usually the time value of an option retains more of its value until it gets closer to the expiration date. Thus, if the share price were to remain exactly the same, for a three month call option, for example, the decline in the price of the option might look something more like this.



As you can see, with a flat share price the option holds more of its value until closer to expiration. Then it begins to fall off fast. An option writer could take some advantage of this by buying back calls to close just before expiration, say when the price of the option is only a small fraction of the original price when it was written. It wouldn't cost too much to buy them back at this time, and then the investor can write a new option at a higher premium with a longer time period to the next expiration than if the investor had simply waited for the first option to expire. The primary disadvantage of doing this is that the investor will pay additional commissions when the options are bought to close, which increases the overall cost. That's the reason why holding the options until expiration is almost always recommended. Some brokerages, however, reduce their commission costs quite a bit for option trades when the price on them is very low, which helps if you want to buy to close.

What are the advantages of writing shorter-term covered calls and the advantages of writing longer-term covered calls? Let's do an assessment:

Advantages of writing shorter-term covered calls

- Less likelihood of your shares being called away from you at expiration because there is less time for the price to go up beyond the strike price if you are writing out-of-the-money calls.
- Greater yield on investment, given the time period of the transaction.
- Greater opportunity for more capital appreciation on the underlying shares, since if the options expire worthless you may be able to increase the strike price in future option writing opportunities if the share price increases gradually.

Advantages of writing longer-term covered calls

- Larger total premium that will be available to you when credited to your account the next business day.
- Less brokerage commissions, because you won't be writing new contracts as often if the expiration periods are longer. If you were writing only one month options, you would incur three times the brokerage commissions compared with writing options with three month expirations.
- More downside protection in the event of a decline in the price of the underlying shares since the premium is greater on longer-term options.
- Less administrative work, since you only have to research option writing opportunities, handle trades and do record keeping as often as options expire.

- Ability to do some tax planning by selecting options that expire in the next tax year (more on this in Chapter 12).

Given the advantages of each, what should a call writing investor do? Here the subject of diversification again comes into play. Arguably the best strategy is to select a variety of expirations so that the options on your shares are not all expiring at once or in large amounts. That spreads out your yields to help you achieve your overall return objective, but it does something else very important.

There are some good reasons why you wouldn't want all of your options to expire on the same expiration date. If the equity markets were in a broad decline at the time of the expirations, you would be faced with a situation where your share prices may have declined significantly. You would have had some nice downside protection from the options that expired, but it could present some problems in writing your next set of options on your shares.

Let's demonstrate the problem with an exaggerated hypothetical example. Say you are diversified with five different ETFs and individual stocks. Let's also say that the difference between the price per share of these shares and the strike prices when you wrote your call options was a uniform $2 per share. That would have given you some pretty decent option writing income for the option period, regardless of when the expiration period is. The closer the market price of the shares is to the strike price when you write a call option, the higher the premium will be. Now, let's say that all of your shares go down by $4 per share between the time you wrote your options and when the options expire. That means if you write a new set of options at the same strike prices you did before, the difference now between the market prices of your shares and the strike prices of your new options will be $6 per share. That's quite a bit greater than the $2 the last time you wrote options. This means that the option premiums and yields you will receive this time will be a whole lot less than the time before that. You would either have to accept much lower returns for that next option writing period, or you would have to reduce the strike prices when you write your next batch of contracts by $4 to give you a similar return. The problem with that is if the market starts to go up again significantly, your lower strike prices would mean that you would give up some of the upside appreciation in your shares. They might be called away from you on the next expiration date at a strike price $4 per share lower than the strike price you used in the first option expiration.

There's another reason you wouldn't want the same expiration on options for all of your shares. If there was a broad rally in the market, you might get a lot of your shares called away from you and be sitting with mostly cash at a time when share prices are a lot higher. By diversifying into several different option expiration dates, it's a bit like buying a portfolio of diversified bonds with a variety of maturities, called a "bond ladder," so that you aren't faced with a large reinvestment situation at a time that may not be to your advantage.

Another diversification strategy would be to take shares in a single ETF or individual company and sell calls with different strike prices or expiration dates. For example, with 1,000 shares of PG, you might write five contracts with an October expiration and five with a January expiration using the same strike price. Or, you might write five contracts with a $60 strike price and five contracts with a $62 ½ strike price using the same expiration date. It's just another way to broaden overall risk and reward exposure.

DIFFERENT STRIKE PRICES

What has been done with the following, second worksheet is to use the very same expiration date for each of the calculations of a given security…namely, next January, which is over a half-year away (except December is used for DVY, as it does not have a January expiration). The reason this has been done is to demonstrate the effect of selecting different strike prices while maintaining the same expiration date. In these examples, the annual yield won't be as exciting. As you will remember, the longer the time to expiration the lower the yield, even though the actual premium you receive is larger with a later expiration.

Let's take a look at the DVY examples. The ETF is trading at $44.52. The first strike selected is $45, which is the closest strike price available at this time above the current market price. The next higher one is $46 and then $47. We could select strike prices both higher and lower, but remember, we are trying to select opportunities that are either at-the-money or slightly out-of-the-money and ones that will meet our overall double-digit return objective within our portfolio of ETFs and stocks.

Selecting from out-of-the-money options with the same expiration, the option that will always have the greatest premium and the highest annual yield will be the one with a strike price closest to the market price…in this case the $45 strike price. The breakeven price closest to at-the-money will also be the lowest because of the high premium relative to the other writing opportunities. You can see that at a premium of $1.80 it will provide a contract yield of 4.04%, the actual yield of the option premium on this deal, but not annualized…about one fourth as large as the annual yield of 16.54%.

The next component to look at is the capital appreciation that can be realized if the shares go up and what your overall yield will be if they are called away from you at maturity.

For the $45 strike price, the maximum capital appreciation that can be realized is $480…the strike price per share of $45 minus the current market price of $44.52 times the number of shares, which is all figured into the sheet. Your capital appreciation can't be any more if you write the $45 strike price, since the shares will be called away from you at that price on expiration if the price is greater than that. If your shares are called away, the annual yield with the capital appreciation is 19.93%…a very solid double-digit return.

SAME OPTION EXPIRATION DATE, DIFFERENT STRIKE PRICES

DATE-------->	23-Aug							
X	X	X		X	X	X		X
CO. SYM.	# SHS.	SHARE PRICE	MARKET VALUE	ANN. DIV.	OPTION EXPIR.	STRIKE	DAYS	OPTION SYMBOL
DVY	1,000	$44.52	$44,520	$1.70	17-Dec-10	$45.00	116	
DVY	1,000	$44.52	$44,520	$1.70	17-Dec-10	$46.00	116	
DVY	1,000	$44.52	$44,520	$1.70	17-Dec-10	$47.00	116	
PG	1,000	$60.00	$60,000	$1.93	21-Jan-11	$60.00	151	
PG	1,000	$60.00	$60,000	$1.93	21-Jan-11	$62.50	151	
PG	1,000	$60.00	$60,000	$1.93	21-Jan-11	$65.00	151	
ABT	1,000	$49.55	$49,550	$1.76	21-Jan-11	$50.00	151	
ABT	1,000	$49.55	$49,550	$1.76	21-Jan-11	$55.00	151	
ABT	1,000	$49.55	$49,550	$1.76	21-Jan-11	$60.00	151	
COP	1,000	$54.10	$54,100	$2.20	21-Jan-11	$55.00	151	
COP	1,000	$54.10	$54,100	$2.20	21-Jan-11	$57.50	151	
COP	1,000	$54.10	$54,100	$2.20	21-Jan-11	$62.50	151	

X	X				CAPITAL		ANNUAL	BREAK-
CO. SYM.	PREM.	$ PREM. INC.	PREM. $ PER DAY	CONT. YIELD	APPR. OR (DEPR.) AT STRIKE	ANNUAL YIELD	YIELD W/ CAP. APPR. OR (DEPR.)	EVEN PRICE OF SHARES
DVY	$1.80	$1,800	$15.52	4.04%	$480	16.54%	19.93%	$42.72
DVY	$1.10	$1,100	$9.48	2.47%	$1,480	11.59%	22.05%	$43.42
DVY	$0.75	$750	$6.47	1.68%	$2,480	9.12%	26.65%	$43.77
PG	$3.30	$3,300	$21.85	5.50%	$0	16.51%	16.51%	$56.70
PG	$1.95	$1,950	$12.91	3.25%	$2,500	11.07%	21.14%	$58.05
PG	$0.90	$900	$5.96	1.50%	$5,000	6.84%	26.99%	$59.10
ABT	$2.40	$2,400	$15.89	4.84%	$450	15.26%	17.46%	$47.15
ABT	$0.70	$700	$4.64	1.41%	$5,450	6.97%	33.55%	$48.85
ABT	$0.12	$120	$0.79	0.24%	$10,450	4.14%	55.12%	$49.43
COP	$2.85	$2,850	$18.87	5.27%	$900	16.80%	20.82%	$51.25
COP	$1.80	$1,800	$11.92	3.33%	$3,400	12.11%	27.30%	$52.30
COP	$0.65	$650	$4.30	1.20%	$8,400	6.97%	44.50%	$53.45

Let's look at the next opportunity. The next higher strike price is $46. At a premium of $1.10 it offers a 2.47% contract yield, and an 11.59% annual yield, about 5% less than the $45 strike price. But the capital appreciation opportunity goes from $480 with the $45 strike price to $1,480 with the $46 strike price. So, if your shares were called away from you at $46 at the expiration, your annual yield including the capital appreciation would be 22.05%. To take this one step further, if you selected a strike price of $47, with a premium of $0.75 your

contract yield would be 1.68% and the annual yield would be 9.12%. But if your shares were called away from you at $47 on expiration, your capital appreciation would go up to $2,480 and the annual yield including the capital appreciation would be 26.65%.

If you owned DVY and were looking today at writing call options on it, what would an investor's thinking process be in deciding what to do? The first thing is to be sure that the term of expiration fits into your overall plan for diversifying your call option portfolio. Another consideration would be what you think will happen to DVY's price in the next year or so. If you feel strongly that it has good appreciation potential, then you might opt for one of the higher strike prices to try to get the additional capital appreciation. As long as the annual yield you select fits into your overall average portfolio objective, then perhaps you go for the option offering greater capital appreciation. But remember, the option premium is a bird in the hand. Appreciation potential by using a higher strike price is a bird in the bush. Or, as Warren Buffett commented in his Berkshire Hathaway Annual Report, "A girl in a convertible is worth five in the phonebook!"

If you really don't have a strong feeling about the shares going up, then it might be best to just get the higher premium, because that will give you more cash income up front and a bit more insurance toward the downside too. That will generally be the best strategy for Boomers that are seeking to maximize income.

Your decision must be balanced with the other things you are doing in your portfolio and with your outlook for each specific ETF and company. For example, with a higher yield on COP calls you might settle for a lower yield, and more capital appreciation opportunity, on the DVY calls, but still reach an overall double-digit annualized yield…whatever your objective might be. Some option writers always go with an at-the-money or the closest out-of-the-money option to maximize the option writing income. Others like a higher strike price to get more of a balance between option writing income and capital appreciation opportunity. Some even prefer in-the-money call writing to obtain a large amount of downside protection, even though it eliminates any potential for upside gain. There's no single best way for everyone. All can be good, depending on what your objectives and needs are…and your outlook for the specific shares in your portfolio as well as economic conditions generally.

As a guideline, though, in assessing the relative attractiveness of option writing opportunities you should focus on the "Annual Yield" column the most. This is the annualized return based on current dividends and premiums. Capital appreciation may or may not materialize, so one should not get too starry eyed by the big percentages that appear in the next to last column.

WRITING IN-THE-MONEY COVERED CALLS

Recognizing that the primary focus for Boomer covered call writers will be on at-the-money and slightly out-of-the-money calls, we will nonetheless now shift our focus to those strike prices where the current market price is greater than the strike price…the in-the-money calls.

IN-THE-MONEY DVY CALLS

DATE-------->	23-Aug							
X	X	X		X	X	X		X
CO. SYM.	# SHS.	SHARE PRICE	MARKET VALUE	ANN. DIV.	OPTION EXPIR.	STRIKE	DAYS	OPTION SYMBOL
DVY	1,000	$44.52	$44,520	$1.70	17-Sep	$42.00	25	
DVY	1,000	$44.52	$44,520	$1.70	15-Oct	$42.00	53	
DVY	1,000	$44.52	$44,520	$1.70	17-Dec	$42.00	116	
DVY	1,000	$44.52	$44,520	$1.70	17-Sep	$43.00	25	
DVY	1,000	$44.52	$44,520	$1.70	15-Oct	$43.00	53	
DVY	1,000	$44.52	$44,520	$1.70	17-Dec	$43.00	116	
DVY	1,000	$44.52	$44,520	$1.70	17-Sep	$44.00	25	
DVY	1,000	$44.52	$44,520	$1.70	15-Oct	$44.00	53	
DVY	1,000	$44.52	$44,520	$1.70	17-Dec	$44.00	116	

X	X							
CO. SYM.	PREM.	$ PREM. INC.	PREM. $ PER DAY	CONT. YIELD	CAPITAL APPR. OR (DEPR.) AT STRIKE	ANNUAL YIELD	ANNUAL YIELD W/ CAP. APPR. OR (DEPR.)	BREAK-EVEN PRICE OF SHARES
DVY	$3.00	$3,000	$120.00	6.74%	($2,520)	20.73%	20.73%	$41.52
DVY	$3.35	$3,350	$63.21	7.52%	($2,520)	17.66%	17.66%	$41.17
DVY	$3.90	$3,900	$33.62	8.76%	($2,520)	14.39%	14.39%	$40.62
DVY	$2.15	$2,150	$86.00	4.83%	($1,520)	25.34%	25.34%	$42.37
DVY	$2.50	$2,500	$47.17	5.62%	($1,520)	19.65%	19.65%	$42.02
DVY	$2.95	$2,950	$25.43	6.63%	($1,520)	14.42%	14.42%	$41.57
DVY	$1.25	$1,250	$50.00	2.81%	($520)	28.09%	28.09%	$43.27
DVY	$1.60	$1,600	$30.19	3.59%	($520)	20.77%	20.77%	$42.92
DVY	$2.35	$2,350	$20.26	5.28%	($520)	16.95%	16.95%	$42.17

As we have seen, at-the-money calls provide the greatest amount of "premium dollars per day" of all call writing opportunities. The out-of-the-money calls provide premium income as well as an opportunity for additional capital appreciation. Unlike either of these writing opportunities, the in-the-money calls start out with a build-in amount of capital depreciation, because if your shares are called away it will be at a strike price that is less than the market price at the time you write the call contracts.

An obvious question needs to be answered. Why would anyone want to put themselves in a situation where they are likely to realize capital depreciation of their investment? The answer is straight forward. Because the premium received is so large, it more than compensates for the depreciation loss in the underlying shares. When considering the very substantial premium income and subtracting the capital depreciation of the shares, the net gain from dividends and premium can still generate double-digit returns as well as provide significantly greater downside protection than out-of-the-money calls or at-the-money calls.

The worksheet on the preceding page consists of in-the-money examples utilizing the DVY ETF.

Writing in-the-money calls can provide excellent results when the price of the underlying security…in this case the DVY… remains flat or has decreased to any degree down to the strike price from the date the calls were written to the expiration date. A profit may even be realized if the market price is somewhat below the strike price at expiration. Any closing price at expiration that is equal to or greater than the strike price would leave the investor in the same profit position that was initially projected on the worksheet.

As you look at the worksheet note the following:

UNIVERSAL TRUTH:

> **For in-the-money calls, the more the strike price of the underlying security is below the market price, the larger the premium and the less the annual yield.**

This sounds like a contradiction. How can the annual yield become less when the premium becomes greater? If you write in-the-money calls, you are putting yourself in a situation where there is a good likelihood that the calls will be exercised (your shares sold) if you do not buy back the call prior to expiration. You are writing calls with a strike price that is actually below the current market value of the shares. Also, you will always experience a depreciation of capital on the shares when considering what their value was on the day the option contracts were written compared with their value if they are called away from you at the strike price. This will be true whether the DVY price increases, stays the same, or declines but remains above the strike price.

On the plus side, the premium increases with each reduction in strike price. However, you will also note that the amount of the capital depreciation in the shares increases by an amount equal to the reduction in strike price times the number of shares. For example, writing a $42 strike price vs. a $43 strike price would result in an additional $1,000 in capital depreciation ($1 x 1,000 shares).

The bottom line is this. The more the call is in-the-money the less the increase in premium compensates for the increase in capital depreciation of the shares. In other words, as the amount by which the price is in-the-money

increases, the share capital depreciation increases at a faster rate than the increase in premium. The result is a lower annual return as the amount by which the price is in-the-money increases. The annual return is only calculated on the amount of premium that constiitutes time value, not intrinsic value.

This makes sense, because the greater the premium the more downside protection you receive. Using DVY at a market price of $44.52, just look at the difference between writing an out-of-the-money call in the earlier example with a $47 strike price compared with an in-the-money call with a $42 strike price for the December expiration. For the $47 strike price, if the market price of the DVY were below $43.77 you would incur a loss. For the $42 strike price, the market price would have to decline below $40.62 before a loss would be realized. The lower in-the-money strike price provides additional downside protection of almost 9% of the current market price during just a four month period of time. This is substantial additional downside "insurance."

THE ESSENTIAL QUESTION REVISITED

The most important question the call writer must try to answer to make the best call writing decision is: ***What do I think is going to happen to the market price of my underlying security during the expiration date timeframes I am considering?***

The answer to this question has not become any easier by introducing in-the-money calls into the equation. Here is what can be said regarding the merits of writing in-the-money calls vs. out-of-the-money calls.

UNIVERSAL TRUTH:

If you are examining two different opportunities to write covered calls with the same expiration date and

- **one of them is out-of-the-money and one of them is in-the-money; and**
- **the annual yield of both is approximately the same; then**

if the price of the underlying security declines, your investment return will always be better with an in-the-money call compared with an out-of-the-money call. (Note: the converse is also true, in that, given the above set of facts, your investment return will always be better with an out-of-the-money call compared with an in-the-money call if the price of the underlying security rises.)

Therefore, in-the-money calls should be considered when expecting a declining market and you wish to benefit from the larger premium.

In studying the worksheet you will note that the "Annual Yield" and the "Annual Yield W/ Capital Appr. or (Depr.)" calculations produce the same

result for in-the-money calls. This is logical, because at the time the calculation is made the expectation would be that the stock would be called away at the expiration date, since the market price of the DVY is already greater than the strike price. The only instance in which your shares would not be called away would be if the market price on the expiration date closed at or below the strike price. The market price of the shares would have to decline fairly significantly for that to happen with a deep in-the-money call. Also, in computing the annual yield, the amount by which the DVY is already in the money is subtracted from the current market price when computing the percentage yield. The reason for this is that at the time the call contracts are written the portion of the premium that is in-the-money (the intrinsic value) should be considered as a return on capital, with only the time value portion used to compute the return. This would be consistent with the computation for out-of-the-money calls where the entire premium is time value and none is intrinsic value.

To help clarify the potential use of in-the-money vs. out-of-the-money calls, let's look at several different scenarios where assumptions are made about the price of the DVY on the expiration date to see what the consequences would be and what would have been the best call writing strategy. We will take all of the out-of-the-money and in-the-money call writing opportunities using the December expiration date, as follows:

DVY: IN-THE-MONEY CALLS AND OUT-OF-THE-MONEY CALLS WITH DECEMBER EXPIRATION

DATE-------->	23-Aug							
X	X	X		X	X	X		X
CO. SYM.	# SHS.	SHARE PRICE	MARKET VALUE	ANN. DIV.	OPTION EXPIR.	STRIKE	DAYS	OPTION SYMBOL
DVY	1,000	$44.52	$44,520	$1.70	17-Dec	$42.00	116	
DVY	1,000	$44.52	$44,520	$1.70	17-Dec	$43.00	116	
DVY	1,000	$44.52	$44,520	$1.70	17-Dec	$44.00	116	
DVY	1,000	$44.52	$44,520	$1.70	17-Dec	$45.00	116	
DVY	1,000	$44.52	$44,520	$1.70	17-Dec	$46.00	116	
DVY	1,000	$44.52	$44,520	$1.70	17-Dec	$47.00	116	

X	X				CAPITAL		ANNUAL	BREAK-
CO. SYM.	PREM.	$ PREM. INC.	PREM. $ PER DAY	CONT. YIELD	APPR. OR (DEPR.) AT STRIKE	ANNUAL YIELD	YIELD W/ CAP. APPR. OR (DEPR.)	EVEN PRICE OF SHARES
DVY	$3.90	$3,900	$33.62	8.76%	($2,520)	14.39%	14.39%	$40.62
DVY	$2.95	$2,950	$25.43	6.63%	($1,520)	14.42%	14.42%	$41.57
DVY	$2.35	$2,350	$20.26	5.28%	($520)	16.95%	16.95%	$42.17
DVY	$1.80	$1,800	$15.52	4.04%	$480	16.54%	19.93%	$42.72
DVY	$1.10	$1,100	$9.48	2.47%	$1,480	11.59%	22.05%	$43.42
DVY	$0.75	$750	$6.47	1.68%	$2,480	9.12%	26.65%	$43.77

Note that the largest annual yield is achieved by writing calls that are closest to at-the-money. Going from there to the strike prices that are above and below, the yield resembles a bell curve, declining in either direction. Even though the yields are lower on both ends of this bell curve, they are lower for far different reasons. In the case of in-the-money calls, it is because the large premium received when writing these calls provides such substantial downside protection and accordingly reduces investment risk. In the case of out-of-the-money calls, it is due to the significant additional capital appreciation which could still be earned by the call writer if the price of the DVY should advance to the higher strike prices. It is simply a matter of accepting a lower return either to reduce risk or to increase reward. This leads us to the next maxim:

UNIVERSAL TRUTH

> **Whether the tradeoff is warranted for accepting a lower yield to increase downside protection or a lower yield to increase capital appreciation, maximizing the opportunity rests on your ability to predict which way the market will go over the term of the call contract. Absent an ability to make such a prediction, data suggests that the best course of action may be to select the strike price closest to the current market value (at-the-money) when writing calls. This will generally be the best strategies for Boomers anyway, as we will usually be seeking the highest possible income for retirement.**

There is one more positive attribute of writing in-the-money calls. Since these calls can provide significantly more premium income, and since this income is credited to your account the next business day after the transaction is completed, there is an opportunity to reinvest this cash in additional shares upon which more covered calls can be written to produce even more income. Alternatively, the cash can be used to support put option writing for additional premium income, which we will be exploring shortly.

SHOULD YOU BUY BACK IN-THE-MONEY CALLS NEAR EXPIRATION?

It has been mentioned previously that this covered call writing program generally provides that the investor not take any further action after writing a call until the option contracts expire. An exception to this could be when in-the-money calls are written and remain in-the-money as expiration is about to occur. Why? First, if the share price is in-the-money at expiration, the shares will be called away at a loss when compared to the share price at the time the call contracts were written. Buying back the calls to close prior to expiration means the investor avoids selling the shares at this loss. Purchase of the options to close

could result in a gain or loss on the option contracts, depending on their price, which obviously is also a consideration.

DIVIDEND CAPTURE FOR IN-THE-MONEY CALLS

Secondly, and very important, is the capture of dividends. Since this guidebook focuses on writing options on high yielding ETFs and individual stocks, it is always going to be necessary to know the ex-dividend dates of your holdings if expiration is approaching and your shares are trading in-the-money. One of the times that early exercise and assignment of shares occurs the most is when the underlying shares are trading in-the-money and an ex-dividend date is about to occur on the shares…especially if the option expiration date is also about to occur in a matter of days or within a couple of weeks. Buyers of options often watch the trading level of the shares and are aware of the ex-dividend date, to the point that when the ex-dividend date will occur shortly before the option expiration date, they will exercise their options to buy your shares by the day *before* the ex-dividend date in order that they may capture the dividend rather than you doing so. You can beat them to the punch by also being aware of this situation and buying back your call options to close well before the expiration date to be sure that the dividend will belong to you. To determine the ex-dividend date for any ETF or individual company, I suggest you simply go to www.google.com, type in the name of the ticker symbol followed by "ex-dividend date" into the search box (for example "DVY ex-dividend date"), and you will find listed a number of Web sites you can go to that will tell you what the ex-dividend date is. If your shares are called before the ex-dividend date, you will miss out on the dividend, so a word to the wise on this subject can pay big dividends…pardon the pun. Do this search early each quarter on dividend paying ETFs and stocks that you own on which you have written covered calls.

A case can be made that it would make sense to buy back in-the-money calls at any point when the time value is zero or very small. Subtract the strike price for your options from the current market price of the stock. Take that number and subtract it from the current price of the option. If the result of this calculation approaches zero, then it would make sense to buy back the call option and keep your shares. You have achieved your objective. Consider buying back the calls and writing a new call. This can also be done to avoid a potentially negative consequence known as the "wash sale rules" described in Chapter 12. See the sections on "rolling forward" and "rolling up" in that chapter for detailed information on how to exit existing call writing positions and still maintain profitability without having your shares called away from you.

Are we having fun yet? On to put writing.

5

THE FUNDAMENTALS OF PUT OPTION WRITING

I am having an out-of-money experience.

Have you been tempted at times to buy a particular stock, but decided not to because you thought it might be overpriced…or you thought you might be able to pick up the shares at a lower price at some time in the near future? Not only might it be possible for you to buy that stock for less, but what if someone were willing to pay you cash today at a double-digit investment rate and also give you the opportunity to buy it at a lower price later? Does that sound too good to be true? It's not. It's called put option writing, and it's available to you on literally thousands of individual stocks and Exchange Traded Funds (ETFs), many of whose names you would recognize immediately. These include most of the high yielding dividend stocks and the ETFs that this guidebook suggests in Chapter 1 should be reviewed and may be attractive to Boomers seeking to retire or who are already in retirement.

Is this a risky proposition for the investor? Not if you are committed to buy the stock at a lower price anyway and have the resources to do it. Why is put option writing virtually unknown to individual investors? After almost thirty years of experience using options with investing and listening to what others have to say, here is my belief: people are easily intimidated by something they don't understand even if it may benefit them. That applies not only to investments but to many things.

Early in my banking career we commissioned a research project on why certain segments of the population don't use ATMs (automatic teller machines) more often. What we discovered was that people who don't use ATMs avoid them for fear of looking stupid. This is especially true of the older generation. They are afraid that someone will see them having trouble when they are trying to get cash out of the machine or trying to make a deposit. It's not that they aren't capable of making the ATMs work with their cards. They just haven't been properly trained on how to perform these functions and they don't want to be caught looking foolish. I'm sure we all have things we don't try because we don't understand them, and the fear of doing something stupid or being perceived as such can be a great inhibitor.

I believe that this principle also applies to many individual investors about using options…especially Boomers like myself who may be very reluctant to try them out if they are not already familiar with them. Let's face it, we Boomers are

getting older and therefore are inherently getting more resistant to trying something new.

Moreover, individual investors are left with the impression that those who use options are exposing themselves to huge risk where they might lose a substantial amount, if not all, of their investment. And that can actually be true for some uses of options. But what is unknown by most individual investors is that there are a few option strategies…not many, but a few…that are *very conservative*. As we have discussed in detail in the preceding chapters of this book, some, such as covered call writing, are even more conservative than simply owning stocks alone. Used appropriately, writing put options can be another such conservative strategy. For investors who would like to buy shares at a lower price than they are currently trading and would like to pick up some additional income (at double-digit rates of return) while waiting, writing put options can be a very viable and profitable strategy.

What follows offers a turnkey program that delivers a comprehensive and easily understood education on the subject and also provides a complete program for self-implementation. It's not at all intimidating and, as with the covered call writing program, can be practiced and executed in the privacy of your home or office using your computer together with this book. Used appropriately, put option writing has many of the risk/reward characteristics of covered call writing. And the strategy fits perfectly with the slow-growth economy and the "new normal" we are expected to experience for years to come.

THE KEY DISCUSSION TOPICS

This phase of our program will revolve around a discussion of put option writing, similar to the previous discussion on covered call writing. Some of it will sound familiar in approach, however the target of the discussion is in some ways a mirror image of discussion about covered calls, even though the two disciplines have similarities in many respects regarding risk and reward. Much of the background information previously provided regarding general information on options does not need to be duplicated here, so we will begin with the information you need that specifically relates to put writing.

PUT OPTION WRITING IN A NUTSHELL

Here is an abridged description of what put option writing is all about. You will not be *buying* put options, which is a potentially high-risk strategy, but rather you will be *selling*, also known as *writing*, put options on shares you have an interest in acquiring at a lower price while earning cash at the same time you wait. If managed according to the program outlined in this book, it can be a conservative, yet potentially lucrative option investing strategy.

When you sell a put option contract you are selling a window of time in which the buyer of the option has the right to sell shares to you of the individual stock or ETF of your choice at a predetermined price. The put buyer is hoping that the price of those shares is going to go down significantly during this window of time that the option is active…in other words, before the option expires. Again, when you sell a put option, you are performing a transaction known as "writing a put" or just "put writing." By writing puts, you can potentially acquire shares in a company or ETF that you would like to own at a price less than they are trading at today and receive income for doing so. You can also predict with greater accuracy how much money you will make, and you can help stabilize your profits. Selling the right to others to sell shares to you at a lower price gives you the ability to earn significant investment returns, and the buyer of the puts immediately pays you cash to do this. This is the opposite of covered call writing where you are selling the right to buy shares from you at a predetermined price.

As we review some definitions, examples and calculations, you will become much more comfortable with how it works. It will become second nature to you and you will be ready to start making money with the program.

Before advancing to that level, however, it is time to answer some questions.

WHAT STRUCTURE IS RECOMMENDED FOR A PUT OPTION WRITING PROGRAM?

Under this program you will write puts where the strike price on the options is generally *lower* than the current market value of the shares on which you are writing options. With reference to put options, this is referred to as being "out-of-the-money." For example, if the current price of shares you are interested in is $28 and you write a put option with a $25 strike price, the option is said to be out-of-the-money by $3. That is the difference between the market price of the shares when a put option is written and the strike price of the put option. The put buyer's shares would be sold to you, that is to say "put to you," or "assigned," if their price is below $25 per share on the option expiration date. You keep your option premium, plus you would pay $25 for the shares you would be buying, which is $3 per share less than it was when you wrote the put option.

If you were to write a put option with a strike price *higher* than the current price of the shares, the option is then said to be "in-the-money." For example, if the current price of the shares is $28 and you write a put option with a $30 strike price, the option is said to be in-the-money by $2. You would receive a significantly higher premium by writing an in-the-money option when compared to an out-of-the-money option, but you are immediately placed into a situation where you would be required to purchase the shares at a higher price

than they are currently trading if they remain about the same price at expiration. If the price in this example remained the same until expiration, you would pay $30 for shares that are only worth $28 at the time you wrote the option, or a loss of $2 per share. However, due to the very large premium collected, it is still possible to realize a net gain (premium less capital depreciation on the shares) while providing greater downside protection from loss than writing out-of-the-money puts. Nonetheless, the program recommended in this book principally involves writing out-of-the-money puts in order to provide both premium income as well as entering stock purchases at a lower price.

Finally, when the market price of the shares is the same as, or very close to, the strike price of an option, the option is said to be "at-the-money." An example of this would be if you were interested in writing a put option with a strike price of $30 and the underlying shares were selling at $30 per share, or very close to that price.

All of this will be simplified shortly with more detailed examples.

WHAT ABOUT PUT STRIKE PRICES AND EXPIRATION DATES?

The subject of strike prices and expiration dates have been fully developed in the discussion about covered call writing. What you have already learned applies. There is nothing new that needs to be added here, other than the fact that put strike prices are listed separate from call strike prices.

HOW DOES PUT WRITING WORK?
DO I OWN THE UNDERLYING SHARES?

No. That is a major difference between covered call writing and put writing. When you write put options you do not own the underlying shares already, nor do you buy them now. By entering into a put contract, you commit to buying 100 of the underlying shares per put contract if the buyer of the put contracts exercises his option to sell you the shares at the strike price at any time during the life of the contract. In most cases this would occur after option expiration, and then only if the underlying shares expire in-the-money, but the buyer can exercise at any time.

WHO RECEIVES THE DIVIDENDS?

Dividends are always received by the owner of the shares. As the writer of puts, you do not own the shares and are therefore not entitled to receive the dividends. If, at expiration, the shares are put to you and you become the owner of the shares, you will then receive the dividends for as long as you own the shares.

WHAT IF THE UNDERLYING SHARES A PUT IS WRITTEN ON RISE SIGNIFICANTLY IN PRICE?

Obviously a rise in the price of shares can occur at any time when a market rally takes place. When you write put options and the price of the underlying security rises, the price of the put options goes down. This is because the stock price is moving further away from the strike price, which makes the puts less valuable. If this occurs, as the put writer you could then buy the options back at a lower price than you sold them for and realize a profit on the difference. This represents a very different characteristic from covered call writing. When covered calls are written on shares that are owned and the share price rises, the price of the calls rises as well. It is therefore not normally attractive to liquidate a covered call position until close to expiration (when time value of the options has mostly expired) or when the shares are assigned at expiration. In the case of put options, when the share price rises significantly, much of the gain may possibly be captured fairly early into the contract period. The writer may in some cases have the opportunity to buy back the put option at a fraction of the initial writing price, pocketing most of the gain well before the expiration date, and with the ability to then write another put to take advantage of the time remaining.

Alternatively, the put writer can wait until expiration when the puts would no longer have value, as option values gradually decay the closer the time comes to the expiration date. Time is your friend, and you have realized the entire premium income as gain.

Even though the put writer is a winner in a rising market, a rapidly rising stock price could be considered a downside to put option writing. If by the expiration date the price of the underlying security increases by more than the premium you were paid by the put buyer, you may have been better off simply purchasing the stock than writing the put. As we will see later, your investment capital allocated to writing the put is often significantly smaller than the cash outlay would be to purchase the shares (unless the put contracts are "cash covered" as will be discussed later), so you are still better off unless the price increases by much more than the premium you received. Another point to be made is that if the stock price increases you didn't get the opportunity to purchase the shares at the strike price of the put option you wrote. But, while the option writer may have "lost" in the sense that writing the put did not result in as great a return as the rise in the shares would have provided, by receiving the premium income the investor has obtained the maximum return objective sought when the puts were initially written. That is a downside with an upside!

WHAT IF THE UNDERLYING SHARES A PUT IS WRITTEN ON DECLINE SIGNIFICANTLY IN PRICE?

If there was no possibility that share prices could decline, everyone in the world would invest everything they have in the stock market. In cases where the underlying shares go down in price, you can wait to see if the shares remain in that position and are below the strike price, at which time you may be required by the buyer to purchase them. Another choice available to you is to buy back the put at what could be a higher price than you initially sold it for. By doing this you remove your obligation to purchase the shares. This is seldom recommended unless you have changed your mind about owning shares in the company or ETF subject to the put. If you were truly comfortable with owning the underlying shares at the strike price when the put was written, you should simply wait until the expiration date occurs, in which case the shares will be assigned to you at the strike price. Another strategy for what to do with these newly acquired shares is discussed in Chapter 9.

WHAT IF I AM NOT REQUIRED TO PURCHASE THE SHARES AT EXPIRATION?

It varies, but reports indicate about eighty-percent of the time options that are out-of-the-money or at-the-money when written expire without being exercised. If the expiration date comes and goes and the buyer does not exercise his put option, this means you have earned the premium and no further action is required. You can then write another put and collect another premium.

UNDER WHAT CIRCUMSTANCES WILL I BE REQUIRED TO PURCHASE THE SHARES?

You can anticipate having the optioned shares put to you, referred to as being "assigned," any time your option becomes in-the-money. Assignment almost always occurs at expiration if the market price of the shares is lower than the strike price, although it could possibly happen at any time during the term of the option contract if the buyer of the option wanted to exercise the right earlier.

WHAT ARE THE BENEFITS, FEATURES AND RISKS OF PUT OPTION WRITING?

In Chapter 2 the benefits, features and risks of covered call writing were outlined. Most of those also apply to put option writing except the receipt of dividends as previously discussed. We will add to the list as follows for those that are unique to put writing:

Benefits and Features:

1. **Opportunity to purchase stock at a lower price** – Puts should only be written on stocks and ETFs that you would find attractive to own at a price you specify, as you may be called upon to purchase the shares subject to the put option should the price decline. Since the program recommended for you in this guidebook primarily involves the writing of out-of-the-money puts, you would purchase your shares at a lower price than was available to you at the time the puts were written.

2. **Predetermined return –** The investment return you receive from put writing can be evaluated prior to initiating the investment position. You will know what the put writing income will be, how much in cash or securities you will be required to maintain in your account when the put options are written and the investment you will make in the underlying shares if the market price falls below the strike price at expiration.

Risks:

1. **Limited gains in a rising market during the option term –** An option writer's potential gain is limited to the amount of put writing income received. Depending on the strike price and the extent of a rise in the underlying shares prior to the expiration date, the option writer, while still in a profitable position, faces the risk that he might have been better off financially to have purchased the shares outright rather than to have written put options in a rapidly rising market.

2. **Investment leverage –** Put option writing in a personal taxable account requires a margin account (depending on the broker's definition of margin). Put writing requires the maintenance of a margin requirement, not ownership of shares. Therefore the amount of investment is less, thereby increasing leverage and offering greater potential investment returns and greater risk.

CAN AN INVESTOR WRITE PUTS IN AN IRA OR OTHER EMPLOYEE BENEFIT ACCOUNTS?

In the past, most brokers only allowed put writing in personal accounts, even though the Securities & Exchange Commission and the Internal Revenue Service will allow such trading in IRA accounts and other retirement accounts over which an individual exercises control. Some brokerage firms (including Fidelity Investments and Charles Schwab & Co.) now allow put writing in retirement accounts such as IRAs. With the proper approval level, the investor

can write put contracts to the extent that there is adequate cash in the account to acquire the number of shares subject to the put contracts (so-called "cash covered" puts). For example, if an investor wished to write 10 put contracts on a stock with a strike price of $60 in his IRA account, the brokerage would freeze $60,000 of the cash in the account until option expiration. If the option contracts are assigned (either before expiration or at expiration) the cash would be available to purchase the shares. If the contracts are not assigned, the cash would again be free to acquire other securities or to use to support additional put writing. Cash covered put writing can be an attractive alternative strategy along with covered call writing for retirement accounts. The last two columns of the "Put" Excel® template can be used to calculate the amount of cash that would be required for cash covered put writing and the corresponding annualized return from the transaction.

6

HOW PUT OPTION WRITING WORKS

If at first you don't succeed, destroy all evidence that you tried.

If you are new to put option writing, we need to look first at a typical put transaction from the *buyer's* perspective, similar to the way we looked at covered call writing. Working through the "buy" side helps with understanding what you will be doing on the "sell" side, which is *your* side of the transaction. For purposes of simplicity, commissions will not be included in any of the following examples. In Chapter 10 we will discuss how you can keep commissions down to a reasonable minimum. But for now, just remember that there will be some commissions involved that will affect these numbers a bit.

THE PUT BUYER'S (SPECULATOR'S) SIDE OF THE TRANSACTION

We will be using examples with Proctor & Gamble (ticker symbol PG) frequently in this section of the book, however the same principles would apply using any individual stock or ETF. Let's say that PG is selling for $60 per share on the third Friday in August (which means that August puts are expiring, as the third Friday of every month is the last day of trading for most expiring options). "Mike," as we will call the investor and buyer of puts, thinks that PG may be poised to fall, so he buys ten PG put contracts with an October expiration date and with a strike price of $57 ½ per share. The premium quote is $.79 per share. Each put contract covers 100 of the underlying shares. So during the term of this option Mike controls 1,000 shares of PG. The price he pays for this, the option premium, is $790 ($.79 premium per share x 10 contracts x 100 shares per contract).

The price of the shares relative to the strike price of the put option is a major factor in the price of the premium. If the price of PG is $60 per share, it only needs to trade $2 ½ per share lower to reach a $57 ½ strike price, while it would need to trade $5 lower to reach a $55 strike price (strike prices are established in $2 ½ increments for PG). Since the likelihood is obviously much greater that PG's price may reach $57 ½ by the end of the same expiration period than $55, the price of the option for a $57 ½ strike will be significantly higher than the $55 strike. In other words, for out-of-the-money puts, the further the strike price is from the current market price of the shares, the smaller the put option premium will be. Correspondingly, the closer the strike price is to the current market price of the shares the greater the put option premium.

If it is now August and you are writing an option, you would expect to receive a larger premium for a put that will expire, say, in October than one that will expire in September. If you are granting the put buyer the option to sell PG shares at a specific price until October, the buyer has a lot more time for the price to go down than if the option expires in September. For that reason, the buyer will have to pay more for puts with the October expiration than for the September expiration.

Another factor that can affect the level of option premiums is the economic environment and its impact on the volatility of equity prices. Volatility in the underlying securities is a key driver of option premiums. During rapidly moving markets in both directions, option premiums tend to increase. The more volatility, the greater the option premiums. However, even during less volatile times when option premiums tend to narrow, the good news is that an investor can still find very acceptable option premiums to reach target investment objectives.

Back to the PG example. How does this work for Mike as the option buyer? The buyer of a put is often a speculator. In this case Mike is speculating that the price of PG will fall fairly quickly so he can make his profit. The puts he has purchased will go up and down *inversely* with the price of PG.

The put option contracts, just like the underlying shares they represent, continue to be traded on the open market after the buyer purchases them. In the short run, if the price of PG would fall, then the price of the put contract should rise. And the price of the option would rise at a higher percentage rate than PG would decline, because the purchase of an option provides "leverage." One of the put buyer's alternatives, if he wished to place a negative bet on PG, would be to initiate a "short sale" for 1,000 shares. Instead, in this case, for a price of $790 Mike has control, for a two month time period, of 1,000 shares of PG worth $60,000. If PG would fall from $60 to $58 the next day after the trade, a short seller of PG shares would have a gain for that day of 3.3%. The put option, however, might in turn rise to $1.70 or a gain of $900, 115% above the option purchase price. The buyer, if he wished to, could then sell his option contracts on the open market and pocket his gain on the transaction. Under our program, this does not affect you and your option strategy, other than the amount of investment you will be required to maintain in your brokerage account, which will be discussed in detail. You will normally just sit on your put options and wait for the expiration date to pass.

If Mike decides to sell his puts, this does not affect you at all. Specific buyers and sellers of options are not matched together unless the underlying shares are assigned at expiration. Either party can get out of his put position through his broker, just like a trade in the underlying shares. That is what makes options fungible.

This demonstrates the reason why a speculator might choose to buy an option rather than initiate a short sale of the actual PG shares. Had Mike shorted

1,000 shares of PG at $60 and repurchased them at $58 his investment risk would have been $60,000 and his profit $2,000, for an immediate return of 3.3%. By buying the option contracts instead, he realized almost a 115% profit on his investment but tied up only $790 of his capital in the process. This sounds terrific, but what is the downside? If PG had risen from $60 to $62 the value of his options would decline, perhaps going from $.79 to $.40. This would represent a loss of $390 or almost 50% of his investment. Had he sold short PG itself and it increased to $62, the percentage loss would only be 3.3%.

One can begin to see the speculative nature of *buying* puts. By purchasing put options a person can control a very large number of shares with very little money when compared with a short sale of the underlying shares. This means the potential for big gains and big losses, although the amount of potential loss is known with the put contracts. And, of course, short selling itself is considered a speculative strategy. There is another major difference between buying a put option versus selling the underlying shares short. Options expire, but stocks and ETFs do not. If an option buyer continues to hold the option, and if the price of the underlying shares does not fall below the option strike price at expiration, the options will always be completely worthless. So, if an investor is a buyer of put options, he not only has to be right about PG going down and by how much, he has to be right about *when* it goes down!

Let's reacquaint ourselves again with two terms…"intrinsic value" and "time value" of options. The terms "in-the-money," "out-of-the-money" and "at-the-money" have been discussed at length, which have to do with the relationship between the option strike price and the current market value of the underlying shares on which options are being written. The "intrinsic value" of a put option's price is the dollar amount by which the market price is less than the strike price of the underlying shares…the amount it is in-the-money. For example, if PG is trading at $58 ½ per share and the strike price of a put option is $60, then the intrinsic value of the option is $1.50. If the price of PG and the strike price are the same, then the intrinsic value is $0. It is also $0 if the market price is any amount greater than the strike price. Obviously this can change at any given moment as the price of PG moves up or down in trading. The strike price of a specific option is fixed until its expiration, but the market prices of the underlying shares and the option normally change constantly as trading takes place. So a given option premium can have intrinsic value at times when the market price of the shares goes below the strike price and have no intrinsic value when the shares are above the strike price.

The "time value" of a put option premium is the market price of the option less the amount of intrinsic value. It is the value of the time remaining until the option expires. The longer the time between the current date and the expiration date the greater the time value of the option. This can be best understood through examples.

Assume the following. You have written a put option on PG. The strike price is $60, the current market price of PG is $57 and the current price of the option is $4. Since the strike price is higher than the market value of the shares, the intrinsic value is determined by subtracting the market price from the strike price, which gives an intrinsic value of $3. The time value is then determined by taking the current option price of $4 and subtracting the intrinsic value. The time value is therefore $4 minus $3, or $1. Another way to say this is that the intrinsic value is the amount by which the underlying shares are in-the-money. The time value is the rest of the price of the option.

Let's look at a second example. You have written a put option on PG. The strike price is $60, the current market value of PG is $61 and the current price of the option is $2. The option is out-of-the-money, so there is no intrinsic value. Thus, the entire market price of the option premium of $2 is regarded as time value. Obviously this might change as the price of the underlying shares and the option go up and down.

Back to Mike's PG put purchase. He stands to realize a substantial profit or loss on his put option investment if there are short-term swings down or up in the market value of PG shares. Let's examine what will happen if Mike continues to hold his option until the expiration date in October. You will recall that the strike price of the option contract he bought was $57 ½. This means that on the expiration date if the price of PG is greater than $57 ½ the options expire with no value. Let's say it closes at $58. Mike has lost his entire investment. Why? Mike would be foolish to exercise his options and sell his shares (or go short) for $57 ½ when he could sell them on the open market for more than that.

Generally options are not exercised until the expiration date and then, of course, only if they are in-the-money. The reason for that is simple. Option buyers are often speculators who really do not want to own (in the case of calls) or short (in the case of puts) the actual shares on a long-term basis or at all. Therefore, if the buyer of the option wants to close out his option position before the expiration, the buyer will almost always sell the put contracts in the open market.

But, in this case we are assuming Mike has not sold his option contracts and the October expiration date has just passed. What happens if after the expiration date PG is below $57 ½ per share? As we just said, Mike would have typically sold his contracts before expiration, but if the market price of the underlying shares is less than the strike price, he would exercise his options and sell PG shares at expiration because the options have intrinsic value. Let's say the price of PG is $57 at the close of the market on the expiration date. Mike may already own 1,000 shares of PG, or he may not own any shares. If he owns the shares, his put option allows him to sell them for $57 ½ per share when the current market price is only $57 per share, or a benefit to him of $0.50 per share. If he doesn't own the shares, he can exercise his put option and sell short 1,000 shares at a price of $57 ½ that are only worth $57 today…still a benefit of $0.50 per share to

him. In either situation he is ahead by $500, so that is why he would want to exercise his put options. But, don't forget that Mike paid $790 for the options, so he still has a net loss on the overall transaction of $290 ($500 investment gain - $790 premium loss = $290 loss).

Again, if Mike had held his options until around the expiration date he would have most likely sold the contracts themselves rather than exercise the options by selling PG shares (unless he already owned the shares in his account and wanted to sell them). Why? It is much simpler, being only one transaction rather than two. He might be subject to some market risk if he had to short the shares to exercise the put option and then buy them back to close out his position the following week when the market opens.

If PG was trading at $57 towards the end of the day on the last day of trading before expiration, the $57 ½ PG put option would be trading at about $.50 per contract (time is up, so there is only the $.50 intrinsic value and no time value is left). He would likely receive about $500 when he sold his ten contracts ($.50 x 10 x 100), for the same result (before commissions).

When you remember that about eighty-percent of options contracts on all securities that are out-of-the-money or at-the-money when the transaction is initiated expire worthless, it becomes clear that buying options is highly speculative. It requires significant price movement in the underlying shares if the buyer is to make a profit, especially if there is not much time remaining to expiration.

It is also clear that in many cases much or all of the put option buyer's investment can be lost, even if the price of the underlying shares declines somewhat before the expiration date.

Let's use the example of Mike's PG options again. We will say the price of PG falls from $60 to $57.55 at expiration and he still holds his options. Even though the price of PG has declined by $2.45, or over 4% in two months (over 24% annualized), Mike has still lost his entire investment. He would not exercise his option to sell shares at $57.50 that can be sold in the open market for $57.55. He has lost the premium he paid for the options. What is his breakeven point on the expiration date? If he paid $.79 per share premium to sell each contract, and if the strike price is $57 ½, then Mike's breakeven is $56.71 per share ($.79 - $57 ½ = $56.71). In other words, if he holds the options through the expiration date, unless the price of PG has declined to at least $56.71 per share, or 5.5% lower (almost 33% annualized) than when he bought the options three months earlier, he lost money. Of course, he could have sold the contracts at some point well before the expiration date and made or lost money, depending on what the price of PG and his options were and also how much time had run out before expiration.

It should be apparent why the opposite, mirror side of this transaction, fortunately the side on which you will be involved as a put option writer, is the more attractive proposition.

THE PUT OPTION WRITER'S (YOUR) SIDE OF THE TRANSACTION

Let's look at the same transaction from YOUR side now. You do not currently own any shares of PG, but you are interested in purchasing 1,000 shares, or are at least committed to do so in order to receive income from writing puts on 1,000 PG shares. It is the third Friday in August, and PG is currently trading at $60 per share. You would like to be able to buy at $57 ½ per share. In fact, you are willing to contractually obligate yourself to purchase 1,000 shares at $57 ½ per share. Rather than simply waiting to see if they go down to that price, you start checking out the premiums for PG put option contracts with a $57 ½ strike price at various expiration dates. You see that the October $57 ½ PG put is trading at $.79 per contract. For receiving a premium of $.79 per share you decide you would be willing to contract to buy 1,000 shares of PG at $57 ½, which would happen if the share price should be less than $57 ½ on the October expiration date. Remember that the option buyer could put these shares to you (obligate you to buy them) at any time up to and including the expiration date, but this rarely happens before the expiration date, even if the market price of the shares goes below the strike price.

Using your computer, you plug all the applicable data into the Excel® option worksheet mentioned earlier (tab name "Puts" on the Boomer file) and read the information as follows:

TODAY'S DATE IS ---------->	23-Aug

x	x	x	x	x	x		
SEC. SYMBOL	EXPIR. DATE	# OF CONT.	SECURITY PRICE	STRIKE PRICE	PREM.	PREM. INTRIN. VALUE	PREM. TIME VALUE
	15-Oct	10	$60.00	$57.50	$0.79	$0.00	$0.79

SEC. SYMBOL	MARGIN REQ.	# OF DAYS	PREM. INCOME	$ RTN. OF CAPITAL	NET PREM. INC.	% ANNUAL RETURN	COVERED CASH LESS RTN. OF CAPITAL	% COV. RETURN
PG	$16,290	53	$790	$0	$790	33.40%	$57,500	9.46%

Shortly we will be discussing in detail every column of information in the above template. For now, however, let's simply focus on the broader scope of this put writing opportunity.

From this transaction you will collect $790 in option writing premium income ($.79 premium per share x 10 contracts x 100 shares per contract, not including commissions). In order to write ten put contracts you will be required

to have at least $16,290 of cash or eligible securities in your brokerage "margin" account. The concept of margin for writing put options is different than using margin for leveraged investing in stocks or ETFs and will be discussed in detail shortly. For now, suffice it to say that margin is a deposit the put writer must make into his brokerage account equal to a portion of the underlying shares. You see that, on an annualized basis, the premium income will return 33.40% based upon the margin requirement on the day of the transaction for a three month period ending October 15, the third Friday in October. The annualized return is used for comparison purposes, as investors are used to thinking in annual terms. When you buy a six-month CD at the bank at a 2% rate of interest, for example, the rate quoted is on an annual basis. They do not say that the CD has a 1% rate for six months. Don't get too starry-eyed about the very high annualized return. You will need a cushion of extra cash or securities in your account. Also, the most conservative way to play this is to have on deposit sufficient cash or unmargined securities to purchase the underlying shares at the strike price should you be called upon to do so. If you were to set aside that much cash, it would effectively reduce your return considerably (see the last two columns of the Excel® template).

Now the downside. If PG would go to, say, $63 before the expiration date, you would probably feel pretty bad that you had lost out on the capital appreciation you could have made if you had just bought the stock. You would have only received your option premium income of $790, so you would have missed out on receiving a gain of $3,000 that your shares would have been worth had you bought them for $60,000. Yet you realized an annualized return well into double digits and earned $790 of income in two months from an investment of only $16,290 instead of investing $60,000. Many transactions will turn out like that. Just remember that as a put option writer you are no longer in the business of maximizing capital appreciation through share ownership. You are in the business of using put options to provide you a rate of return that will meet or exceed your objective on a consistent and predictable basis. Now and then you will also purchase shares at a discount. If you keep that in mind, you will not be greatly disappointed, even if the underlying shares would have produced a greater gain at times had you bought them instead of writing puts. An analogy to a baseball player may be appropriate. As a put writer, you are not "swinging for the fence" on every pitch. You are content with the more conservative approach of hitting singles and doubles, scoring runs more consistently over time. Besides, how likely is it that we will see such rapid appreciation in securities prices (homeruns) when so many experts are predicting slow-growth?

Another result might be that you are obligated to buy the shares because the put buyer exercises his option and you receive an assignment. If the market price of the shares is close to the strike price on expiration of the option contracts you should be quite happy with the outcome. Not only have you earned the premium of $790, but you have also purchased 1,000 shares of PG at a price per

share $2 ½ less than they were at the time you wrote the put options. Should you purchase shares as a result of the exercise of your puts, refer to Chapter 9 for information on how covered call writing can complement put option writing.

In this example, any price at expiration below $56.71 for PG means that you will experience an overall loss in the transaction. This is not a risk in writing put options per se, but is rather a risk in the underlying stock that you have committed to buy. You would still be much better off having written the puts and acquiring the shares at $57 ½ (net cost to you of $56.71 considering the put premium income) instead of purchasing them initially at $60.

Here is another way of looking at this transaction. Even if PG shares had gone down by 4% (24% annualized) at the expiration date, you would still earn your $790 and your 33.40% annualized return. In fact, PG would have to go down by more than 5% (30% annualized) before you would have a loss.

You decide to go ahead and place an order to "sell-to-open" ten contracts of the PG October $57 ½ puts at $.79. Since this is the opening of the transaction for you, it is referred to as "sell-to-open." If you decided later that you wanted to close out the transaction rather than wait for the options to expire or be exercised on or before the expiration date, you would then do the opposite and enter an order to "buy-to-close." That would close out the position. Again, this is seldom recommended except when a profit of most of the premium is earned quickly or in some situations when writing in-the-money puts, which, although discussed later, is not the primary strategy employed in this book.

When you have entered your order, Mike or some other purchaser buys your contracts through his broker and pays $790. The deal is settled and you get the money placed into your brokerage account *the next business day*. The reason you receive the premium income now is that the buyer obviously has to pay for the buy side of the transaction immediately, and you are the lucky beneficiary of immediate cash when you are on the sell side of the transaction. As long as you have adequate margin in your account, you are free to immediately withdraw that money, let it sit, or invest it in something else that will also produce more income and capital gain opportunity.

What do you do after you have sold your puts? Almost always, you will just sit on them and wait for the expiration date to occur. You can look forward to each passing day. Time is the best friend of an option writer as the time value of put options gradually decays. Every day that ticks off toward the expiration date means you are closer to the time the contracts expire so you can either write more puts or you will have the opportunity to acquire the underlying shares at the strike price, which would be a discount from their initial price when you wrote the put options.

Let's assume for a moment that the market price of PG remains at $60 on the expiration date. What happens? Since a put buyer would not sell his shares to you at the lower strike price of $57 ½ when they are trading at $60 in the open market, the options expire unexercised. You have previously pocketed the

buyer's $790. Now you can write more put options. With the share price the same, if you write more put contracts that expire in about the same time period later, you will likely receive a similar amount of option writing income as the previous transaction. In fact, if you were to do that for an entire year and the price of PG shares would remain at $60 at the end of the year, you would have received a return of over 33% from your premium income based upon your margin requirement…a terrific gain in a flat market. An owner of PG shares would have no gain at all, other than from dividend income. This is how put option writing can work its magic in a flat to slowly rising market, or even one that is slightly declining.

If PG closed between $57 ½ and $60…say $58…you still get to keep all of your option premium income, but you will not be called upon to buy the shares, as the price of PG was not below the $57 ½ strike price on the expiration date. The nice thing about this is that when you write your next option contracts, say the December contract, you will find that the $57 ½ strike price contracts will be trading at a higher relative price. This is because the market price is much closer to the strike price now than it was the last time you wrote the option contracts. This new writing opportunity would look something like the following worksheet.

Remember that for out-of-the-money puts, the closer the market price is to the strike price, the higher the option premium will be. This time your ten contracts would give you $1,600 of premium income and an annualized return of almost 53%, with an only slightly larger margin requirement.

TODAY'S DATE IS ---------->	18-Oct

x	x	x	x	x	x		
SEC. SYMBOL	EXPIR. DATE	# OF CONT.	SECURITY PRICE	STRIKE PRICE	PREM.	PREM. INTRIN. VALUE	PREM. TIME VALUE
	17-Dec	10	$58.00	$57.50	$1.60	$0.00	$1.60

SEC. SYMBOL	MARGIN REQ.	# OF DAYS	PREM. INCOME	$ RTN. OF CAPITAL	NET PREM. INC.	% ANNUAL RETURN	COVERED CASH LESS RTN. OF CAPITAL	% COV. RETURN
PG	$18,500	60	$1,600	$0	$1,600	52.61%	$57,500	16.93%

Another strategy that might be effectively used in this case, depending on your market outlook, would be to write contracts at a lower strike price this time…for example the $55 contract instead of the $57 ½ contract. This would reduce your premium income because the strike price is lower, but it would

allow you to purchase PG shares at an even lower price if they were to decline below the $55 level by the next selected expiration date. The strike price you select will largely be based on your income needs and what you think may happen to the share price by the expiration date. Of course, that is very difficult to project, but the investor usually has some informed thoughts on the subject from what is heard and read.

Remember…it is still possible to lose money writing put options if the underlying shares decline to a price that is lower than the strike price minus the per share premium income you receive. But if you are caught in a declining market where the shares are going down in price, you will *always* be better off if you have written puts and then acquired the shares at the strike price compared to purchasing the shares at the market price on the date you wrote the put options. Not only does the premium income have the effect of reducing your cost, but the purchase at the lower strike price assures that you receive an additional discount.

Having said that, there have been extreme examples of sudden precipitous declines, sometimes even overnight, in the price of a given stock. Companies such as Enron, WorldCom and Level 3 Communications come immediately to mind. Either as a shareholder of such a company or as a writer of put contracts on the underlying shares, it is always conceivable that an investor may awake and find himself in a situation where huge losses have been incurred. The put writer would need to either buy back the option contracts at a loss (the price of in-the-money put contracts will move almost dollar for dollar and inversely with the fall in price of the underlying stock) or buy the shares at the strike price on the expiration date.

The possibility of such losses underscores one of the most critical elements of the program described in this book. You should be absolutely certain if you utilize individual stocks for your put writing that you research and select those that would not have catastrophic downside risk, that you would be comfortable owning the underlying shares at the strike price you select and that you are fully prepared to accept the market risk associated with that decision. Since our objective in this guidebook is to select high yielding dividend stocks or ETFs, that objective is equally critical with put writing as it is with covered call writing. If the shares are put to us through assignment, we will turn around and write covered calls on the shares and also begin to collect dividends.

You should never select a stock for put writing simply because it offers a large option premium and a high investment return. Obviously a high return is little compensation for a significant loss of your principal. Use of appropriate Exchange Traded Funds can go a long way to mitigate the risk of a sudden huge downward price movement because of their diversified portfolios.

7

SELECTING FROM PUT WRITING ALTERNATIVES

The best time to start thinking about your retirement is before your boss does.

When you bring up the Excel® file "Boomer files" that we e-mailed to you, you will note a tab at the bottom named "Puts." You will find this template a useful resource to assist in making decisions on which put options to write once you have decided on a specific stock or ETF you would be willing to own. It will provide excellent information to simplify decision-making and save a good deal of time in "crunching the numbers."

The worksheet example that was used earlier is duplicated below. This example is what the "Puts" file template looks like when the data is completed, except it appears as one continuous line on the template. It has been broken into two parts here for space considerations.

TODAY'S DATE IS ---------->	23-Aug

x	x	x	x	x	x		
SEC. SYMBOL	EXPIR. DATE	# OF CONT.	SECURITY PRICE	STRIKE PRICE	PREM.	PREM. INTRIN. VALUE	PREM. TIME VALUE
	15-Oct	10	$60.00	$57.50	$0.79	$0.00	$0.79

SEC. SYMBOL	MARGIN REQ.	# OF DAYS	PREM. INCOME	$ RTN. OF CAPITAL	NET PREM. INC.	% ANNUAL RETURN	COVERED CASH LESS RTN. OF CAPITAL	% COV. RETURN
PG	$16,290	53	$790	$0	$790	33.40%	$57,500	9.46%

The use of this template by inputting multiple strike prices and expiration dates is the primary tool you will use in making specific put writing selection decisions. Let's discuss the data on this worksheet in detail so you can become comfortable with it.

Note the row towards the top with the small "**x**"s in the first six columns. As with the covered call template, this means you need to supply the

information in the cells under those columns. If there is no "**x**" in a column, the information in that column is automatically calculated for you.

DATA YOU NEED TO ENTER INTO THE WORKSHEET

Security Symbol ("Sec. Symbol")**:** Many of the columns are obvious. The first column is the ticker symbol, in this case the option symbol you will obtain from your brokerage's option chain or other online source. Since all option symbols now begin with the letters for the symbol of the underlying stock or ETF, it will serve a double purpose.

Expiration Date ("Expir. Date")**:** The second column is the put option expiration date you are considering. There are typically a wide variety of option expiration dates to choose from on most stocks and ETFs. As of the new option month beginning on the Monday following the third Friday in August, there were options available expiring in September, October, January, April and the LEAPS a year from January…expending over a period of one year and four months. This gives investors quite a few choices to suit their own unique put option writing needs. More detail will be provided shortly on how those selections are made, but at this point suffice it to say that you would often have quite a selection to choose from in making your option writing decisions.

Number of Contracts ("# Of Cont.")**:** The third column is the number of put contracts you wish to write.

Security Price ("Sec. Price")**:** The current share price of PG shares follows in column four.

Strike Price ("Strike Price")**:** The put writer should simply focus on those strike prices and expiration dates that are available at the time the research is being done and enter the strike price of the contract being considered.

Premium ("Prem.")**:** Column six is your final entry. Plug in the current quote for the option, which you will get from your broker. Keep in mind that for option contracts quoted under $3.00 the contracts trade in increments of 5 cents. For contracts priced over $3.00 the increment is 10 cents. Very actively traded and some lower priced contracts trade in penny increments for many of the strike prices, particularly those close to the current market price. You will be able to determine the amount of the increment for each option as you review option chains and place orders online.

CALCULATIONS AUTOMATICALLY MADE FOR YOU ON THE WORKSHEET

The rest of the data on the worksheet are calculations that are made for you for purposes of analyzing alternatives so that you can make the best put option writing decisions to suit your investment objectives.

Premium Intrinsic Value ("Prem. Intrin. Value")**:** This is the amount by which the put option is in-the-money, if any. In the event that you write in-the-money puts, it is important to look at the breakdown between the intrinsic value and the time value components of the premium.

Premium Time Value ("Prem. Time Value")**:** This is the time value portion of the premium. If you are writing an out-of-the-money put, the entire premium will be time value. For in-the-money puts, the time value is the premium amount less the intrinsic value.

MARGIN

The calculation of your margin requirement is one of the more complicated aspects of put option writing. Fortunately the Excel® template does it all for you. For investors in shares, margin refers to buying stock or selling stock short on credit provided by the broker. Margin customers are required to keep securities on deposit with their brokerage firms as collateral for their borrowings.

When writing put options, margin means the cash or securities required to be deposited by the put option writer with the brokerage firm as collateral for the writer's obligation to purchase the underlying shares if assigned through an exercise of the option. Minimum margin requirements are currently imposed by the Board of Governors of the Federal Reserve System, the options markets and other regulatory organizations. Higher margin requirements may be imposed either generally or in individual cases by the various brokerage firms. We are using a method of margin calculation that is typical for the brokerage industry for individual stocks and ETFs. It consists of three separate calculations, with the calculation resulting in the highest amount constituting the margin requirement (described beginning on the next page). Your broker likely uses these same calculation methods, however the percentages applied in the calculations may vary from broker to broker. This is an important issue, and you should always determine how margin is calculated by any broker with whom you are considering trading. You should also find out from your broker what assets in your account are eligible to meet the margin requirement. This would typically include cash, government securities, other bonds, and unmargined stocks and ETFs.

The margin requirement is then recalculated using these methods each day after the market closes based upon the new closing price for the underlying security and the closing price for the put option that has been written. Again, the margin requirement is the larger of the three calculations. If you do not have sufficient cash and/or securities on deposit in your account based on the new calculation on any given day, you will receive a "margin call" from your broker requiring the deposit of additional cash or securities into your account immediately to meet the new margin requirement. In the event you do not meet a margin call within the time constrictions imposed by your broker, assets in your account may be sold to meet the requirement. After finishing the discussion on the rest of the worksheet we will outline different margin requirements in sample situations so you can get a better understanding of how the margin requirements work and how they change depending on price volatility. The following margin calculations are made automatically for you on the worksheet template:

Margin Calculation #1:

- 15% of the stock price
- Add the per share amount of the premium
- Multiply times 100 (the number of shares per contract)
- Multiply times the number of contracts written

In this example the calculation would be as follows:

- .15 x $60 = $9.00
- $9.00 + $.79 = $9.79
- $9.79 x 100 = $979
- $979 x 10 = **$9,790**

Margin Calculation #2:

- 30% of the stock price (some brokerages have gone to 25%)
- Add the per share amount of the premium
- Subtract the amount by which the share price is out-of- the-money
- Multiply times 100 (the number of shares per contract)
- Multiply times the number of contracts written

In this example the calculation would be as follows:

- .30 x $60 = $18.00
- $18.00 + $.79 = $18.79
- $18.79-$2.50 = $16.29
- $16.29 x 100 = $1,629
- $1,629 x 10 = **$16,290**

Margin Calculation #3:

- Multiply the number of option contracts by $1,000.

In this example the calculation would be as follows:

- 10 x $1,000 = $10,000

The initial margin would be $16,290, the largest of the three numbers.

It was mentioned earlier that your broker may apply different percentages to these calculations. If that is the case, the "Puts" template can be customized to calculate your broker's margin requirements. In cell address "W4" insert the lower of the two percentages in your broker's calculations and in cell address "W5" insert the higher of the two percentages (the calculation that subtracts the out-of-the-money amount). You broker also likely sets a minimum dollar amount per contract (typically $1,000). If your broker uses a different number, it can be entered in cell address "W6." Be sure to save the template. It is now adapted for your use.

Margin Required ("Margin Req."): This is the initial margin that you will be required to have in your account before you can execute this trade. It is the larger of the amounts from the three calculations, which you will find to the right of the worksheet data. Note: Some brokers also establish an additional margin requirement for the *first uncovered writing position*, but not for subsequent ones as long as there is at least one position open. This is often an extra $1,000 per contract, up to a maximum of $10,000 more, *in addition* to the highest of the other margin calculations. You should check with your broker to see if you have to meet such an additional margin condition. If so, keep a mental note of it, as the template does not take this into consideration. The additional requirement will also affect the annual return.

Number of Days ("# Of Days")**:** This column shows the number of days from the date you are using the worksheet through the date of expiration you entered. So, for example, for the PG option expiring October 15 there are 53 days remaining from the date the worksheet was prepared through the last trading day.

Premium Income ("Prem. Income")**:** You will see the total premium income you would collect the next business day after your order is executed under the next column marked "Prem. Inc." The commissions obviously vary from broker to broker. You can customize your own template to accommodate the charges for your brokerage accounts by entering the appropriate information on the template to the right of the put calculation in cell addresses "W2" and "W3."

$ Return Of Capital ("$ Rtn. Of Capital")**:** This calculation only applies if you are writing an in-the-money put. For in-the-money options, part of the premium

consists of intrinsic value at the time the options are written. The intrinsic value portion should be regarded as a return of capital rather than an investment return. Therefore, any return of capital from intrinsic value in this column is subtracted from your premium income before calculating the percent annual return. In so doing, only the time value of the premium is taken into consideration when calculating the investment return.

Net Premium Income ("Net Prem. Inc."): This is the total premium less return of capital from intrinsic value, if any.

Percent Annual Return ("% Annual Return"): This column calculates the *annualized yield from the premium based upon the initial margin requirement*. It is annualized because investors are used to thinking about their returns that way. For example, if you are seeking a 12% annual return you would not likely say you want a one-percent return per month, because people just do not think that way. In our earlier example of the PG put options expiring on October 15, it means that if you could continue to write the same option at the same premium price and with the same frequency--days to expiration--you would realize an annualized return from premium income on your investment, based on its current value, of 33.40%, not including commissions. This would mean that at the October expiration date you would need to do the exact same deal again and again to get that precise return. Obviously it is not going to happen that way, because the price of PG shares will change, and that means the price of the put options in the future will change too. But it is the best information we have at a given point in time, so that is why it is used. Obviously we cannot predict where prices will be in the future, so we must use the measurements we have now. That gives us the ability to compare one option opportunity with another in an "apples to apples" manner. Since your broker's margin requirement changes from day to day, the actual amount of cash or securities you need to have in your account at any given time to support the position may be less or more than the initial requirement, which would impact your investment return.

Covered Cash Less Return Of Capital ("Covered Cash Less Rtn. Of Capital"): This represents the amount of cash you would need in your account (less any intrinsic value if you are writing in-the-money puts) if your contracts are assigned and you need to purchase the underlying shares. This is a good reminder that, even though the margin requirement is considerably less, the amount of cash in this column would be needed to fulfill your obligation if you are called upon to do so. Having this amount of cash or securities in your account, even though it exceeds the amount required by your broker, is a much more conservative approach than only having the required amount of margin. If you were writing a cash covered put in an IRA, this is the amount of cash you would need to support the trade.

Percent Covered Return ("% Cov. Return")**:** This figure takes the amount of premium income and divides it by the covered cash amount in the previous column. It tells you what your return would be from premium income if you had all of the cash in your account necessary to purchase the underlying shares. This may or may not be a meaningful figure for you, but it is another good comparison figure for different writing opportunities. And, if you wish to be very conservative and have the amount of cash in your account you would need to purchase the securities, it will tell you what your return is from your investment.

Some of these calculations may be more meaningful for you than others in selecting your put writing choices. All of them can be good tools for comparing choices with different strike prices and expiration dates.

UPDATING MARGIN CALCULATIONS

As previously stated, your broker will make daily calculations of your margin requirements after the close of the market using each of the calculation methods. This is necessary because the amount of margin you are required to maintain becomes larger or smaller with changes in the price of the underlying security, the variance of the underlying security from the strike price, and the price of the put option. Below are examples of how the margin requirement would change based upon the movement in the price of the underlying security and the price of the put.

x	x	x	x	x	x			
SEC. SYMBOL	EXPIR. DATE	# OF CONT.	SECURITY PRICE	STRIKE PRICE	PREM.	PREM. INTRIN. VALUE	PREM. TIME VALUE	MARGIN REQ.
PG	15-Oct	10	$61.50	$57.50	$0.50	$0.00	$0.50	$14,950
PG	15-Oct	10	$60.50	$57.50	$0.60	$0.00	$0.60	$15,750
PG	15-Oct	10	$59.50	$28.00	$0.85	$0.00	$0.85	$10,000
PG	15-Oct	10	$58.50	$28.00	$1.00	$0.00	$1.00	$10,000
PG	15-Oct	10	$57.50	$57.50	$1.35	$0.00	$1.35	$18,600
PG	15-Oct	10	$56.50	$57.50	$2.20	$1.00	$1.20	$20,150
PG	15-Oct	10	$55.50	$57.50	$2.90	$2.00	$0.90	$21,550
PG	15-Oct	10	$54.50	$57.50	$3.70	$3.00	$0.70	$23,050

You can see that as the security price comes closer to and goes lower than the strike price, the margin required increases (far right column). The converse is true. If the security price increases, thereby moving further away from the strike price, the margin required decreases (ultimately subject to the minimum of $1,000 per contract). You will typically find that if the puts are out-of-the-money the calculation of $1,000 per contract will determine the margin requirement unless the underlying security is rather high priced, such as the case here with

PG shares. When the puts become in-the-money, the other calculations take precedence and the margin requirement increases. While your broker will make these calculations daily and let you know if you ever need to deposit additional cash or securities into your account, you can monitor the requirement yourself as often as you like by using the "Puts" template. It would be a good idea to model prospective put writing opportunities before making your final writing decisions by looking at some "worst case" pricing scenarios to see what the margin requirement would be.

8

THE PUT OPTION WRITING STRATEGY

> Work hard and save your money and when you are old you will be able to buy the things only the young can enjoy.

Your goal will be to select option writing opportunities which will average an overall investment return at least equaling your own personal return objective. As discussed in the last chapter, you may maintain only the minimum amount of cash and/or securities to support your initial margin requirement (aggressive) or up to (and even exceeding) the fully covered amount of cash you would need to purchase the underlying shares (very conservative). Obviously this impacts your overall investment return.

Depending on the rate of investment return you are seeking, there may be several different alternative strike prices and expiration date combinations for a writing opportunity on a given security that could accomplish your objective. Once you have selected a stock or ETF for which you wish to write put options, the right decision for you then comes down to two factors: your degree of willingness to assume risk, and your short-term outlook for the stock market.

ASSESSING YOUR RISK TOLERANCE

When used appropriately, writing put options is generally considered to be one of the most conservative option strategies and, if done on a cash covered basis, can even be more conservative than simply owning equities alone. There are considerations and decisions you will make that will define more specifically the amount of risk you are taking. Obviously any time you own stocks or ETFs, you are exposed to market risk. But the most important factors over which *you have control* in determining risk are the following:

- the underlying securities you select for put writing
- the difference between the market price of the underlying securities and the strike price selected
- the expiration date selected
- the amount of margin requirement for your put option writing activities relative to your investment resources

We will discuss each of these factors in detail.

RISK IN SELECTION OF UNDERLYING SECURITIES

One of the most important determinants of risk relates to the specific underlying securities you select for put writing. Let's be more specific.

If you are writing puts on Exxon Mobil, you are being much more conservative than if you are writing puts on Facebook. Your opportunity for financial gain or loss with Exxon Mobil is considerably less than with Facebook simply because the volatility of the underlying stock is far less with Exxon Mobil. The risk involved in individual stocks and ETFs can be compared by using a statistic called "beta." Beta is a mathematical measure assigned to a stock or an ETF (based on the stocks that comprise it). It is an indication of how volatile the stock or ETF is relative to the entire market. By definition, a beta of 1.0 represents the volatility of the stock market as a whole. Therefore, a beta of less than 1.0 means a given stock or ETF is less volatile and a beta of over 1.0 implies more volatility, and therefore a riskier security than the market. The further away from 1.0 the beta gets under and over, the less and more volatile that security is respectively compared with the overall market. Stocks and ETFs with a beta of greater than 1.0 will tend to outperform the broad market when the market is going up and will incur greater losses when the broader market is going down. Stocks and ETFs with a beta of less than 1.0 will tend to underperform the broad market when the market is going up and will decline less when the broader market is going down.

The beta for Exxon Mobil is currently .5, which means that it is 50% less volatile than the overall stock market. In an up market, therefore, Exxon Mobil could be expected to rise only 50% as much as the market in general, and decline in a down market by only 50% as much. The beta for Facebook is currently 1.7, which makes it much more volatile than the market in general in both up and down markets. Obviously it is far more volatile than Exxon Mobil. Due to the greater share price volatility for Facebook as measured by its beta, the prices for put options on Facebook will be much greater than those for Exxon Mobil. Therefore the writer of Facebook puts is compensated for the additional risk through higher premium income compared with Exxon Mobil.

Some individual stocks have an even lower beta while the beta of others can be well over 3.0 (U.S. Steel approaches this at 2.8). Again, this represents the price volatility of these stocks and measures the degree of risk of loss as well as the opportunity for gain when compared with the market in general.

The beta for ETFs is calculated by a weighted average of the betas for the underlying securities in the fund. ETFs generally exhibit somewhat less volatility than individual stocks within the same industry due to the diversification obtained through owning multiple stocks within the ETF. Similar to the example with Exxon Mobil and Facebook, an ETF comprised of stocks within the energy sector would have a lower beta than an ETF dominated by technology stocks.

It is common practice for equity investment advisors to suggest lowering investment risk through ownership of a broadly diversified group of individual securities, ETFs or mutual funds. This same bit of wisdom applies to writing put options, although it applies only to individual securities and ETFs, as options cannot be bought or sold on mutual funds. In developing your own put option writing program, it is imperative that you give much consideration to the amount of market risk you are willing to take, recognizing at the same time that this decision will considerably affect the premium income, and therefore the investment return, that can be earned. Investors willing to assume risk equal to the market in general should write puts on stocks or ETFs with a beta in the area of 1.0. More conservative investors can look for betas below 1.0, while more aggressive risk takers can find plenty of opportunities in stocks and ETFs with betas above 1.0. This is a good time to remind the investor *never* to write puts on a security that he is not prepared to purchase at the strike price selected. Also, a reminder that an underlying security should never be selected for put writing simply because it would provide a large amount of premium income. Investors will rest far easier if they select stocks and ETFs for their put writing program that they believe can be owned for the long term and that they are prepared to purchase in the event of a market downturn.

The two high dividend yielding stocks and the fifty high yielding dividend individual stocks discussed in Chapter 1 are a great starting place for a Boomer to make selections for put option writing. As you get more comfortable with the process you can expand your horizons to include other names that accomplish your objectives, presumably to provide as much income as possible for your retirement or to build your portfolio with retirement in mind.

RISK IN RELATIONSHIP OF STRIKE PRICE AND MARKET PRICE

The next determinant of risk you are assuming in put writing is the strike price you select. Looking at this factor in isolation, it can be said that the greatest risk is taken when the strike price selected is at-the-money…when the market price of the underlying security and the strike price selected are approximately the same. How do you know this? Because the investment return for an at-the-money put writing opportunity is greater than for an out-of-the-money or an in-the-money writing opportunity. Investment return almost always correlates proportionately with risk. This sounds contrary to what is recommended for your covered call writing program, namely that you write at-the-money calls or slightly out-of-the-money calls to maximize income. It is contrary.

Here's the point. If you write puts at a strike price that is about the same as the market price of the underlying security (at-the-money puts), you will not have the opportunity to buy shares at a lower price. In such a case the only advantage you have is the ability to leverage the number of put contracts you can write through the use of margin. Writing an excessive number of put contracts is

the most dangerous aspect of put writing. You always want to be sure that you have sufficient cash or liquid assets on hand to fully purchase the shares subject to all put contracts should you be called upon to do so. Accordingly, rather than write at-the-money put contracts, it would be preferable to simply purchase the stocks or ETFs of choice and follow the covered call writing program outlined earlier in this book. In doing so you would be collecting dividends as well.

In summary, the out-of-the-money puts provide a lower investment return due to the reduced likelihood that the investor will be called upon to purchase the underlying shares. In-the-money puts provide a lesser return due to the increasingly greater portion of the premium that is intrinsic value rather than time value and a higher margin requirement. If the price of the underlying shares increases by the expiration date, an in-the-money put will have provided the best overall return. If that does not occur, you would have been better off with an out-of-the-money put contract.

PRIMARY STRATEGY: WRITE OUT-OF-THE-MONEY PUTS

The strategy recommended in this book is to write out-of-the-money puts on high dividend yielding securities. Why out-of-the-money puts? Because a fundamental premise in this section of the book is that you would like to own and are prepared to purchase the shares of the underlying stock of your choice, but that you would like to buy them at a lower price. Therefore, the lower the strike price you select, the lower price at which you would be able to purchase the shares if the market price goes down to that level by the expiration date. It is also true that the further the strike price is below the market price, the less the premium income you will receive and the lower your investment return will be on the put writing trade.

Part of the process in selecting a strike price, however, has to do with the price at which you would be comfortable owning the stock. In other words, if you would be really comfortable buying shares of a company at $40 and the current price is $43 ½, it would not make a lot of sense to write puts with a strike price of $35 rather than $40, as the amount of premium income you would receive, and accordingly your investment return, would be significantly less. So the process of selecting a strike price for your writing activities would be a balance between meeting your investment return objective from the premium income received and the price at which you would be comfortable owning the shares if they are assigned to you. For put writers who want to receive premium income but would prefer not having to purchase shares, even at a lower price, then the tradeoff of a lower return for a lower strike price may be the best route for them, depending on their outlook for the market in general and the expected performance of the underlying shares during the option contract period. Alternatively, investors not wishing to acquire the shares can buy back their put

contracts, potentially at a loss, if the market goes against them and if they are prepared to take that level of risk by incurring losses.

If the desire for an opportunity to purchase shares at a discount while receiving premium income for waiting is the primary motivation of the investor, then writing in-the-money puts would not be consistent with this strategy. Selecting an in-the-money strike price would mean there is a good probability the put writer would be required to purchase the underlying shares at a *higher* price than the current market rather than a lower price. While the greater premium received from writing in-the-money puts would make up for the higher price paid for the security, there is little room for error on the downside. Most put writers will probably not be terribly enamored with this type of put writing. Downward movement of the stock price to any significant degree could result in sizeable losses for the investor, as he would be required to purchase shares worth well less than the acquisition price. The best opportunity for writing in-the-money puts would occur when the price of the underlying security subsequently rises so that on the expiration date the market price is above the strike price. The investor will have earned substantially more premium income than from an out-of-the-money put and still would not be required to purchase the stock. This sounds good in theory, but few investors have the ability to predict future prices to achieve such results with any consistency. As one old saying goes, in theory there is no difference between theory and practice, but in practice there is!

RISK IN CHOICE OF EXPIRATION DATE

The expiration date chosen is another factor affecting risk. This is a two-edged sword. By selecting an expiration date with a short time period from the time the put contract is written until the expiration, there is less time for the underlying security to decline in price compared with a lengthier expiration date. To that extent, there is theoretically less risk that you will be required to purchase the underlying shares for a shorter-term expiration than one of longer duration. Weighing on the other side of that equation is the fact that a longer-term put option will *always* pay you a higher per-share premium than a shorter-term option, thereby providing more downside protection. It is the author's personal bias that put writing is best done on a shorter term basis…contracts that expire in one or two months. The average premium amount you will receive per day (based on the number of days from the date the put was written to the date of expiration) is normally greater the shorter the time to expiration. You, however, should examine your own personal desires and needs. If you would prefer to receive more total premium income and are fully prepared to purchase the stock at the strike price, then there is certainly nothing wrong with selecting a longer expiration date. As we will see in Chapter 12, there can be some significant tax advantages on occasion in doing this.

MARGIN REQUIREMENT IN RELATION TO INVESTMENT ASSETS

As was discussed earlier, writing put options allows the investor to potentially achieve solid double-digit returns, in part due to the substantial leverage available from the low initial margin requirement. The result is that it may be tempting for the investor to overextend himself by writing too many put contracts. If the prices of the underlying securities move below the strike prices, the result would be a significantly increased margin requirement. This proclivity of some investors to overextend themselves by writing too many put contracts can be one of the primary disadvantages of put writing vs. covered call writing. From the standpoint of margin management, it may appear that writing a large number of put contracts is supportable by the assets in the brokerage account. It must be recognized, however, that a significant downward move in the prices of the underlying stocks on which puts have been written can cause substantial increases in the margin requirement. This may necessitate adding additional cash or securities to the account to avoid being sold out by the broker at a loss if a margin call is not met in time. Due to this leverage, the investor must have discipline. There are some precautions that can be taken to make overextension less likely:

- Only write as many put contracts as you are fully prepared to purchase the shares they represent should all of the market prices go below the strike prices.

- Either keep sufficient cash and/or securities in your brokerage account to purchase all of the underlying shares subject to your put writing activities or have such additional resources in other accounts that could be added to your account if you receive a margin call (this would be the most conservative position a put writer could take). Recognize that if you do not have access to sufficient resources to do this, you may be compelled at times by your broker to buy back your put contracts at a loss if you cannot meet a margin call.

- Prior to trading, use the Excel® template "Puts" to model different assumptions on the number of put contracts and price changes in the underlying securities to see what the margin requirements would be under those assumptions. Compare the results with the cash/securities you have in your brokerage account or otherwise available for adequacy.

Sometimes brokerage firms will take steps themselves to reduce the risk you are taking. They do this by assigning a higher margin requirement for certain underlying securities than for others. For example, under the "Margin

Calculation #2" previously discussed, a broker might assign a 30% margin requirement for a conservative, low beta ETF, 35% to most other stocks, and as much as 50% to 60% for higher risk stocks with a very high beta. Assigning a greater margin requirement has the effect of reducing the number of put contracts you can write. You should check with your brokerage firm or prospective brokerage firms to determine their policies and adjust the percentages in your calculations accordingly.

OUT-OF-THE-MONEY PUT WRITING: HOW TO DO IT

Our focus now will be on the primary put writing strategy…where the strike price is lower than the current market price at the time of the trade…the out-of-the-money puts.

Writing out-of-the-money puts can provide excellent returns when the price of the underlying security remains relatively flat or increases or decreases slightly from the time the puts are written up to the expiration date, even though there might be significant volatility during the time the options are in force. In these circumstances, the put writer's investment percentage return will outperform the investor who simply owns the underlying security. So, if your market outlook is flat or for slow growth or decline, puts with strike prices that are out-of-the-money should be reviewed on your worksheet calculations. If you are expecting a downtrend and you would like to buy stocks at a lower price and be paid cash while waiting, then put writing can achieve that.

Let's take a look at some worksheets for several different securities where data has been input to make decisions on out-of-the-money put writing:

As you look at the worksheet below, the following becomes apparent:

> **For out-of-the-money puts, the closer the market price of the underlying security is to the strike price, the larger the premium and the greater the annual return.**

This makes sense when you appreciate the perspective of the put *buyer*. If the buyer purchases the PG $60 strike price put, the price needs to decline less to reach the strike price (at which point it becomes in-the-money and starts to build intrinsic value) than if he had purchased the $57 ½ put. Therefore, he would expect to pay more for the put which has a strike price closer to the market price. As the put writer, you would expect a greater return on the $60 put than on the $57 ½ put (54.98% vs. 25.15% for the October expiration).

What then are the factors the put writer should take into consideration in making a writing decision, other than the obvious attractiveness of considering the one with the highest annual return? Let's take a closer look.

TODAY'S DATE IS ---------->	8-Sep

x SEC. SYMBOL	x EXPIR. DATE	x # OF CONT.	x SECURITY PRICE	x STRIKE PRICE	x PREM.	PREM. INTRIN. VALUE	PREM. TIME VALUE
	15-Oct	10	$60.30	$55.00	$0.20	$0.00	$0.20
	15-Oct	10	$60.30	$57.50	$0.40	$0.00	$0.40
	15-Oct	10	$60.30	$60.00	$1.05	$0.00	$1.05

SEC. SYMBOL	MARGIN REQ.	# OF DAYS	PREM. INCOME	$ RTN. OF CAPITAL	NET PREM. INC.	% ANNUAL RETURN	COVERED CASH LESS RTN. OF CAPITAL	% COV. RETURN
PG	$12,990	37	$200	$0	$200	15.19%	$55,000	3.59%
PG	$15,690	37	$400	$0	$400	25.15%	$57,500	6.86%
PG	$18,840	37	$1,050	$0	$1,050	54.98%	$60,000	17.26%

THE ESSENTIAL QUESTION

The most important question the put writer must try to answer to make better put writing decisions is: ***What do I think is going to happen to the market price of the underlying security from the date I write options until they expire?*** The answer to this question will in part determine which strike price you select and will also influence the expiration date you select as well.

This is clearly not an easy question. Even "expert" portfolio managers, economists and stock traders, not to mention the "average" investor, have trouble arriving at a good answer to this question with any consistency. Investors obviously have some faith that over the long term equities will provide a return that will exceed other investment alternatives. Part of your answer may just be a gut feel for the price at which you would be comfortable committing to buy.

Regardless of your selection, one of the advantages you have as a put writer is this:

> **If you have written a put and the price of the underlying security goes down, you will always be better off than the investor who owns the equivalent number of shares in the security instead of writing puts.**

The premium income you receive from writing the puts will give you a profit down to the strike price, and then some downside protection to the extent of the premium received, that the investor does not have who simply owns the shares.

Earning premium income from writing out-of-the-money puts is not the only consideration, however. The next component to look at is the lower price at which you may be able to purchase the underlying security if the price declines beyond the strike price at the expiration date. This is where your forecast of market direction comes importantly into play. If you write puts at the $55 strike price and the market price is $58 ½ at expiration, some important things will have happened. You did not purchase the stock at expiration, as the shares remain out-of-the-money. This may be good or bad from your perspective, depending on how much you wanted to acquire the underlying shares. Of course, you can always buy them at the market price at any time and write covered calls on them. You also could have obtained a greater return on investment had you written the $57 ½ puts. Nonetheless, you have obtained a decent return and can now write new put contracts based upon your expectations going forward.

Without thoughts to the contrary, it might be best to write the lower strike price if the return meets your investment objective…the more conservative posture to take in all put writing decisions. While you would receive less premium income (and correspondingly a smaller investment return), the lower strike price selection would allow for a deeper decline in the stock before you would be called upon to purchase the shares. And, even with a lower strike price, the return is still very substantial when compared with almost any alternative investment vehicle available today.

Some option writers always go with the closest out-of-the-money option rather than a lower strike price to maximize the option writing income. Others prefer the lower strike price to get more of a balance between option writing income and the opportunity to buy shares at a lower price. There is no single best way for everyone. Both can be good, depending on what your objectives and needs are, analysis of economic conditions and your penchant for risk.

CHOOSING PUT OPTION EXPIRATION DATES

In addition to strike price selection, choosing an expiration date is the other decision the put writer faces. There is one thing that can *always* be said about expiration dates:

> **For all strike prices, there is always an upward progression in the price of a put option premium as the length of time to expiration increases.**

You can see in all of the examples we have discussed that as the number of days to expiration increases, the amount of the premium per contract increases. This will always be the case for this reason: if you are comparing options with various expirations using the same strike price, it makes sense that if you were a

buyer of a put option you would be willing to pay more for one expiring in December than you would be for one expiring two months earlier in October. That is because with the December contract the buyer has two more months for the shares to possibly go down so he can profitably sell his option contract or exercise it at expiration. And as an option writer, you should be willing to accept a lesser return in exchange for a larger premium and locking in your return for a longer period of time.

As the number of days increases to expiration, *the rate of increase* in the amount of the premium tends to slow down. Accordingly, many put option writers prefer to stick with the shorter term writing opportunities. The rate of decay in the option price accelerates as the time to expiration draws nearer, so time decay works in favor of option writers who write short-term puts. Shorter-term put options, while actually providing more premium dollars of income per day and a higher investment return, will however not give you as much downside protection as longer-term puts. So, the proper selection of an expiration date is dependent on your beliefs about the near-term direction of the market, just as with strike price selection.

Let's look at several of the slightly out-of-the-money PG puts. With these puts the entire premium consists of time value and no intrinsic value:

As you can see when looking at the same strike price, the premium for the September put contract is significantly less than the October contract. Yet the annual return of the September contract is much greater. The same is true in comparing the September contract with the January and April contracts. If a $57 ½ strike price were selected for all expirations, the premiums would be lower across the board, but the same trends would apply.

TODAY'S DATE IS ---------->	8-Sep

x	x	x	x	x	x		
SEC. SYMBOL	EXPIR. DATE	# OF CONT.	SECURITY PRICE	STRIKE PRICE	PREM.	PREM. INTRIN. VALUE	PREM. TIME VALUE
	17-Sep	10	$60.30	$60.00	$0.37	$0.00	$0.37
	15-Oct	10	$60.30	$60.00	$1.05	$0.00	$1.05
	21-Jan	10	$60.30	$60.00	$3.05	$0.00	$3.05
	15-Apr	10	$60.30	$60.00	$4.00	$0.00	$4.00

SEC. SYMBOL	MARGIN REQ.	# OF DAYS	PREM. INCOME	$ RTN. OF CAPITAL	NET PREM. INC.	% ANNUAL RETURN	COVERED CASH LESS RTN. OF CAPITAL	% COV. RETURN
PG	$18,160	9	$370	$0	$370	82.63%	$60,000	25.01%
PG	$18,840	37	$1,050	$0	$1,050	54.98%	$60,000	17.26%
PG	$20,840	135	$3,050	$0	$3,050	39.57%	$60,000	13.74%
PG	$21,790	219	$4,000	$0	$4,000	30.60%	$60,000	11.11%

Writing short-term puts with expiration dates from one to two months generally makes the most sense, subject to your thoughts about diversifying expiration dates. Again, the most critical consideration is that you are prepared to purchase the underlying shares at the strike price if you are called upon to do so. The diversification of your portfolio should always be taken into consideration in determining the number of different securities on which you are writing puts, especially if you are using individual companies. If you are using ETFs, built-in diversification is a definite advantage, especially in smaller portfolios or with investors who do not have the time or desire to research individual companies.

PUT WRITING AND COVERED CALL WRITING: TWO COMPLEMENTARY STRATEGIES

9

Today Monday, tomorrow Tuesday…where will it all end?

We just examined in detail how put writing can be used as a conservative investment strategy. When the program is followed, the risk/reward characteristics of put writing and covered call writing are nearly identical, even though in many respects they appear to be the mirror image of each other.

WHAT ARE SIMILARITIES AND DIFFERENCES BETWEEN PUT WRITING AND COVERED CALL WRITING?

Similarities:

- Both covered call writing and put writing can be very effective in generating double-digit investment returns in a flat or moderately increasing market.
- Both strategies involve the opportunity to earn a pre-defined amount of money should the price of the underlying security remain flat or change moderately.
- Both have downside risk should the underlying security decline in price (although the covered call or put writer will always be better off than simply owning the shares should they decline). The share owner/call writer is at risk because of the ownership of the underlying shares. The premium income received from covered call writing provides a degree of downside protection against a declining share price, however if the price of the shares decline below the strike price from the time the call contracts were written by an amount greater than the per share amount of premium income, the investor would be in a net loss position (although better off than a shareowner who did not write calls). The put writer is potentially at risk because he has contracted to purchase the underlying shares at a predetermined price, typically below the current market price. Compared to an investor who owns an equivalent number of shares to the put writer's option contracts, the put option writer is better off in two ways: first, if the shares decline below the strike price at expiration, he will purchase the shares at a lower price than if he had

purchased them at the time the options were written, and second, the put premium income received also provides a degree of additional downside protection. However, if the shares decline below the strike price by an amount greater than the per share premium income, the investor would be in a net loss position (although better off than a shareowner who did not write puts).

Differences:

- In a moderately declining market, the covered call writer may have moderate profits or losses, depending on the degree of decline and the amount of premium. The put writer will fully profit from the writing activity and may also purchase the underlying shares at a discount to the market price at the time the put contracts were written, depending on the degree of the price decline.
- In the case of an increasing price, the owner of shares on which out-of-the-money calls are written receives a predetermined amount of premium income plus an opportunity for a defined amount of capital appreciation. The writer of out-of-the-money puts, on the other hand, simply receives a predetermined amount of premium income.
- Put writers have one big advantage over call writers…the amount of money they need to initially commit. While the covered call writer must purchase or own the underlying shares before calls can be written, the put writer does not purchase any shares (unless the shares are assigned at expiration). Instead the put writer is required to maintain cash or securities to support a margin requirement (which changes from day to day). The margin requirement is typically far less than the amount needed to purchase the underlying security. This has the effect of increasing the return opportunity for the put writer based on the amount of investment.
- The advantage for the put writer of a smaller investment can also work against him if he becomes too aggressive. The brokerage firm will allow the put writer to sell more contracts than he has the money to acquire the underlying shares, because the margin requirement is significantly less than the amount that would be needed to purchase the shares (he is an "uncovered" or "naked" option writer," not "covered" as in the case of a covered call writer who owns the underlying shares). Therefore, it is incumbent upon the put writer not to overextend himself by writing more put contracts than he can afford to purchase the underlying shares.
- Writing puts involves only one trade (selling the put option), while a covered call writer must initiate two trades (the purchase of the underlying security and selling the call option). Therefore, unless the

put writer is called upon to purchase the shares at expiration, he pays less in commissions than the covered call writer.

- The put writer may believe that a particular security is somewhat overvalued. Unlike the covered call writer who would purchase shares at the current market price and write calls, the put writer receives income by writing puts that give him the opportunity to purchase the shares at a lower price (the strike price) should the shares decline to that level on the expiration date. Therefore, relative to the owner of shares who writes calls, if held until expiration, the put writer is better off with the put option if the share price declines and he may have an opportunity to pick up the shares at a more reasonable price. Writing puts can even be viewed as an income producing alternative to placing a limit order to buy the underlying stock.
- Equity investments have an upside price bias over time. As a result, put options generally tend to have slightly less premiums than call options. Since demand is slightly greater for calls, the liquidity (number of contracts traded) of puts can be somewhat less than calls.
- Since writing puts involves naked or uncovered writing (unless trading is conducted on a purely cash covered basis), brokers require a higher level of approval than covered call writing before they are willing to handle such trades for the investor. If the investor has sufficient education and/or trading experience there should not be a problem obtaining approval.

HOW CAN COVERED CALL WRITING COMPLEMENT PUT WRITING?

When writing put options there is always the possibility that the investor may be called upon to purchase the underlying shares at the strike price on the expiration date. If this occurs, it transforms the uncovered (short) put position into a covered (long) stock position. The investor is then faced with the decision of what to do with his shares. Presumably he decided that the purchase would be attractive to him when he wrote the put contracts. Therefore, he may wish to keep the shares rather than sell them. If he chooses to retain the shares, writing covered calls can be a very attractive complement to put writing. When I purchase shares as a result of a put assignment, I typically then write covered calls at the same strike price as the put strike price I had utilized.

IS THERE SUCH A THING AS COVERED PUT WRITING?

The term "cash covered put" is sometimes used to signify that the put writer has sufficient cash or equivalent (e.g., Treasury bills) necessary to cover the purchase price of the underlying security should the put writer be required

to purchase the shares at the strike price on the expiration date. This would also apply to put writing in a retirement account when the brokerage permits the investor to write puts while maintaining sufficient cash in the account that would be needed to acquire the shares subject to the put contracts if they are assigned.

10

BROKERAGE ACCOUNTS AND WRITING COVERED CALL AND PUT OPTIONS

The chief causes of problems are solutions.

Now it is time to delve into the mechanics of how to make this all happen. As stated earlier, purchases and sales of ETFs and stocks coupled with the covered call and put option writing strategies can be done through either a discount broker or a full-service broker. If you have an investment advisor or broker with whom you are satisfied, then he/she may be worth the extra money you pay in commissions. If that is not the case, it is very difficult to beat the low cost and ease of an online discount broker. If you do not already have one, you are encouraged to review some of the discount brokers listed at the end of this book and compare commission costs for ETF, stock and option trades as well as compare services offered. Since you will be incurring additional commissions as a call and put writer, it is important to keep your commission costs down in order to maximize the opportunity to realize your investment return objective. The rest of this chapter operates under the assumption that you are trading through an online discount broker and utilize a cash management type of account.

In the event you do not have a computer and/or do not have Internet access, you will still be able to implement the strategies in this book by using either a full-service broker or a discount broker over the phone. You local public library may also provide computers that would likely have Excel® software for purposes of using the templates. They may also offer free high-speed Internet service, which can be used both for investment research as well as for doing your trading through an online broker.

ONLINE DISCOUNT BROKERAGES

You need to do your option trading with the brokerage firm that holds your shares on deposit and provides your margin account. Once you get the hang of it, trading shares and options online is much quicker, easier and less expensive than dealing with humans. As an investor who has used put and call option writing strategies for almost thirty years, the last thing I would want to do would be to slow myself down when trading by talking with a live person. They are there if I have a problem, but I have no use for them otherwise. For example, it is very cumbersome to be going to a human broker to find out what option strike prices and expiration dates are offered for the shares you own so that you can

make decisions on your writing program. You also need to obtain bid and ask quotes. Finally you need to place your orders and get quick feedback on whether your orders are filled, especially when you are placing limit orders. All of this information is available through an online broker as fast as you can make your fingers move on a keyboard and mouse. You really won't have any need to work with an individual unless you have some kind of problem with your account.

COMMISSIONS

The discount brokers generally charge far less than full-service brokerages, but even among the discounters there's a great deal of difference. Most of all you want to be sure you are dealing with a sizeable, stable and reliable brokerage firm who will be around for at least as long as you are (and those who have reached Boomer age have continued long life expectancies!).

Typically discount brokerages charge for option trades based upon two components. First, there is usually a flat fee per transaction. This is why it is more cost efficient when you trade a larger number of put or call contracts, as this component doesn't change regardless of how many contracts are traded. Second, there is usually a fee per option contract as well. This component tends to make it more expensive to trade a large number of option contracts on a lower priced ETF or company with a small premium than would be the case with a higher priced security with a large premium.

These two components are added together and charged as one fee per trade. As an example, let's say there is an $7 flat fee plus $1.50 per contract. If an investor sells 10 call or put contracts on an ETF, the commission would be $22. The larger the number of contracts traded, the smaller the commission as a percentage of the premium collected.

You can see that the way this fee schedule is structured, the commission does not vary with the amount of the premium collected. Therefore a commission schedule with a flat fee and per contract charge would tend to favor longer-term call options, as they will always have a larger premium per contract than a shorter-term option.

Also, longer-term options obviously expire less frequently. A writer of options expiring in one month would need to trade three times more frequently than a writer of options expiring in three months. So, you pay a lesser percentage of the premium income in commissions by writing call options with longer-term expiration dates. Of course, the commissions paid is just one of many factors an investor would take into consideration as part of an overall option writing strategy.

Commissions on option trades tend to be higher than the discount brokerage commissions charged for a purchase or sale of shares, which often run between $7 and $20, depending on the broker. But in recent years, fees on

options trades have come down significantly and represent only a very small percentage of the call option writing income you will be collecting.

There are many online brokers such as Scottrade, TD Ameritrade, E-Trade, and on and on. Fidelity Investments and Charles Schwab & Company are often thought of first, as they are among the largest and most financially sound. The commissions are somewhat higher with Schwab and Fidelity than with other online brokers, but they are much, much lower than traditional full-service brokers. They both offer a full-blown cash management account at no extra charge and they pay a market rate of interest (if there is such a thing anymore) on uninvested cash balances. An investor should be able to go to the Web site of any of the online brokerages and check out the fees for ETF/stock and option trades very easily. Or, a phone call could be made to get the same information.

The "Calls" and "Puts" templates can be easily customized to include all ETF, stock and option fees charged by your brokerage in the return calculations. Just enter the appropriate charges on the "Calls" template in cells S4, S5 and T4 and in the "Puts" template in cells in cells W2 through W6.

Both personal and IRA accounts are eligible for covered call writing as long as you are approved for option writing by your brokerage. Put writing generally involves a higher level of approval from your broker. IRA accounts are eligible for cash covered put writing (cash on deposit to cover the full cost of share acquisition in the event shares are assigned, as IRAs are not eligible for a margin account). Taxable personal accounts are eligible for margin trading in uncovered puts upon broker approval.

There are two things important to focus on in conjunction with writing covered calls or puts through your brokerage account. The first is getting the information you need to complete the Excel® template so you can make your decisions on which calls and puts to write. Second is the process of executing the option transactions. The rest of it takes care of itself. When you write covered calls or puts your broker will credit the cash to your brokerage account the next business day. All of the mechanics occur automatically. Not only will the cash be put into your brokerage account then, but with a cash management account they will automatically invest the cash in the money market fund you have selected for your account. That way your premium income is at least earning some interest until you decide to withdraw it or to reinvest it in something else. And, if you have a margin loan balance from acquiring additional shares, the money credited to your account from the premium income would automatically reduce the loan balance.

THE OPTION AGREEMENT

Before we focus on these two key points of option selection and trading, there is one critical piece of paperwork that will need to be completed before any option writing can be done. You need to sign an "Option Agreement" for each

account you have with your brokerage firm so that you can trade covered call and put options. What you need to do is to either go online to your brokerage account, call or write them, tell them that you want to write covered calls, cash covered puts and uncovered puts in your accounts (as allowed), and ask them to send you the necessary paperwork to set up your accounts for options. They will send the Option Agreement form to fill out and also a publication they are required to provide called *Characteristics and Risks of Standardized Options*. This is a very informative booklet that reviews option terminology and theory, tells about the different kinds of options, how they can be used and the relative risks. As previously mentioned, some option strategies involve high risk and some, like covered call writing and forms of put writing as described in this guidebook, are very conservative. This booklet reviews them all. In many cases all of this paperwork and the booklet can be downloaded on the broker's Web site.

The purpose of the agreement is to help the brokerage firm assure that the investor has adequate knowledge about investing in options and that the option transactions are suitable for the investor. By the time you finish this guidebook, you will be very knowledgeable about writing covered calls and puts. But you should go ahead and complete the paperwork now to get the account fully set up so you are ready.

The Option Agreement covers a wide variety of option strategies, so when you prepare the paperwork you should indicate that you want to only write covered calls, cash covered puts and uncovered puts (the latter for taxable personal accounts). You will also be asked about your investment knowledge and activity, and you should answer those questions honestly.

Finally, you will be asked about your investment objectives on the agreement. You should answer that you desire to produce income, which is consistent with writing covered calls and puts, in addition to other investment objectives you may have. Once you see the paperwork you'll find it easy to complete. Just answer the questions discussed here and return it to your broker. It should be approved in a few days and you will be ready to initiate trades.

COMPLETING THE "CALLS" AND "PUTS" WORKSHEET DATA ON THE EXCEL® TEMPLATES

As previously discussed, you need to fill in all of the columns that have an "**x**" at the top. After you have entered these fields of information onto the Excel® template, you are ready to get into the option writing portion.

If you click on the "Expiration Dates" tab at the bottom of the Excel® template you will see a progressive list of monthly option expiration dates. You should select the dates you want, one at a time, by placing your cursor over a date, pressing the "Copy" button, and then going back to the "Calls" or "Puts" tab and placing the cursor in the appropriate cell under the "Option Expiration" column. Then press the "Paste" button and the date will be there. You could also

manually type in the expiration date. You should do that on a separate line for each option expiration date you want to consider. Then you need to type in the strike price you wish to review. You may need to create some more rows and replicate the information for the same ETF or company on the templates if you have a lot of expiration dates and strike prices you want to consider.

Once you have this information in the template, you are ready to begin looking up quotes. This may be done a bit differently with various online brokerages, but typically what you do is request a quote on the ETF or stock by typing in the ticker symbol for the underlying shares. When you have the quote, you can then enter the current price information on the template in the appropriate column so it is up to date. When you are getting a quote on the shares on the broker's Web site, you should find the words "option chain" somewhere near the quote. By clicking on this, their system should take you to a listing of all of the expiration dates and strike prices offered for the shares. By scrolling up and down, you should be able to see the option ticker symbol for each option you wish to consider.

On the next page is a sample of a typical online option chain. As you scroll down, note the ticker symbol for those you want and type in that information on the Excel® template. Again, if it is not obvious after a little searching how to find the information you need, a call to the customer service center would be in order. As an alternative to this preferred method of obtaining quotations from an online broker, CNBC (www.cnbc.com), the Chicago Board Options Exchange Web site (www.cboe.com**)** and Yahoo! Finance (www.yahoo.com/finance) provide extensive option chains for stocks and ETFs, however their information is not as current as you will find with an online broker who generally provides real-time options quotations.

After entering the option price, the rest of the data will complete itself automatically. By entering the quotes in this way for each option symbol onto the template, you are then in a position to take a look at the worksheet, compare alternatives and make a decision on what option you wish to write.

That is how you use your online quotation system to obtain the information you need to complete your template. Gathering all of this data may take awhile initially, but it will go quickly and smoothly after you have done it a few times.

We won't discuss the decision making process again, as this was discussed in detail earlier. Of course your goal is to achieve your total return objective while obtaining diversity in your option expiration dates and basing your strike price decisions on how you think the shares will be performing between now and the date on which the option that you are considering will expire.

Puts								
Symbol	Date - Strike	Last	Chg	Bid	Ask	Vol	Open Int	Trade
	Jul 25.00	0.05	0.00	0.00	0.05	190	50,957	Trade
	Jul 26.00	0.05	-0.05	0.05	0.10	118	94,980	Trade
	Jul 27.00	0.10	-0.05	0.10	0.15	1,474	140,472	Trade
	Jul 28.00	0.25	-0.05	0.20	0.25	2,914	195,445	Trade
	Jul 29.00	0.45	0.00	0.40	0.45	3,417	208,079	Trade
	Jul 30.00	0.75	-0.10	0.75	0.80	16,652	162,872	Trade
	Aug 25.00	15.00	+14.85	0.10	0.15	133	19,719	Trade
	Aug 26.00	0.25	0.00	0.20	0.25	0	1,803	Trade
	Aug 27.00	0.30	0.00	0.30	0.35	190	35,283	Trade
	Aug 28.00	0.55	0.00	0.50	0.55	529	72,786	Trade
	Aug 29.00	0.80	-0.05	0.75	0.80	645	27,639	Trade
	Aug 30.00	1.20	+0.05	1.15	1.20	3,448	31,272	Trade
	Sep 25.00	0.25	0.00	0.25	0.30	132	135,431	Trade
	Sep 26.00	0.40	0.00	0.35	0.45	4,762	176,034	Trade
	Sep 27.00	0.50	-0.10	0.55	0.60	302	50,132	Trade
	Sep 28.00	0.85	0.00	0.75	0.85	4,590	88,121	Trade
	Sep 29.00	1.15	0.00	1.10	1.15	3,910	38,823	Trade
	Sep 30.00	1.50	-0.05	1.50	1.55	3,171	45,060	Trade
	Dec 25.00	0.60	-0.05	0.60	0.65	119	41,424	Trade
	Dec 26.00	0.85	+0.05	0.80	0.85	106	26,754	Trade
	Dec 27.00	1.05	-0.05	1.05	1.10	486	23,470	Trade
	Dec 28.00	1.40	0.00	1.35	1.45	117	9,467	Trade
	Dec 29.00	1.75	0.00	1.70	1.80	69	12,441	Trade
	Dec 30.00	2.15	+0.05	2.10	2.20	827	12,624	Trade
	Jan 25.00	0.75	0.00	0.70	0.75	28	69,087	Trade
	Jan 26.00	1.00	+0.05	0.90	1.00	125	34,272	Trade
	Jan 27.00	1.20	0.00	1.15	1.25	68	24,534	Trade
	Jan 28.00	1.55	+0.05	1.45	1.55	752	65,917	Trade
	Jan 29.00	1.85	+0.10	1.85	1.95	505	21,096	Trade
	Jan 30.00	2.35	+0.05	2.25	2.35	2,081	51,996	Trade
	Jan 30.00	6.80	0.00	7.00	7.10	0	50	Trade

In deciding which contract to write, remember there is no assurance that your shares will rise to the strike price at expiration (for calls), which is reflected in the "Annual Yield With Capital Appreciation" column. Likewise with put contracts, there is no assurance that your shares will not fall below the strike price at expiration. Therefore, the most realistic and conservative way to evaluate this would be to look primarily at the "Annual Yield" for your decisions. Then you should balance out all of your decisions to reach your target yield return. That way you can consider any capital appreciation from out-of-the-money call

writing or the acquisition of shares at a discount from out-of-the-money put writing as "icing on the cake" if it happens.

HOW MANY PUT CONTRACTS?

When writing covered calls it is obvious how many call contracts you will write…one contract for each 100 shares you own. In the case of puts, since you don't own shares, a decision needs to be made regarding the number of contracts that will be written. This is one of the most important decisions you will make with put writing, as you are leveraging the number of contracts using margin. The reason this is so important is that the easiest way a put writer can become overextended financially is by writing more contracts than can be supported by his financial wherewithal. The amount of cash or securities required by the broker to be on deposit is quite low in proportion to the amount of put writing income received due to the fact that the broker will typically require cash available in your account of only about a third to a fourth of the full market value (cash covered basis) of the shares that might ultimately be put to you. Therefore, should the price decline, this leverage causes the margin requirement to rapidly increase. When examining put writing opportunities, the initial margin requirement may seem very manageable. As previously stated, however, it changes with every trading day as the price of the underlying security and the put option contract change. An upward movement in the underlying security may reduce the margin requirement and a declining price will increase the requirement. Should there be a major move downward in the price of one or more of the underlying securities on which you are writing put options, the margin you are required to maintain could rise significantly. Should the margin requirement rise beyond the level supported by the assets in your account, a margin call will be issued. This will require your *immediate* attention, as you are normally allowed only a short period of time (days or less) to either liquidate positions in your account or add additional cash or assets to support the higher margin requirement.

During the process of reviewing put writing opportunities using the Excel® template, you should calculate different downward price scenarios in the underlying security and an estimated corresponding upward price movement in the put contract. This will allow you to determine whether you have adequate margin in your account or other assets available to support the number of contracts you are writing. If you would be at risk of a margin call under a price decline scenario that you think is a possibility, then you should reduce the number of contracts you are planning to write to make it more manageable. The last two columns of the Excel® template present the most conservative position. You are shown how much cash you would need to have on hand in order to purchase the shares subject to the put contracts if you were required to do so. In the last column the investment return is calculated based on the amount of

income you receive from writing the puts if you had set aside the entire amount necessary in the previous column.

Put writing can have similar risk characteristics to covered call writing or it can be riskier, depending largely on the degree of leverage, if any, the investor uses through margin management. The investor must assess and apply his own individual risk profile.

ONLINE COVERED CALL AND PUT OPTION TRADING

So, after considering the alternatives, you've made a decision on an option to write. At this point you are now ready to use the online brokerage to execute the option transaction. What you need to do now when you are logged on to your brokerage account is to go to the Web page that is used for option trades.

Now go back to the first worksheet showing the covered call calculations for the four ETFs and individual stocks (pages 42-43). Let's assume that you are going to execute the trade in the second row on the printout for PG…namely, you are going to write 10 contracts of the October $60 calls. The current quote midpoint is $1.60.

The information required by different brokers for their online system should be essentially the same. The pieces of it may just be located in different places on their Web pages. You will become familiar with your broker's pages very quickly after you do a few option trades.

There should appear several choices for the kind of option trade you wish to place. The buyer of an option would click on "buy-to-open" to purchase a call option. A seller (writer) would click on "sell-to-open" in order to sell it. As you are not a buyer, but are a writer of call options, to initiate a new transaction you will always click on "sell-to-open," however it is termed by your brokerage (unless you "buy-to-close" to close out a position before expiration). You are selling…that is, writing…the option, and the transaction is an opening transaction. You will enter the number of contracts, remembering that one option contract is for one hundred shares of the underlying shares. In this example you would enter 10. You then need to type in or click on the option symbol in the appropriate place to be sure you get the right contract. Get this information from the entry you made into your template if need be or the broker's option chain.

There will also be a section that will ask you to click whether you wish a "market order" or a "limit order." A limit order requires that a "limit price" be set.

If you select market order, the transaction will be carried out at the "best price available" when the order reaches the marketplace. It assures that the transaction will be executed at some price. The difficulty with options is that typically they are not as liquid as the underlying shares. PG, for example, trades millions of shares per day, but there are not millions of call options for PG that trade daily. The number of option contracts traded in a day is much, much

smaller. As a result, even though there is a highly efficient, fungible market for options, sometimes the difference between the bid and ask can be wide and can change to an investor's disadvantage if a market order is placed. You could then end up getting your order filled for something less than the price you were expecting. For that reason, it is suggested that you *use limit orders and set a limit price* for your option trades unless the option contract you are trading is very active and has a very narrow spread between bid and ask. While you will not be guaranteed that your order will be filled, you will be assured that if it *is* filled the price you will receive will not be less than the limit price you have set…and it may be more, depending on the best price available at the time.

So, you should click on "limit order" and then set a limit price you are willing to accept. Since your transaction will not be completed for less than the limit price, you need to be sure that the amount you set is either at the midpoint between the bid and ask or perhaps even a bit lower to give greater assurance that the transaction will be completed. For example, if the bid on your option transaction is $1.50 and the ask is $1.70, to have a reasonable assurance that your order will get filled, you should bid about $1.60. Or, you could plug $1.55 into your calculation template, and if that amount would result in a return that is acceptable, you could consider entering your limit order for $1.55.

The risk is that if you enter a market order you will often get filled at the bottom end, namely the bid of $1.50 in this case, or even lower on occasion. By setting a realistic limit order price, you can almost always get your transaction completed and assure yourself that you are getting a reasonable market price for your option trades.

If you were to put in a limit price that is a bit higher than the midpoint between the bid and ask, it would probably take a change in the price of the underlying shares (up for calls, down for puts), and correspondingly the option, before your trade would be executed. Since there would be no assurance that the price would change, your order might not be filled. In a volatile market, however, this might be a reasonable strategy.

There is one risk you do run, however, when setting a limit price. If, in the case of calls, by the time you get your order placed the price of the underlying shares has declined, then the option price will have also declined and your order will not be filled unless the price of the shares and the option rise again. The opposite is true for puts. The best guard against this is to be sure you have a very current quote on the bid and ask for the option contract and that you enter your limit order as quickly as possible after you have made your decision to write the option. In the event the price of the shares changes, however, you should be prepared to cancel your option order and replace it with a lower limit price. Otherwise you would need to wait to see if the market returns to a price where your order will be filled. You can see that much of this would be difficult if you were dealing with a live broker and had to be making phone calls back and forth until your trades were completed.

Of course, if the bid price fulfills your return objective and is acceptable to you, you could actually enter the bid amount as your limit price, but you should typically try to do at least somewhat better than that. You can plug in quotes for various premium alternatives into your template to see what the yields look like compared with your objective.

There's another element that needs to be mentioned…an "all-or-none order."

When initiating an option trade, "all or none" is a further restricting element of a limit order whereby you specify that either your entire order be executed at the same time or none of it is to be executed. For example, if you are trying to sell-to-open ten call contracts, it is possible that only part of your order might be filled…say two contracts, with the order for the other eight not filled if the price of the option should quickly back off of your limit price. If you have to go in later and alter your price to fill the rest of your order, or if the balance of your limit order is not filled until a later date, your commission costs would go up. These trades would be treated as separate transactions for commission purposes. In an effort to avoid this, it may be advisable to place your limit orders fairly early in the day to allow time for execution.

The "all or none order" can be a good idea, particularly when you are dealing with options that are thinly traded. It's not always possible to know how liquid the market is for the options you are trading. As you gain more experience with option trading you will get a feel for this. You should also be able to get volume information on option contracts from your broker's quotation system. At least initially you may wish to use "all or none" orders to avoid partial order fills, particularly if you are trading a large number of contracts. When you are initiating your transaction, either online or through an automated voice response phone system, you will be asked whether you wish to place any special conditions on the transaction. This will give you an opportunity to indicate if you wish the order to be "all or none." There is a potential downside to this. Option market makers and specialists can fill orders first that do not have an "all or none" designation, so in some cases your order may not have top priority in execution.

There's one final element to add. You also have an opportunity to indicate the time-in-force of the transaction. You can specify that the order will only be valid for the day, referred to as a "day order," or that it will be a "good-'til-canceled order," also referred to as "GTC." If you use orders that are valid only for the day and the order is not filled, that provides an opportunity to reevaluate what you want to do at that point. You can then enter a new order for the following day. With a good-'til-canceled order, the order will remain on the brokerage firm's books until it is filled or until the order time limit expires.

The process of trading options is pretty much the same as trading stocks or ETFs. Since you are looking up quite a few quotes, computing a midpoint between bid and ask, and entering the information into the template for review,

it may just seem a bit more complicated at first. It is more work with options, but the end result definitely justifies it. And the more trades you do, the easier it will become.

Once you have entered your order, you can check your online account at any time to see if the order is still pending or if it has been executed. Until it is filled, you will probably want to continue to monitor the price of the underlying shares and the option to see if you need to make any adjustment to your limit price if the market declines or rises. Or you may wish to wait it out to see if the market reverts to your price.

In addition to receiving a brokerage statement periodically in the mail, you can, of course, also check at any time online to see a current statement of positions and cash balances as well as a transaction history. When you have written covered calls and puts, they will show up online and on your brokerage statements as a negative balance until the options expire or are assigned. This is a "short position" offset to the cash you received into your account. It will reflect the current market price of the options as they fluctuate up and down based upon the price of the underlying shares. In addition to the price of the underlying shares, the other variable that will affect the price of the option is the time remaining until expiration. If the price of the shares were to remain constant after the trade, the negative balance of the option on your brokerage statement would gradually diminish as time dwindles to the expiration date.

11

TRACKING RESULTS

A person who learns from his mistakes is smart. A person who learns from others' mistakes is smarter.

Now that you are ready to start your option writing program it is important that you have a mechanism to keep track of how you are doing on an ongoing basis compared with your investment return objective. To accomplish that, the Excel® template "Boomer files" contains a tab called "Results."

The following is a sample of how you would use this file template. It appears here in two pieces whereas on the actual template it is in one, but the information is the same.

RESULTS TRACKING TEMPLATE

X ACCT.	X P/C	X STK	X SHS/ CONTS	X SHARE PRICE	X MARKET/ MARGIN	X TRADE DATE	X EXPIR.	X STRIKE	DAYS
IRA	C	DVY	1,000	$44.52	$44,520	23-Aug-10	15-Oct-10	$45.00	53
PER	P	PG	10	$60.00	$21,300	23-Aug-10	21-Jan-11	$60.00	151

STK	X OPTION SYMBOL	X PREM.	X PREM. INC.	X STOCK GAIN/LOSS	TOTAL $ RETURN	ANNUAL % RETURN
DVY		$0.90	$900	$480	$1,380	21.35%
PG		$3.30	$3,300	$0	$3,300	37.45%

The appearance is reminiscent of the "Calls" and the "Puts" templates, but serves a different purpose. Again, the "**x**" at the top of some of the columns means you need to type in that information. Otherwise the template makes the calculations. There are a few more columns with an **"x"** in this template. To start you need to enter the account type in the first column. This is particularly handy if you have more than one account. You may wish to enter "PER" in this column for transactions having to do with your personal taxable account and "IRA" for an IRA account. You can obviously use whatever designation you wish, as long

as you are consistent. If you have only one brokerage account, you could leave this column blank. In the column before the expiration date, you enter the date of the trade. If, for example, the trade date was August 23, 2015, you would type 8/23/2015 into the cell. You also need to enter the net amount of the premium income as shown in your brokerage confirmation (net of commission). Also, for covered calls, if your shares are called away from you or otherwise sold, you need to determine the gain or loss on the shares (the amount of capital appreciation or capital depreciation realized based upon the price of the shares on the date when the calls were written) and enter that information in the "Stock Gain/Loss" column as well.

In the case of put writing, you need to manually enter the amount of the margin requirement calculated by the "Puts" template in place of the calculation that is made in the "Market/Margin" column. That's all there is to it. In the unusual circumstance that you bought back your call or put options prior to expiration, you would need to reduce the amount of premium income you received by the amount you paid to buy back the options.

You can see in the first example that this option writer wrote call contracts on 1,000 shares of DVY…the DVY October $45 calls in an IRA account and received $900 in premium income. The "P/C" column is used to indicate whether the option written is a put or call. If the write is a covered call, the number of shares is placed into the "Shs/Conts" (shares or contracts) column. If the write is a put, the number of put contracts is entered. As this option expired and was exercised (assigned), there was a sale of the shares at the strike price and therefore a gain of $480. The annualized percentage return from the option income and capital gain was 21.35% (note that dividend income is not included in this template, as its purpose is simply to track your results from option writing and any associated capital gains.

In the second example, the option writer wrote 10 call contracts in a personal account of the PG January $60 calls and received $3,300. There will never be any stock gain or loss on a put writing trade (if the shares are assigned to you below the strike price, a gain or loss in the shares would be reported in a subsequent transaction). The annualized percentage return on the margin requirement is 37.45%.

The best time to enter the information into the "Results" template is when you get your broker confirmations in the mail and when options expire. Or, you can get the information online after the trade is executed.

It can be useful to sort and look at your data by ETF or stock, for example, so that you can see how many times you have written options on specific shares and how it has worked out for you. That will give you a very good feel for the market over time.

12

TAX CONSEQUENCES OF OPTION WRITING

Did you ever notice that when you put "THE" and "IRS" together it spells "THEIRS"?

People seem to wish they had a big tax problem…until they actually have one, that is…and then they wish it was gone. When you have success with an option writing strategy in a personal account it's going to mean more income taxes to pay. But, on the other hand, you are going to have a lot more income than you otherwise would have had, so that obviously more than makes up for it.

TAXABLE ACCOUNTS

As we've said earlier, when you write covered call or put options you get the premium income up front into your account the next business day to use as you wish. The good news from a tax standpoint is that *even though you have the use of the premium income immediately, it isn't taxed to you until the options expire* or until you close out your position if you buy-to-close, whichever occurs first. That can lead to some tax planning opportunities at times, depending on the time of year and the expiration date on the options you are writing.

Let's say it is August and you wrote options on PG shares you own with an October expiration date. The options expired without your shares being called away. Now you are ready to write another option. You use the "Calls" template to look at the premiums that are available for various expiration dates. You also look at your tax picture and realize that you have built up a lot of taxable income during this tax year and you would like to try to defer some taxable income into the next tax year. What you could do is select one of the call options with an expiration in January or later of next year. That way the premium income you receive on those options now will not be taxed until the options expire, which would be in the next tax year. By writing this call, you have just deferred the income tax consequence into next year, even though you receive the money right now. And you can do this with as many different put or call option contracts as you like. This can give you a powerful tax planning tool at times.

Speaking of tax consequences, perhaps the most important point is that the premium income you receive from writing calls is "capital gain" for tax purposes. The bad news is that the premiums are almost always "short-term" capital gain, regardless of the length of time the call was outstanding. That

means your option writing income is usually taxed at the same rate as if it were "ordinary income." And, if you would decide to close out your option position by buying back the options, any gain or loss would be short-term capital gain or loss in the year that the position was closed out. For example, let's say you wrote options in July that were not due to expire until the following year and you received $3,000 in premium income. In November you bought back the options for $1,000. You would have a short-term capital gain of $2,000 for the tax year in which you bought back the options, not in the next tax year when the options would have otherwise expired.

PREPARING SCHEDULE D

You will need to report your option trades on Schedule D of Form 1040. As a tool to help prepare your Schedule D, you will find a template that can be used for this purpose on the "Boomer files" Excel® file. Just click on the "Schedule D" tab.

The "Schedule D" Excel® template can be used to prepare this schedule for your Form 1040 as you make trades during the tax year and as results are finalized on each expiration date on which you have option positions. This will spread out the recordkeeping during the year so that you don't have to prepare the entire schedule at tax time. Entering the data onto the worksheet should be helpful if you have a lot of options transactions during the tax year.

	A	B	C	D	E	F	G
1	**JOHN Q. TRADER**		**012-345-6789**				
2							
3	**SUPPLEMENT TO SCHEDULE D - 2011**						
4	**CAPITAL GAINS AND LOSSES**						
5							
6		**DATE**	**DATE**	**SALES**			
7	**DESCRIPTION**	**ACQ.**	**SOLD**	**PRICE**	**COST**	**LOSS**	**GAIN**
8							
9	10 Proctor and Gamble Aug $57 1/2 puts	23-Aug-10	15-Oct-10	$ 790	$0		$790
10	10 ConocoPhillips Sep $55 calls	23-Aug-10	15-Sep-10	$1,000	$150		$850
11							
12							
13	**GAIN AND LOSS TOTALS**			$2,100	$150	$0	$1,640
14							
15	**NET GAIN**						$1.640

First enter your name as it will appear on your tax return in cell reference A1. Then enter your Social Security number in cell C1. As transactions occur, you should start by entering the description in column A, beginning on row 9. A description of an option transaction might read as indicated here on rows 9 and 10. In column B enter the date you wrote the option contracts (enter as

MM/DD/YY and it will be automatically formatted as shown). Enter the expiration date of the option contracts, or the date you bought back the contracts to close, whichever applies, in column C using the same format. Enter the net amount of premium income you received (after commissions and any other costs) in column D. Finally, enter your cost in column E. This will be $0 if the options expire and are not exercised. If you buy the option to close, this will be the net amount you pay after commissions and other costs. The amount of gain or loss will be automatically entered into the appropriate column and will be totaled at the bottom. If you need more rows for transactions, simply place your cursor on the number below the last row into which you entered data, click on "Insert" and then "Row."

Note that if puts are assigned to you and you acquire the shares, you do not report the premium income from the put writing transaction separately on the Schedule D as you would have done if they had simply expired. You should subtract the amount of net put premium income from the cost of the shares you acquired. It then becomes an adjustment to the cost basis of the shares and becomes reportable on Schedule D when the shares are eventually sold.

At the end of the tax year, all you will need to do is to highlight the data you wish to print for your Schedule D supplement, then click on "File." When the drop-down menu appears next click on "Print Area" and finally click on "Set Print Area." You are now ready to print the schedule.

If you have a preparer do your return, simply give this supplement to your preparer. If you do your own return, on the Schedule D page in your tax package simply write or type "See attached supplement to Schedule D." Then enter the totals from the bottom of the columns of your supplement to your tax form Schedule D. Include the supplement after the Schedule D in your tax package when you mail it to IRS. As an alternative, your brokerage 1099 can be attached to your return, as it should contain all of the required reporting information to support your Schedule D.

CAPITAL GAIN VS. CAPITAL APPRECIATION

We've used the term "capital appreciation" frequently so far, and now we are referring to "capital gain." There is an important difference. When we are talking about capital appreciation, it is an investment term that simply means an increase in value of a security, such as shares or an option. For example, if an ETF goes from $35 to $50, it has experienced capital appreciation of $15 per share. Capital gain is a tax term that comes into play only when a capital asset, such as shares or an option, is sold. It occurs when the proceeds from the sale is greater than its cost.

You are likely aware that if you have capital gains you can offset them with capital losses to reduce your tax burden. So, if you had shares you sold on which you took a "capital loss," you could use that loss to offset some of the gains you

realize on your option writing income. If you had gains from writing put or call options, you could also use prior year losses carried forward to offset the gains on the option income. And for any current "unrealized loss" in any of your ETFs or individual companies, you could sell those shares and use the realized capital losses to offset option writing income.

AN EXCEPTION: WHEN SHORT-TERM CAPITAL GAIN FROM COVERED CALL WRITING CAN BE TREATED AS LONG-TERM GAIN

The tax effect may be different, and beneficial to you, if your calls are assigned and shares on which you have a long-term gain are sold to the option holder at expiration. If you sell covered calls and the calls are assigned, the strike price at which you sell your shares *plus* the premium you received becomes the sale price of the shares to determine the amount of gain or loss. Let's say you had paid $20 per share several years ago for your shares. They were trading at $42, and you had written call options on them for a premium of $2 per share at a strike price of $45. On expiration the shares were called away from you at the strike price. Your gain would be $45 minus $20 plus $2, or $27 per share. When your shares are assigned, the resulting gain or loss depends upon the cost of the underlying shares delivered and the holding period of the shares. What is meant by "holding period" is the length of time you have owned the shares. In this case, because you had held them for a long enough time period to qualify for "long-term" capital gain treatment, the gain on your shares *and the option premium* will be long-term capital gain at a favorable tax rate. So, this is the exception when an option premium is taxed as a long-term capital gain rather than a short-term capital gain.

Here's the rule. Under current tax law, writing an at-the-money or an out-of-the-money covered call does not affect the holding period of the underlying shares for purposes of determining whether any gain is long-term or short-term if the shares are eventually assigned. This will cover almost all of the transactions you will be doing. The tax consequences on in-the-money transactions can sometimes become more complicated, especially if the underlying shares would qualify as a long-term holding for tax purposes. You should consult your tax advisor if you enter into any such covered call writing transactions and the shares are assigned. And, of course, there's always talk about possible changes in the tax rates for capital gains based on the holding period, so it's a good idea to keep up with that or to consult your tax advisor. It's always a good idea to consult your tax advisor about all of these tax matters. The laws are cumbersome and they can always change.

THE WASH SALE RULES

In Chapter 4 we discussed the desirability under some circumstances of writing in-the-money calls. Writing such calls increases the probability of your shares being sold at a loss (but of course the large premium income received at the time the calls are written more than compensates for the loss). This brings up a potential tax complication when we are using shares in the same security that may likely be repurchased multiple times when called away if you are following the strategy suggested in this book. We need to be careful that we do not violate the "wash sale rules. " Part of these tax rules state that if you sell your shares at a loss and buy them back within a 30-day period before or after the loss sale date, the loss cannot immediately be claimed for tax purposes. The loss must be added to the cost of the newly purchased shares instead pursuant to IRS Publication 550.

Fortunately, there is a way out of this dilemma. You can trade in and out of the same security all you want during the year, purposely incurring losses on the underlying security as you reap the benefit of a great amount of premium income. You can buy back the same security each time it is called away from you at a loss and still claim the loss as a deduction in the current tax year as long as you sell *all* of your position in that security prior to the end of the tax year and do not repurchase any shares in it for at least 30 days following that sale. The sale could come either from the shares being called away before the end of the year, or through an outright sale.

Each time during the tax year that you sell the same security at a loss and repurchase it within thirty days, the wash sale rules require that you accumulate the losses by increasing the cost basis of the newly acquired shares each time. When you finally sell your most recently acquired shares before year-end and do not repurchase for at least 30 days, the accumulated losses are then triggered, allowing you to claim the loss deduction in the same tax year as if you had never been subject to the wash sale rules.

You have two choices with respect to shares if they are called away from you and you incur a loss on them:

(1) Do not repurchase that security for a period of at least 30 days following the sale that resulted in a loss (note: the purchase of another, similar ETF or stock within 30 days upon which covered calls were written would not violate the wash sale rules unless the new shares were "substantially identical," according to the rules);

or

(2) Sell any shares in the security generating the loss prior to the end of the year and do not repurchase any shares in that security for at least 30 days following the sale (again, similar but not

"substantially identical" shares could be purchased within 30 days and calls written).

THE CHALLENGE OF WRITING CALLS ON HIGHLY APPRECIATED SHARES

As Ben Franklin said many years ago, there are only two certainties in life…death and taxes. We all generally accept this, but we'd like to be able to plan for both of them. As far as capital gains tax is concerned, we are used to having the certainty of timing it so that our best tax interests are served. When we are writing covered calls on shares we own that have grown in value substantially, we never know exactly when that big capital gain might be triggered through an exercise of the option causing a sale of the shares.

First, you should never write a call option on shares that you are absolutely unwilling to sell. But the opportunity to earn call option premium income may outweigh the possibility that the shares might be called away, triggering an unwanted capital gain. One choice might be to write calls on only a portion of the shares. If they are called away, you would only have a portion of the total gain taxed to you. That way if the share price went up you could write options on the rest of the shares at a higher strike price and structure it so the expiration date falls into another tax year to spread out the potential tax on the gains if the rest of the shares are called away.

Also, keep in mind that there are favorable tax laws for long-term capital gains on the sale of stocks and ETFs. Under current law, for taxpayers in higher brackets, you would pay a lot less on the capital gain than you would on your ordinary income. Perhaps that's not much consolation if you are facing taxes on a big gain, but unless you donate the shares to a charity or die owning them, taxes on the gain will be paid by someone at some point. Also Congress has been known to change the tax laws with some regularity. There's no assurance that the tax on capital gains won't be greater at some point in the future than it is today.

But if you really don't want to trigger the capital gain, and you really do want to write options on the shares, what can an investor do?

Let's assume that you have written calls on shares with a large unrealized long-term capital gain and that the price of these shares has gone up above the strike price of the calls you have written. As we discussed before, options are usually not exercised until expiration, even though the buyer of the option has the right to exercise them at any time up through the expiration date. So, if you are, say, within a month of expiration, and the price of the shares is above the strike price of the calls, this is what you may wish to consider doing: you can buy back the call contracts at the current market price to close out your option position, and then write new calls with a different and more distant expiration date. In this case it may be advantageous to act before the expiration date.

ROLLING FORWARD WITH COVERED CALL WRITING

This, in effect, would dispose of the old call option and defer the exercise of the new call option until a later date. If the new options have the same strike price as the old ones, the option premium on the new calls will always be greater than your cost of buying back the old calls. You could, of course, have a gain or loss on the old options when you buy them back. It would largely depend on how much the market value of the shares went above the strike price of the original calls…in other words, how much intrinsic value there is.

There is a name for this. Buying back your calls and then writing new calls at the same strike price, but with a more distant expiration is called "rolling forward."

Let's say, for example, you bought shares of a stock ten years ago. You now own 1,000 shares and your cost basis, adjusted for several splits, is only $5 per share. About 2 ½ months ago the market value of the stock was $50 per share, or $50,000. At that time you sold ten call contracts on your shares at a strike price of $55. Since then two months have passed and the options will expire about two weeks from now.

When you wrote the options you collected a premium of $2.50 per share for total premium income of $2,500. From the date you wrote the options 2 ½ months ago the price of the stock has gone from $50 to its current price of $57 per share. The call contracts you wrote are now priced at $3.50 reflecting the current intrinsic value of $2 per share (the $57 current market value less the $55 strike price) and the remaining time value of $1.50 per share (the $3.50 current market less the $2 intrinsic value). If you hold your position where it is now, and the price of the stock remains above $55, you will realize a capital gain of $50 per share (the $55 strike price less your $5 cost basis) or $50,000 when the shares are called away from you.

Not wanting to pay the capital gains taxes at this time, you decide that rolling forward is a strategy that makes sense for you. You get quotes from your broker on calls with the same strike price, but with a longer expiration date. There are several option expiration dates available to you. Which one you select is purely a matter of preference and planning. You might want to take into consideration the expiration dates of calls currently existing that you have written on other shares for purposes of expiration diversification. After review, you decide on the contract at the same strike price and with an expiration date in about 6½ months. If your shares were called away at this new expiration date, it would place the capital gain into the next tax year, which would be more acceptable to you. Of course, it's always possible that the share price may decline below the $55 strike price by the new expiration date, in which case you would keep your shares and the new option premium income. There would be no capital gain realized on the shares and therefore no taxes to pay in that event…just tax to pay on the short-term capital gain from the premium income.

The price of the option contract with the new expiration date is $5.50 (larger due to the longer expiration term). You are ready to roll forward.

First you buy back the old option contracts at $3.50 with an order to buy-to-close ten contracts. After the order is filled, you then sell-to-open (also termed "sell covered call ") ten contracts of the new option at $5.50. When that order is filled, you watch what happens until the new option expiration date approaches.

This sounds a lot more complicated than it really is. Let's first consider the sale and repurchase of the first option. You sold the initial calls for $2,500 and repurchased them for $3,500 for a loss of $1,000. This loss can be used to offset other capital gains you've earned. The new option transaction stands on its own. If held until expiration, the premium income of $5,500 would be taxed the same as other option transactions we've previously discussed. Of course, if the shares are called away at the new option's expiration you would still have a $50,000 long-term capital gain to pay tax on.

What you have accomplished is that you have bought additional time and thereby have extended out the realization of the capital gain and the corresponding tax on it. And, again, if the shares were to go back down below the strike price at expiration, the capital gain tax would be a moot issue.

If the price of the shares just kept going up, there are a couple of choices you would have. First, you could continue to roll forward the expiration dates by buying back the older contracts and writing new options as each expiration date approaches, just as we did in the previous example. The higher the price rises, however, the more likely it becomes that your shares will eventually be called away from you at the $55 strike price at some point. So, if your share price keeps rising, this strategy is simply one of deferral of the capital gain recognition to a time when it may be more acceptable from a tax planning standpoint.

ROLLING UP WITH COVERED CALL WRITING

Going back to the example, another alternative would be to buy back the first call options and then write new calls with a higher strike price. This is referred to as "rolling up." Doing this can take the pressure off a bit, because if the strike price on the new option was $60, for example, you now have out-of-the-money calls that wouldn't be exercised at expiration unless the share price continued to rise. If it did go up further, your shares would be called away at $60, not $55, and you would have a $55,000 capital gain subject to tax.

Of course, the premium you would receive on a call with a $60 strike price would be quite a bit less than one with a $55 strike price. As you know, the higher the strike price relative to the share market price for a call option, the lower the premium. Depending on how much higher the strike price is on the new option compared to the old option, and also how much further out the expiration is extended, the premium income on the new calls could be significantly reduced. You would need to consider all of the choices. The best

alternative in some cases might be a combination of rolling forward and rolling up. A lot depends on what might happen later. Unfortunately, of course, we can't often predict the future.

There is one additional alternative you should know about. It's not likely that you would use it often, if ever. But in a situation like this you might consider it: when you write calls on your shares and your shares are assigned, that doesn't mean that you have to deliver those exact same shares. Like option contracts, shares of ETFs and individual stocks are fungible. That is to say, shares are freely interchangeable among investors. The buyer of your shares subject to the calls doesn't care whether you deliver the shares you owned at the time your calls were written or different shares. Their fungibility makes them all the same. Therefore, if you would prefer not to deliver the shares you own with the low cost basis, you can always purchase new shares on the open market and deliver them to fulfill your assignment obligation. This would create an immediate capital loss rather than triggering the capital gain that would be realized by selling your original shares (as the market price you pay for these new shares would be higher than the strike price you receive for the shares), but that might also work to your advantage, depending on your tax situation. You would, of course, need available cash or margin borrowing capability to buy these new shares to do this.

You can see why it is always best to write options on shares that you don't mind being called away from you at expiration. You just let the shares be called away and accept your gains rather than having to chase a rising share price by rolling forward and/or rolling up. Nonetheless, these are workable ways to handle the writing of call options on highly appreciated shares when the price rises. It's best to have a plan at the very start so that if the share price increases significantly you know in advance what action you will want to take. As stated earlier, about eighty-percent of options that are at-the-money and out-of-the-money when written expire unexercised, so this scenario is not something you would frequently have to face, and not unless you write options on highly appreciated shares…but forewarned is forearmed!

ROLLING FORWARD WITH PUT WRITING

Our primary put writing strategy focuses on writing puts on shares of an underlying security that you would be interested in purchasing at a discount (the strike price you have selected). What can be done, however, if the market price declines below the strike price around expiration time and you decide you do not wish to have the shares put to you now? To liquidate your short put option, you could buy back the put to close out the position. You might incur a loss in this transaction, depending on how much the market price had fallen below the strike price (the amount of intrinsic value) and how much time was left until the expiration date. If the issue is simply one of timing (you would prefer to

purchase the shares at the strike price at a later date), after buying back your original put contracts you could write the same number of new put contracts at the same strike price but for an expiration date that is further out into the future. As before, this is known as "rolling forward."

If the new options have the same strike price as the old ones, the option premium on the new puts will always be greater than your cost in buying back the old puts.

An example might help clarify this. Let's say you sold ten put contracts at a strike price of $55. Since then 2 ½ months have passed and the options expire about two weeks from now.

When you wrote the options you collected a premium of $2.50 for total premium income of $2,500. From the date you wrote the options 2 ½ months ago the price of the shares have gone from $60 to its current price of $52 per share. The put contracts you wrote are now priced at $3.50 reflecting the current intrinsic value of $3 per share (the $52 current market value less the $55 strike price) and the remaining time value of $.50 per share (the $3.50 current market less the $3 intrinsic value). Let's say you have decided that you do not want to purchase the shares on the expiration date. You conclude that rolling forward is a strategy that makes sense for you. You get quotes from your broker on puts with the same strike price, but with a longer expiration date. There are several option expiration dates available to you. Which one you select is purely a matter of preference and planning. After review, you decide on the contract at the same strike price and with an expiration date in about 3 ½ months from now. Of course, it is always possible that the underlying share's price may rise above the $55 strike price by the new expiration date, in which case you would keep all of the new option premium income but would not be obligated to purchase the shares. The price of the option contract with the new expiration date is $5.50 (larger due to the longer expiration term). You are ready to roll forward.

First you buy back the old option contracts at $3.50 with an order to buy-to-close ten contracts. After the order is filled, you then sell-to-open ten contracts of the new option at $5.50. When that order is filled, you watch what happens until the new option expiration date approaches.

This also sounds a lot more complicated than it really is. Let's first consider the sale and repurchase of the first option. You sold the initial puts for $2,500 and repurchased them for $3,500 for a loss of $1,000. This loss can be used to offset other capital gains you have earned. The new option transaction stands on its own. If held until expiration, the premium income of $5,500 would be taxed the same as other option transactions we have previously discussed. Of course, if the shares are put to you at the new options' expiration the cost basis of the shares you acquired would be reduced to $49 ½ to reflect the premium income you received from writing the second puts.

What you have accomplished is that you have bought additional time and thereby have extended out the time requirement of purchasing the shares at the

option of the put holder. And, again, if the shares were to go back up above the strike price at expiration, you would not need to purchase the shares at all.

If the price of the shares just kept going down, there are a couple of choices you would have. First, you could just continue to roll forward the expiration dates by buying back the older contracts and writing new options as each expiration date approaches, just as we did in this example. The more the price declines, however, the more likely it becomes that the shares will eventually be put to you at the $55 strike price at some point. This strategy will not appeal to most put writers.

ROLLING DOWN WITH PUT WRITING

Going back to the example, another choice available would be to buy back the first put options and then write new puts with a lower strike price. This is referred to as "rolling down." Doing this can take the pressure off a bit, because if the strike price on the new option was $50, for example, you now have out-of-the-money puts that would not be exercised at expiration unless the shares continued to fall. If they did decline further, the shares would be put to you at $50, not $55, so you would have a lower acquisition cost for the shares.

Of course, the premium you would receive on a put with a $50 strike price would be quite a bit less than one with a $55 strike price. As you know, the lower the strike price for a put option, the lower the premium. Depending on how much lower the strike price is on the new option compared to the old option, and also how much further out the expiration is extended, the premium income on the new puts could be significantly reduced. You would have to consider all of the choices. The best alternative in some cases if you wish to defer purchase of the shares or reduce the likelihood of having to purchase them might be a combination of rolling forward and rolling down. A lot depends on your belief about the direction of the market. Unfortunately, of course, we cannot often accurately predict the future.

You can see why it is always best to write put options on shares that you are fully prepared to purchase at the strike price on the expiration date. You just let them be put to you and accept your purchase at the strike price rather than having to chase a falling share price by rolling forward and/or rolling down. Nonetheless, these are workable ways to defer the purchase of the underlying shares if the price of the shares falls below the option strike price. It is best to have a plan at the very start so that if the share price declines significantly you know in advance what action you will want to take, if any.

ROLLING UP WITH PUT WRITING

What if the price of the underlying security rises significantly prior to expiration? First, your margin requirement may decline. Second, the price of the

put contract will also decline substantially, depending on how much the stock has risen and how much time there is left until expiration. Some put writers will do the opposite of what we just discussed. They will buy back their put contracts to close at a much reduced price from when they were sold (thereby locking in their profit) and then write new put contracts at a higher strike price. This is referred to as "rolling up." The put writer will collect a higher premium for writing the higher strike price, however he will now be committed to purchase the shares at a higher price than with the first put contracts should the shares decline in price at this point. The writer may also extend the expiration date of the new contracts by rolling forward, further increasing the premium income.

Use of tactics such as rolling up, rolling down and rolling forward may be useful but are not absolutely necessary for put writers who wish to keep things simple by writing puts and then just waiting until option expiration date to see if they purchase the underlying shares.

TAX DEFERRED ACCOUNTS

The best news is that none of these tax consequences apply when you are dealing with a tax-deferred account, such as an IRA, since no income or gain is taxed until actual distributions are made from the account. That gives an investor a tremendous opportunity to earn a large amount of current premium income from covered call writing and cash covered put writing and not pay any taxes on it until withdrawals are made from the account. And, with a ROTH IRA the premium income and any capital gains on the shares go untaxed.

Now we are having fun!

"FINDING FINANCIAL FREEDOM" A LIFELONG FINANCIAL PLANNING MODULE

13

Employment application blanks always ask who should be notified in case of an emergency. I think you should write, "A good doctor!"

Ask yourself this: "If I run out of money at age 85, how easy would it be for me to get a job?"

I think we all intuitively know the answer to that question. We Boomers all need to assure ourselves that we do not run out of money at any age. With this guidebook you have important tools that can help you maximize investment income on your hard-earned productive assets. But even with those tools, sometimes we just haven't built up a sizeable enough estate to assure long term provision of income as we age. Or perhaps we had it, but lost much of it through the declines of the Dot-Com crash and the Great Recession, either in the stock market, in real estate, or both. A new study recently conducted by Boston College's Center for Retirement Research reports that Americans are from $6.6 trillion to $7.9 trillion in assets short of what they need to retire, based on projections of retirement and income for American workers aged 32-64.

Financial planning is a lifelong process. With me it began in my early twenties when I began to develop a template for my personal use that would tell me how I was doing financially and guide me in making future "what if" financial decisions as I planned for future retirement. Through these many years I have made many improvements in it and now have a detailed Excel® template that allows anyone, regardless of age, amount of income or resources, to plan out your entire financial life for as many years into the future as you wish to plan. It utilizes a personal cash flow projection that is integrated with a personal net worth statement. The template is flexible enough to provide for any contingency. It does take time, but what could be more important than a one-two punch of maximizing your investment returns (this guidebook) and assuring financial freedom through proper financial planning that you can readily do yourself if you are committed?

My eBook *Finding Financial Freedom* instructs on using the Excel® planning template to create your own personal lifelong financial plan. It is available to you at no charge as a buyer of this guidebook. If you choose, and when you are ready to begin this process, please send an e-mail to arrowpublicationsUSA@gmail.com

and request the "Finding Financial Freedom" files. We will send you the 132 page eBook and the extensive Excel® files that accompany it by return e-mail.

Below is the table of contents from the book to let you know a bit more about it:

By maximizing your investment returns utilizing the put and call writing strategies detailed in this guidebook, coupled with the development of a long-term financial plan through the tools contained in *Finding Financial Freedom*, you will be far ahead of the almost 60% of Boomers who, when surveyed, said they had no idea how much they needed to be able to afford to retire or even at what age they would be able to retire.

14

CONCLUSION

> There is only one of each of us. We are unique. We are neither better nor less than anybody else, but rather the best or least of ourselves. I am still working on becoming the best of me.

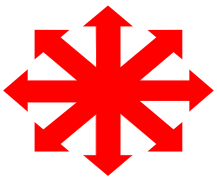
It has been more than four decades since put and call options were first offered on regulated exchanges in the United States. There are a wide variety of strategies that can be employed using options…some highly risky, some conservative, and some in between. Perhaps it is because of the variety of alternatives investors have with options that the average investor remains largely confused and unaware of how to use them. In particular it is amazing that the most conservative option strategies of all…writing covered calls and cash covered puts on stocks and Exchange Traded Funds…remains a mystery to the masses while their fruits are enjoyed primarily by large institutional investors who manage billions and billions of dollars for themselves and for others.

There is evidence that the word is starting to get out to individual investors about covered call writing and put option writing. Articles are appearing in magazines, guests are invited to speak on CNBC TV, Bloomberg and Fox Business (the cable stock market channels) on the subject, and Web sites are being created offering outlandish claims of investment success.

Clearly the market doldrums have taken their toll on individual investors as they frantically seek out alternatives to "traditional" investing, after losing billions of dollars in the value of their stocks in past years. And, with interest rates at historic lows, plus real estate having been decimated, few reasonable alternatives for decent returns remain available to us. Moreover, hearing from some of the country's best known and most respected investors, economists and educators that stock market and fixed income returns may be paltry in the future when compared with the past for perhaps one or more decades is most unsettling for Boomers who were looking forward to early retirement, normal retirement or any retirement.

Few good new investment ideas are apparent. While writing covered call options and put options is certainly not new, it is new to most individual investors. If the flat to slow-growth market predictions of many knowledgeable professionals hold up, it would appear that the returns achievable from writing covered calls and puts on high dividend paying ETFs and individual stocks may

well be one of the few ways for Boomers to obtain adequate diversification and achieve double-digit investment income returns for many years to come.



GLOSSARY

ALL-OR-NONE ORDER – A type of limit order which directs a broker to either fill the entire order or, if it cannot be filled, to fill none of it.

ASK – The price offered by an owner to sell a security, such as an ETF or an option.

ASSIGNED – The requirement by the writer of an option to perform according to the terms of the contract by making delivery of the underlying ETF to the holder (buyer) of the option. This is done by the option writer's broker.

AT-THE-MONEY – The strike price and the market price of the underlying ETF are exactly equal or very close.

BETA – A mathematical measure of risk regarding rates of return on an equity portfolio, specific stock or ETF compared with risk and rates of return on the market as a whole.

BID – The price offered by a buyer to purchase a security, such as an ETF or option.

BUY TO CLOSE – The placing of an order by an option writer to buy back the option in order to close out the position.

CALL – An option permitting the holder (buyer) to purchase an ETF at a predetermined price until a certain date. For example, an investor may purchase a call option on AAA ETF giving the investor the right to buy 100 shares (for each option contract) at $50 per share until June 15.

CAPITAL APPRECIATION – An increase in the market value of a security.

CAPITAL DEPRECIATION – A decrease in the market value of a security.

CAPITAL GAIN – Occurs when the proceeds from an ETF or an option sale is greater than its cost. When writing covered calls, for example, if you receive $3 per share in premium income and the calls expire worthless, your cost is $0 per share and the capital gain is $3 per share.

CAPITAL LOSS – Occurs when the proceeds from an ETF or an option sale is less than its cost. When writing covered calls, for example, if you receive $3 per share in premium income and you buy back the calls at $4, the capital loss is $1 per share.

CASH COVERED PUT WRITING – Many brokers will now permit put writing in self-directed employee benefit accounts such as IRAs if the investor is approved and if sufficient cash is held in the account that would be needed to fully fund the acquisition of assigned shares subject to put contracts on a "cash covered" basis.

COVERED – Implies that the investor who writes a call option owns the underlying ETF, so that if the ETF is assigned the writer has the ETF to deliver to the call holder (buyer).

COVERED CALL OPTION WRITING – An investment program for ETF owners and shareholders of individual companies who are generally seeking a conservative way to increase income from their shares by selling (writing) calls on the ETF they own. There is also the opportunity for a defined amount of capital appreciation in the ETF (for out-of-the-money calls) and the ETF owner receives any dividends. The option writer receives premium income in exchange for assuring that the buyer of the option can purchase the shares at the agreed strike price during the operative time period of the option contract.

DAY ORDER – An order to buy or sell a security that will expire at the end of the day the order is placed if it is not executed.

EX-DIVIDEND DATE – Refers to shares that no longer carry the right to the next dividend payment because the settlement date takes place after the record date. If a shareholder (with or without covered calls) sells his shares on the ex-dividend date or after, he is entitled to the dividend instead of the buyer of his shares. If a shareholder sells his shares on any day before the ex-dividend date (whether through a sale initiated by himself or by exercise of shares through assignment of covered calls), he is not entitled to the dividend…the new owner of the shares will receive the dividend.

EXCHANGE TRADED FUND (ETF) - ETFs represent shares of ownership in portfolios of common stocks which are designed to generally correspond to the price and yield performance of their underlying portfolios of securities, either broad market, industry sectors, regions, investment styles, or international. ETFs give investors the opportunity to buy or sell an entire portfolio of stocks within a single security, as easily as buying or selling a share of stock. They offer a wide range of investment opportunities.

EXERCISE – In the case of covered call options, to require delivery of the underlying ETF by the seller (writer) of the options to the holder (buyer).

EXPIRATION DATE – The last day an option holder (buyer) can exercise the rights in an option contract.

FUNGIBLE – Relates to assets that are identical and are interchangeable. For example, shares of QQQQ, the PowerShares ETF that tracks the NASDAQ-100 Index or the April $35 QQQQ calls are both fungible. All QQQQ shares are the same and are interchangeable and all of the QQQQ April $35 call contracts are the same and are interchangeable.

GOOD-'TIL-CANCELED ORDER (GTC) – An order to buy or sell a security that remains in force until it is executed or canceled.

INSTITUTIONAL INVESTOR – Large investors in the securities markets such as mutual funds, bank trust departments, insurance companies, brokerage firms and pension funds. Many institutional investors use covered call writing as one of their investment strategies.

IN-THE-MONEY – The strike price of a call option is below the market price of the underlying ETF. For example, the call option for an ETF with a strike price of $50 when the ETF is trading at $52 would be $2 in-the-money.

INTRINSIC VALUE – That part of an option's market price which is in-the-money. For example, if the current market price of an option is $3 ½ and the option is in-the-money by $2, the intrinsic value is $2 and the time value is $1 ½. If an option is at-the-money or out-of-the-money there is no intrinsic value.

LEAPS – An acronym for Long-Term Equity Anticipation Securities. These are options with expiration dates extending up to three years, which is well beyond the term of regular options.

LEVERAGE – An attempt by an investor to increase the rate of return from an investment by assuming additional risk. Examples of leverage would be buying securities on margin and speculating by purchasing options.

LIMIT ORDER – An order to execute a transaction only at a specified limit price or better. Investors would use a limit order to establish a price at which they are willing to trade.

LIMIT PRICE – The price specified by an investor for a limit order. For an order to write covered calls, this represents the lowest price the investor will accept.

LONG-TERM – Relates to the gain or loss in a security that has been held for a certain period of time. For example, to qualify as a long-term capital gain under current tax laws, a security must be held for twelve months or more.

MARGIN (ACCOUNT) – A feature of a brokerage account which permits an investor to borrow funds through the broker to purchase additional securities, thus providing investment leverage.

MARGIN CALL – A call by the broker for additional funds or securities to be added to the margin account when the value of the equity in the account has declined below minimum requirements.

MARKET ORDER – An order for immediate execution at the best price available when the order reaches the exchange.

NAKED – An option transaction that is opened whereby the investor does not own underlying security (also called "uncovered"). An investor writing an uncovered put option on 100 shares of the DVY, for example, does not own the shares.

ODD LOT – Refers to fewer than 100 shares of a common stock or ETF.

OPEN INTEREST – The total number of option contracts for an ETF option that are in existence at any given time.

OPTION – A contract permitting the holder (buyer) to purchase (call) or sell (put) an ETF at a fixed price (strike) until a specific date (expiration).

OPTION AGREEMENT – A written document that must be signed by an option investor and given to the brokerage firm before the investor may be approved for trading in options. The purpose of the agreement is to help assure that the investor has adequate knowledge (such as the knowledge contained in this book in the case of covered calls) and that the investor's goals are appropriate for the type of option transactions the investor is asking the brokerage firm to provide. The investor is also supplied with a copy of *Characteristics and Risks of Standardized Options*.

OPTION CHAIN – A string of option quotes for a specific ETF which includes every expiration date and strike price available for options on that ETF. This is typically provided by online brokers as a part of their automated quotation

service to simplify the identification of ticker symbols for options and to facilitate obtaining quotes and executing trades.

OPTION CONTRACT – An agreement by an option writer to sell a given ETF at a predetermined price (strike) until a certain date (expiration). The holder (buyer) of the option is not obligated to exercise (act on) the option, but the seller (writer) of the option must perform the obligation if the buyer exercises rights under the option contract.

OPTION CYCLE – Each ETF is given a series of up to four months during which option contracts expire. Options for an ETF generally expire on the same four months every year, plus the current month and the next following month.

OPTIONS CLEARING CORPORATION – Referred to as the OCC, it is an organization established in 1972 to process and guarantee options transactions that take place on the organized exchanges.

ORDINARY INCOME – Income from sources such as wages, dividends and interest. These items of income do not qualify for special tax treatment. Short-term capital gains are also taxed as ordinary income.

OUT-OF-THE-MONEY - The strike price of a call option is above the market price of the underlying ETF. For example, the call option for an ETF with a strike price of $55 when the ETF is trading at $52 would be $3 out-of-the-money.

PREMIUM – The current price at which an option contract trades and the amount a buyer would pay and a seller would receive. The amount of the premium is determined by a variety of factors, including the time remaining to expiration, the strike price chosen, the price and volatility of the underlying ETF, and interest rates.

PUT - An option permitting the holder (buyer) to sell an ETF at a predetermined price until a certain date. For example, an investor may purchase a put option on AAA ETF giving the investor the right to sell 100 shares (for each option contract) at $50 per share until June 15.

PUT OPTION WRITING – An investment program for investors who are generally seeking a conservative way to increase income by selling (writing) puts on individual stocks or ETFs. The option writer receives premium income in exchange for assuring that the buyer of the option can sell the shares at the agreed price during the operative time period of the option contract.

ROLLING DOWN – Buying back a call option position and then writing a new call with the same maturity, but with a lower strike price.

ROLLING FORWARD – Buying back a call option position and then writing a new call at the same strike price, but with a longer expiration.

ROLLING UP – Buying back a call option position and then writing a new call with the same maturity, but with a higher strike price.

ROUND LOT – For common stocks and ETFs the standard unit of trading is a round lot, which is 100 shares or a multiple thereof.

SECURITIES & EXCHANGE COMMISSION (SEC) – The federal agency that administers securities laws in the United States. The SEC, created under the Securities Exchange Act of 1934, governs the following: registration of organized securities exchanges, proxy solicitation, disclosure requirements for securities in the secondary market and regulation of insider trading. This Act, along with the Securities Act of 1933, forms the basis of securities regulation.

SELL-TO-OPEN - The placing of an initial order by an option writer to sell an option in order to establish a position. The writer receives premium income from the buyer of the option. (Also referred to as "sell covered call" in the case of covered call writing.)

SHORT POSITION – An investment position where the investor has written an option with the contract obligation remaining outstanding.

SHORT-TERM – Relates to the gain or loss in a security that has been held for a certain period of time. For example, under current tax laws the gain or loss in a security held for less than one year would be short-term.

STRIKE PRICE – The price at which the holder (buyer) of a call option can purchase the underlying ETF. Also sometimes referred to as the "exercise price."

TICKER SYMBOL – The abbreviation for an ETF or option used on securities quotation machines. For example, "TMW" is the ETF ticker symbol for the Fortune 500 Index Tracking ETF.

TIME VALUE - That part of an option's market price which is solely attributable to the remaining time before the expiration of the option. If the option is out-of-the-money or at-the-money, the entire premium is attributable to time value. If the option is in-the-money, the amount attributable to time value is calculated by subtracting the amount by which the option is in-the-money from the current

option premium. For example, if the current market price of an option is $3 ½ and the option is in-the-money by $2, the time value is $1 ½.

UNCOVERED (NAKED) – Implies that the investor who writes a call option does not own the underlying ETF, so that if the ETF is assigned the writer must purchase shares at the current market price to deliver to the call holder (buyer). Also known as "naked" because, if the option is exercised, the writer is without shares and is caught naked. If the ETF subject to the call rises significantly, the writer could be exposed to substantial (theoretically unlimited) losses. This is an extremely high-risk strategy, even more speculative than buying calls.

UNDERLYING SHARES – The shares owned by the option writer that the option holder (buyer) has the right, but not the obligation, to purchase according to the terms of the option contract.

UNREALIZED GAIN – Occurs when the value of an unsold asset rises above its original cost. Also referred to as a "paper gain."

UNREALIZED LOSS – Occurs when the value of an unsold asset is reduced below its original cost. Also referred to as a "paper loss."

WASH SALE –Tax rules that state if you sell your shares at a loss, and buy them back within a 30-day period before or after the loss sale date, the loss cannot immediately be claimed for tax purposes. The loss must be added to the cost of the newly purchased shares instead pursuant to IRS Publication 550.

WRITING CALLS – Another term for selling covered call contracts on an ETF an investor owns.

WRITING PUTS – Another term for selling put contracts on a stock or ETF an investor contracts to own at a chosen strike price.

INVESTMENT RELATED WEB SITES ON THE INTERNET

The following Web sites may be useful to those desiring basic information about investments, options, discount brokerages and ETFs.

PERIODICALS

www.barrons.com - Barron's. The Web site and weekly publication have articles on business and economic topics, individual industries and companies, stock market indicators and interviews with investment professionals. It also has regular sections on capital markets (including information on interest rate trends), real estate markets, international markets, commodities, and options. Barron's is known for its extensive statistics and quotations on different markets, indexes, and economic and investment indicators. Corporate earnings and dividends are reported as well.

www.businessweek.com - Business Week. The Web site and weekly magazine have various articles divided into sections such as current business and company news, international, economic analysis, government, people, labor, finance, information processing, science and technology, marketing, environment, and personal business. Specific investment ideas and recommendations usually are provided in the finance and personal business sections. Each issue features a cover article that addresses a major business, economic, or news subject. Economic and monetary indicators, economic trends, business outlook, and various investment data also are provided.

www.forbes.com – Forbes. The Web site and magazine contain a variety of articles divided into sections about companies, industries, government, international, taxes, investing, marketing, computers/communications, personal affairs, and careers. It also provides economic news and investment information and advice from different columnists.

www.fortune.com - Fortune. The Web site and magazine also consist of articles divided by sections on topics such as companies to watch, money and markets, selling, the environment, managing, the economy, innovation, and corporate performance. Articles on specific industries are common. Regular features include economic forecasts, news and trends, and personal investing, which

provides specific investment recommendations and interviews with professional money managers. Fortune also devotes a special issue to investment ideas and recommendations.

www.investors.com – Investor's Business Daily. The Web site and daily newspaper contain quotations each business day for stocks, bonds, international currencies, options, futures, mutual funds, and foreign stocks. Charts for selected stocks, as well as major market indicators, are printed. There are also articles on certain companies, industries, and the U.S. economy. Earnings and dividend reports are presented.

www.money.cnn.com – Money. The Web site and magazine contain personal finance articles, some of which are investment oriented and some of which are consumer oriented. The articles cover a variety of investment vehicles and investment strategies. Specific investment recommendations are common. The articles are easy to read and are perhaps better for the relative novice.

www.wsj.com – The Wall Street Journal. The Web site and daily newspaper provide a wealth of information to the investor. They report various economic data as well as opinions from economists about their expectations for the economy. They also present articles on investment topics, trends, and advice and reports on different industries and different companies. They also supply quotations on stocks, bonds, options, Exchange Traded Funds, futures contracts, mutual funds, and foreign stocks and currencies for each business day. Corporate earnings and dividends are also reported.

INVESTMENT NEWS & INFORMATION SITES

www.bestcalls.com – This site maintains a calendar of upcoming conference calls, the quarterly ritual during which executives discuss with analysts the recent performance and future prospects for their companies, which often provides valuable insights. The conference calls available are searchable by name or stock ticker symbol. These conference calls are becoming more and more public as a result of new disclosure rules for companies. Investors can sit in on the meetings via telephone or streaming audio links on the Web site. Recent calls are archived on the bestcalls.com site for ninety days.

www.bloomberg.com - Web site for Bloomberg. Among other things, the site contains a list of all Exchange Traded Funds (ETFs) which are available anywhere in the world.

www.briefing.com – Professional quality analysis of investment news. This is one of the most respected sources of daily stock market news online. The "Short Stories" feature describes individual companies making news during the course of the business day. Information includes brokerage company evaluation changes, technical stock analysis, earnings estimates, and much more.

www.cbs.marketwatch.com – In addition to a great deal of investment news, this site offers stock tracking, charting, broker research, industry analysis, and much more.

www.cnbc.com – CNBC. This cable TV channel, and the Web site that goes with it, has become a phenomenon. Investors of all types from day traders to long-term investors tune in to the TV show for hours daily to glean stock tips from guest analysts and portfolio managers in addition to feeling part of the CNBC "family" of regular commentators. Soon you won't feel complete without your daily dose of Joe, Sue, Bill, Becky, Michelle, Sara, Kelly and all the rest. The brief talks live on the floor of The New York Stock Exchange with Art Cashin and others are a highlight as well as highly informative and humorous. The Web site mirrors all that is happening on the TV show, with up to date market news and also the stock pickers' selections. In addition, the site offers research capabilities, quotations, financial calculators, tax, retirement and other personal financial advice, career management links to other sites and message boards where CNBC community groupies can chat about their favorite stocks to love or hate.

www.motleyfool.com – The Motley Fool. The real purpose of this Web site is to educate beginning investors in a certain approach to selecting stock purchases. The "Fool" motif, which runs throughout, keeps things fun and light, but the advice is serious and worthwhile. This organization is respected throughout the online world. Their approaches to investing, as well as the updated investment information each day, is well worth a look on an ongoing basis.

www.10kwizard.com – If you are looking for company specific information beyond just financials and news, this is the site for you. 10K Wizard allows you to do a complete background check on a company by retrieving the quarterly and annual reports which publicly held companies are required to file with the Securities and Exchange Commission's EDGAR database. You can search for documents by company name, ticker symbol or a keyword. By registering at the site, it will send you an e-mail any time one of the companies you select files a report. This is heavy-duty information…and all of it is free.

www.bigcharts.com – Free charts, quotes, reports and indicators on over 50,000 stocks, mutual funds and indexes. The site lets you alter a graph's look with nine different designs from mountain and bar chart to candlestick and logarithmic.

SUBSCRIPTION INVESTMENT SERVICES

www.valueline.com - Value Line Investment Survey (800-634-3583). This subscription service provides one-page summaries on more than 1,700 common stocks. The report on each stock has a "timeliness" and "safety" ranking from "1" to "5." Also included is a chart of the stock and financial data for at least the past twelve years. It also describes the company's business, recent developments, beta (a measure of the stock's volatility), and future expectations for the company. Prior to each section is an industry analysis describing the current situation, trends, and composite statistics for that industry. Service is also available in hard copy format, which many public libraries carry.

www.zacks.com – Zacks Investment Research (800-767-3771). There is a wealth of information on this site, both for free and for a charge, including quotes, statistics, an earnings calendar and news. For those who want the complete advisory service, you can sign up for a free online trial.

OPTIONS

www.cboe.com – Chicago Board Options Exchange. This is the largest exchange for trading options. The CBOE Web site is a tremendously valuable resource about how options work. This is probably the best educational site about options available to the nonprofessional. The booklet *Characteristics and Risks of Standardized Options* is available on this Web site.

www.888options.com – The Options Industry Council. The OIC is a non-profit organization created to educate the investing public and brokers about the benefits and risks of exchange-traded options. In addition to providing a great deal of options related education on this site, the OIC also conducts free seminars around the country. The schedule for these seminars is provided on the site.

DISCOUNT BROKERAGES

All of the following provide quotes on various securities and online investment capabilities for options, Exchange Traded Funds, bonds, mutual funds, and other types of investments. Some provide general business news, company specific news, investment research, and other information. This list is not meant to be exhaustive, but is representative of the largest online discount

brokers. Information on these and other companies is available at libraries for non-computer users.

www.fidelity.com - Fidelity Investments; 800-544-5555

www.schwab.com - Charles Schwab & Co.; 800-2-schwab

www.tdameritrade.com - TD Ameritrade; 800-454-9272

www.etrade.com - E-Trade; 800-etrade1

EXCHANGE TRADED FUNDS

www.bloomberg.com – Web site of Bloomberg.com. For information about ETFs click on "ETFs."

www.nasdaq.com – Web site of the NASDAQ stock market. For information about ETFs click on "ETFs."

www.ishares.com – Information on ETFs offered by Barclays Global Investors.

www.proshares.com – Information on short and leveraged ETFs offered by ProShares.

BOOKS BY PAUL D. KADAVY

AVAILABLE ON THE FOLLOWING WEBSITES: ARROW PUBLICATIONS (www.arrowpublications.net); AMAZON.COM (www.amazon.com):

Boomer's Guidebook to Double-Digit Investment Income: *Earn Two Incomes on Your Stocks from Dividends & Option Writing*

Covered Call Writing Demystified: *Double-Digit Returns on Stocks in a Slower Growth Market for the Conservative Investor*

Covered Call Writing with Exchange Traded Funds (ETFs): *Double-Digit Returns, Diversification, Downside Protection*

Covered Call Writing with Qs and Diamonds: *Double-Digit Returns on Ready-Made Portfolios*

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Short Spider Straddles: *A Winning Combination*

Put and Call Option Writing for the Investment Advisor and Financial Planner: *Achieving Double-Digit Income Returns in a Slower Growth Market for You and Your Investor Clients*

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The Book of World-Class Quotations**:** *The Best of the Best Quotations on Earth*

ABOUT THE AUTHOR

As a thirty-year career banker and trust officer for Norwest Corporation, now Wells Fargo & Co., one of the nation's largest financial institutions, Paul D. Kadavy was president of numerous banks in three states. He also headed a multi-billion dollar trust department, managed a team of investment professionals, and was a trusted advisor to many of the banks' individual clients. He also subsequently served as president and chief executive officer for another banking enterprise in Las Vegas, Nevada. Now retired from banking, he is a writer, teacher and public speaker.

Kadavy has served as a faculty member of the National Graduate Trust School at Northwestern University, The Schools of Banking, Inc., the American Institute of Banking and numerous community colleges in several states. He was a lecturer on trust, investment and banking subjects to FDIC and Federal Reserve Bank examiners in Washington, D.C. He has been a public speaker for the past twenty-five years.

In addition to authoring *Boomer's Guidebook to Double-Digit Investment Income,* Kadavy has also written books including *Covered Call Writing Demystified*, *Covered Call Writing with Exchange Traded Funds (ETFs), Covered Call Writing with Qs and Diamonds*, *Put Option Writing Demystified*, *Writing Uncovered Put and Call Combinations*, *Short Spider Straddles*, *Put and Call Option Writing for the Investment Advisor and Financial Planner, Finding Financial Freedom* and *The Book of World-Class Quotations*: *The Best of the Best Quotations on Earth*. His books are available on the Internet through Arrow Publications (www.arrowpublications.net) and Amazon.com.

He is the author of banking, trust and investment articles for such national publications as *Financial Review*, *Trusts & Estates*, *Pension World*, *The Collector/Investor*, *Cases & Comment* and *American Bankers Association Trust Management.*

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ISBN 0-9765849-1-3
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