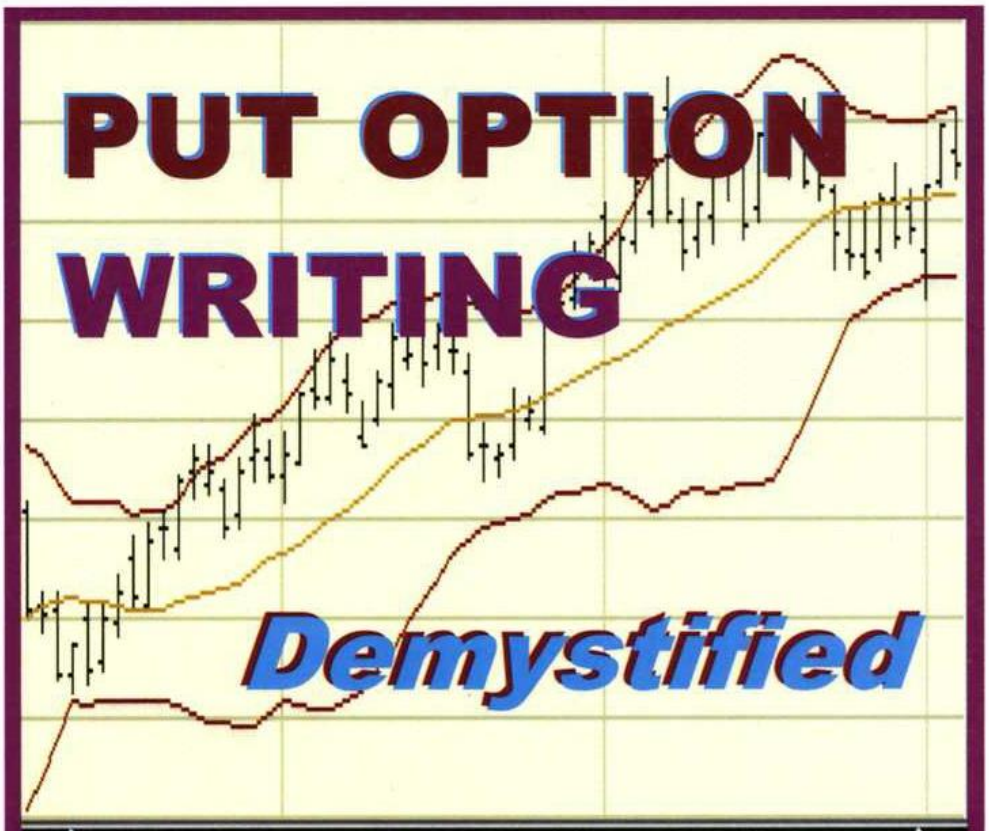

PUT OPTION WRITING

Demystified

Earn Double-Digit Cash Returns While Waiting to Buy Stocks at a Discount

Paul D. Kadavy

PUT OPTION WRITING *DEMYSTIFIED*

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PUT OPTION WRITING
DEMYSTIFIED

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

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~ PREFACE ~

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 stocks and Exchange Traded Funds (ETFs), many of whose names you would recognize immediately.

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 more than 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. 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. 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. If you visit any major bookstore you will find at least several books on the subject of investing using options, both puts and calls. Most of these books include *all* of the potential option strategies in a way that not only confuses investors but intimidates them as well. Puts, calls, futures, short/reverse/variable hedging, arbitrage, covered, uncovered, derivatives, combinations, swaps, bull/ bear/box/butterfly/diagonal/ horizontal spreads, binomial trees, Black-Scholes model, straddle…it seems to go on forever. Investors end up feeling stupid…rather than being educated…by these authors. 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 almost all individual investors is that there are a few option strategies…not many, but a few…that are *very conservative*. Some are even more conservative than simply owning stocks alone. Used appropriately, writing put options can be one such conservative strategy, as is covered call writing.

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 viable and profitable strategy.

Put Option Writing Demystified 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 can be practiced and executed in the privacy of your home or office using your computer together with this book. And best of all, using the put option writing strategy fits perfectly with the slow-growth market we are expected to experience for years to come.

THE FUTURE ISN'T WHAT IT USED TO BE

Many investment experts and economists have been making public statements warning about investor expectations for the long-term future. This includes two prominent individuals: Warren Buffett, Chairman of Berkshire Hathaway, often referred to as the "Oracle of Omaha" for the incredible investment success he has achieved over the past four decades, and John Templeton, the now deceased mutual fund pioneer and founder of the Templeton mutual funds.

Unfortunately these experts are strongly suggesting that investors should not hope for anywhere near the level of investment returns from the stock market that they have come to expect over the past two decades. Buffett and Templeton believe that *at best* investors may only realize about 5% or 6% annual returns before taxes and inflation going forward. If this prediction from such highly qualified experts is close to accurate, new ideas will be needed for stock market investors to have any hope of achieving double-digit returns in the future.

When the enormous Internet, telecommunications and financial bubbles eventually burst, many of the investment "experts" people had come to trust either lost their jobs, or at the very least lost their credibility. Some were heavily fined for breaking securities laws. The dust likely won't completely settle for years to come.

Yet through it all, we find that there are still real experts out there who can be trusted. Among them are Warren Buffett and John Templeton.

Warren Buffett is arguably the most successful investor in modern times, with average annual returns to his investors exceeding 25% annually since the late 1960s. As far back as 1999 Buffett, who had always been silent about his beliefs on the stock market, began to publicly express his concerns about the expectations that investors have for market returns in the future. He stated in *Fortune* that for perhaps the next decade or two, stock market returns would average about 5% per year after brokerage costs, but before taxes. Shortly thereafter the markets, particularly the NASDAQ, began their substantial fall.

He has not warmed up much to the market since that time. In one of his Berkshire Hathaway annual reports, Buffett commented:

> *Despite three years of falling prices, which have significantly improved the attractiveness of common stocks, we still find very few that even mildly interest us. That dismal fact is testimony to the insanity of valuations reached during The Great Bubble. Unfortunately, the hangover may prove to be proportional to the binge.* [1]

And, following the annual meeting of his shareholders attended by 15,000 loyal believers, Buffett had the following to say in an exclusive interview with Maria Bartiromo of CNBC in which he seems to have lengthened his time horizon for slow growth in the market:

> *If you own equities, over the next twenty or thirty years you'll get a reasonable return…maybe it's 6%, maybe it's 7%. People who expect 15% a year are doomed to disappointment.*[2]

Looking back, Buffett was right. From the time he made that statement in 1999 until now, the major stock indexes have performed at exactly about that level, counting dividends. While it is possible that Mr. Buffett could be wrong regarding the future, history has certainly been on the side of those who have believed in him.

There are many other individuals with acknowledged expertise in investments as well as economists who believe that stock market returns in the future will be significantly less than they have been in the past. They offer several themes to support their conclusions:

WHY WILL THE MARKET'S GROWTH LIKELY BE SLOWER IN THE FUTURE?

[1] "Chairman's Letter, " Berkshire Hathaway 2002 Annual Report: 15-16

[2] Interview with Maria Bartiromo, CNBC TV, May 3, 2003

- Despite past market corrections in the major averages…the Dow Jones Industrial Average, the Standard & Poors® 500 Index and the NASDAQ…stocks are still selling at heftier prices now than even a historical midpoint of a range of values for these averages.

- Bubbles previously created in the Internet, telecommunications and financial sectors through unprecedented access to the capital markets, resulted in unsustainable levels of borrowing and capital spending. This has been unwinding for some time as the bubbles burst and as deleveraging has begun. Many believe that such bursting, high past borrowing by both businesses and consumers and increased government borrowing have long-term implications that will slow future economic growth and affect other industries.

- Corporate profits would have to grow at an abnormally high rate in the future as a percentage of Gross Domestic Product (national output) to support much higher stock prices. Since this is very unlikely, the relatively high level of current stock prices will increase more slowly as corporate earnings growth works to catch up and bring about more normal stock price averages in the future.

- Interest rates are now at lows not seen since the Eisenhower Administration in the 1950s. Inflation is very low. Both of these factors are certainly strong supporters of relatively high stock prices. Yet to support significantly higher stock prices, both interest rates and inflation would need to decline even more. The problem is that there is no additional room for either to decline further.

These are the primary schools of thought regarding why stock prices are likely to grow at a slower pace in the future than they have in the past.

If this vision becomes reality, new paths will be needed for investors to have any hope of achieving double-digit investment returns. A simple strategy unknown to the vast majority of individual investors--put option writing--may present one of the best opportunities to achieve double-digit returns in this projected future.

Do you believe the market has bottomed, or is close to a bottom, but that going forward our average stock market returns will be significantly less than

the boom years of the past? This is the best possible market environment for put option writing.

* * * * *

The reader should be aware that brokerage commissions and other transaction costs have not been included in the investment calculations for the examples used in order to simplify the subject matter presented. Such costs are discussed in this book and would need to be considered in actual calculations. Provisions have been made to customize the software available with this book to fit the commission schedule of the user's brokerage firm.

Prior to trading any option, an investor must receive a copy of *Characteristics and Risks of Standardized Options*. A copy may be obtained from the investor's broker or on the Internet at www.cboe.com.

Paul D. Kadavy

NOTE REGARDING THE MICROSOFT EXCEL® TEMPLATE DISCUSSED IN THIS BOOK

We have created an Excel® file template that will facilitate your use of the program outlined in this book.

The use of this template will greatly assist you with the calculations necessary to make quality decisions using the put option writing program. Now, or when you are ready to use this Excel® file, please send an e-mail to arrowpublicationsUSA@gmail.com requesting the "put file." We will promptly provide you with the file by return e-mail. 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. Your e-mail address will *never* be sold or given to anyone. If you would prefer to create this template yourself, the formulas are included for this purpose in the back of the book.

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

If you have a computer but do not have Microsoft Excel® or Word®, you may download the Apache OpenOffice software for free at www.openoffice.org. This software includes Calc, a spreadsheet program with which you can fully utilize the Excel® file templates, and Writer, a word processing program that can access Word® files.

~ CHAPTER 1 ~

Put Option Writing: What It Is and How It Works

Writing put options can present a very attractive opportunity for both option investors and stock investors. For the option investor, it can provide a steady stream of cash income. For stock investors, it can provide income as well as a chance to purchase desired shares of stock at a lower than current market price. This book will give you the theoretical and practical tools necessary to develop an investment discipline that will help you achieve double-digit investment returns through **"put option writing"** on individual stocks and **"Exchange Traded Funds (ETFs)** ."

What comes to mind with the words **"put," "call,"** or **"option"**? Many investors think of high risk…a situation where they might lose up to their entire investment. Actually, that can be very true for some types of option investments. But the opposite is true in the case of writing puts if you follow this program. In fact, the put 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 can be one of the more conservative option strategies available to investors.

The term **"writing"** when used in conjunction with put options simply means selling…you are selling puts on the shares of individual stocks and ETFs you are prepared to own.

THE KEY DISCUSSION TOPICS

This phase of our program will revolve around these subjects: what put options are and how they work; how and where they are traded; how to decide which put options to write; being alert to economic trends and using short-term technical indicators to assess market direction; how to use an Excel® spreadsheet template available to you at no cost through e-mail to assist you in those decisions; how to select and use a broker to execute your transactions; 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 investors need to take with this program using put option contracts:

- Decide which individual stocks and/or ETFs you are interested in owning at a discount.
- Select the specific put option contracts to be written.
- Initiate put option trades.

This program, put option writing, has been available for decades. Nobody talks much about it though, and most individual investors are not involved in it. Any reputable full-service or discount brokerage firm can verify the validity and usefulness of writing put options. They provide brokerage services not only for stocks and ETFs, but also for options as part of what they do for their customers.

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. 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 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.

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 and also introduce additional important terms and provide their definitions. These terms will be used frequently going forward. (Note: An alphabetical listing of all terms appearing in bold type 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 either in individual stocks or ETFs 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 to you…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 investor who initiates a transaction by selling a call or put is the option *seller* or *writer*.

In the case of puts, the buyer of the put option is *not* obligated to sell the shares, but the seller of the put *is* obligated to buy them if the buyer decides to **"exercise"** his right to sell under the option. When the buyer of a put exercises the option, the buyer's shares are **"assigned,"** meaning they will be sold to one or more specific put writers. In the case of our investment program, you will *always* be the seller of options. Later we will also discuss money making opportunities for you using call option writing if you purchase shares from a put buyer. For now, we will focus entirely on puts.

WHERE ARE PUT OPTIONS TRADED?

Option contracts are considered to be securities. As such, they are bought and sold through a brokerage firm. Either a full-service broker or a discount broker 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), the Philadelphia Stock Exchange (PHLX) and the Pacific Stock Exchange (PSE). 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 is 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 are all handled through an independent and unbiased third party.

HOW IS MONEY MADE WRITING PUTS?

You are always paid cash, called a "**premium**," for giving someone the right to sell their shares to you at a specific price, which is called the "**strike price**," on or before the "**expiration date**" when the option expires. You keep the premium money whether or not you actually buy the shares later from the put buyer. There are typically a variety of strike prices available, some of which will be above the current market price of the shares and some of which will be below 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 stocks and ETFs. These very long-term options are referred to as **"LEAPS,"** which stands for "Long-Term Equity Anticipation Securities." They are traded through your broker the same as other options and are available on many stocks. LEAPS have a January expiration date. There are also a growing number of stocks on which weekly options are available.

Under this program you will generally write puts where the strike price on the options is *lower* 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 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 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 loss 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,"** that is to say the shares on which you would be writing the put options, were selling at $30 per share, or very close to that price.

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

WHAT IS A STRIKE PRICE AND HOW IS IT DETERMINED?

Again, a strike price is the actual price at which the buyer of the option has the right to sell the shares covered by the option contract. Strike prices are established when the underlying shares either advance or decline to a certain price level and trade consistently around that level. Let's say for example that shares of a security were trading at a low of $31, then went down to a price of $30 and traded consistently at this level. A new and lower strike price of $30 would be added by the exchange where the option is traded. Volatile stocks and ETFs 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 and some below. Strike prices for most stocks and ETFs are typically established in $2 ½ or $5 increments, depending on the price of the underlying security. Three notable exceptions to this are the PowerSharesQQQ that tracks the Nasdaq-100 Index. This index includes the 100 largest stocks listed on the Nasdaq, nicknamed the "Qs" or "Cubes" (**"ticker symbol"** QQQ), the Spiders Trust Series 1 that mirrors the performance of the highly diversified Standard & Poors® 500 Stock Index (ticker symbol "SPY") and the SPDR® Dow Jones® Industrial Average ETF, known as the "Diamonds," which tracks the Dow Jones Industrial Average (ticker symbol DIA). These highly popular ETFs trade in huge volume and so do many of the option contracts associated with them. Accordingly, strike prices are set in $1 increments both above and below the current market price, which gives the investor in these shares tremendous selection flexibility that is not otherwise available with other securities. A growing number of more actively traded stocks also have strike prices available in $1 increments.

WHEN DOES THE PUT WRITER RECEIVE THE PREMIUM INCOME MONEY?

Once you have written a put the cash premium is deposited into your brokerage account *the next business day*, even though you have not yet earned it. That is one of the many attractive benefits of put option writing mentioned earlier. 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 months for your interest to be paid on a bank CD or 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 option, this date is officially the third Friday of the expiration month. The last trading day is the third Friday. If Friday is a holiday,

the last trading day will be the preceding Thursday. Note that some options are configured to expire at the end of the month. Weekly option contracts expire on Friday.

WHAT IF THE 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. Or you can wait until expiration when the puts would be worthless, 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.

Just like shares of individual stocks and ETFs, put options are traded continuously on the exchanges that offer them. This is because option contracts, like their underlying securities, are **"fungible**." 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 contracts owned by other investors on the exchanges where they are traded.

The **"bid**" and **"ask**" prices of the options change too, even from minute to minute, as the price of the underlying shares change and as the time to expiration becomes shorter.

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 significantly smaller than the cash outlay would be to purchase the shares, 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 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 would 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 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 about eighty-percent of the time options that are out-of-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. This 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 (unusual).

IF THE PUTS I WRITE EXPIRE WITHOUT BEING EXERCISED, DO I HAVE TO PAY A COMMISSION AT EXPIRATION?

No. As a writer of put 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 rarely recommended. If the option expires worthless, as a put

writer you keep the entire option premium and pay no additional commission at expiration.

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

The following is a summary:

Benefits and Features:

1. **Additional income –** Writing put options can provide you with an ongoing stream of put writing income. 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. The put writing income can significantly enhance total returns in a flat, slower growth or even a modestly declining stock market. Even in a more rapidly growing market, you will still achieve your target investment return.

2. **Income paid up front -** The income received from put writing is credited to your brokerage account the next business day, creating immediate cash flow. Since the put writing income is paid up front, if the income is reinvested it can serve to enhance the overall return on the original investment.

3. **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 this program 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.

4. **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.

5. **Fungibility –** Exchange-listed options, as is true of individual stocks and ETFs, are fungible. That is, each listed option is interchangeable with any of the same listed option contracts. 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.

6. **Ease of trading -** Since options are actively traded on the open market, put option transactions can be as easily executed as trading stocks and ETFs. With the assistance of this book you will readily accomplish this yourself with online or phone trading through a discount brokerage account or through a full-service broker.

7. **Options listed in daily newspapers, brokerage firms, 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.

Risks:

1. **Exposure to the stock market –** Writing put options means that the investor is subject to stock market risk, as the performance of the put contracts is tied to the price movement of the underlying securities. Should the put writer be required to purchase the shares, it is possible that their price could continue to decline, resulting in investment losses.

2. **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.

3. **Unanticipated exercise of put options –** The holder (buyer) of a put option has the right, but not the obligation, to exercise his option to sell his shares at the strike price at any time through the expiration date. A writer can expect that his put contracts will not be subject to assignment if the market price of the shares is above the strike price of the put option written. If, however, the market price falls below the strike price, it is possible that the holder could exercise the put option at any time, thus requiring the option writer to purchase the underlying shares at the strike price before the expiration date. Exercise of options generally occurs at the expiration date, and then usually

only if the market price falls below the strike price. On occasion, however, a holder will exercise an option prior to the expiration date.

4. **Potential lack of option market liquidity –** Option contracts generally trade in much smaller quantities than common stock or ETF shares. Options for some stocks and ETFs, such as SPY and QQQ, are very actively traded. Others trade very few contracts. This may cause the bid and ask price spread to widen significantly. For this reason, investors are generally encouraged to 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 put 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 stocks 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 from put writing less 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 for the investor to find a broker, whether discount or full-service, where commission costs can be minimized.

7. **Investment leverage –** Put option writing usually requires a margin account (depending on the broker's definition of margin). Although not specifically excluded by the ERISA laws, until a few years ago put writing has generally not been available in retirement accounts, in which use of margin is not allowed. 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 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.

~ CHAPTER 2 ~

Understanding Both Sides of The Put Option Trade

If you are new to put option writing, we need to look first at a typical put transaction from the *buyer's* perspective. 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 7 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 the PowerShares QQQ Exchange Traded Fund (QQQ) frequently in this book, however the same principles would apply using any individual stock or ETF. Let's say that the QQQ is selling for $30 per share on the third Friday in June (which means that June puts are expiring, as the third Friday of every month is the last day of trading for expiring options). "Mike," as we will call the buyer, thinks the QQQ may be poised to fall, so he buys ten QQQ put contracts with a September expiration date and with a strike price of $27 per share. The premium quote is $.70 per share. Each put contract covers 100 of the underlying shares. So during the term of this option Mike controls 1,000 shares of the QQQ. The price he pays for this, the option premium, is $700 ($.70 premium per share x 10 contracts x 100 shares per contract).

Mathematical formulas are the framework behind the pricing of options for both buyer and seller. Ultimately, actual trading prices are established by what a willing buyer and willing seller agree upon. The option price largely revolves around the price volatility of the underlying shares, how far the strike price of the option is from the current price of the QQQ, and how much time exists between now and the time the option will expire.

The more volatile the underlying security's recent price history in the marketplace, the higher the premium a put will command. For example, all other things being equal, a put on an ETF or a stock with significant technology exposure, such as the QQQ, would typically have a premium greater than an ETF or stock involved in the health care sector. In turn, the health care sector ETF's or stock's options would logically have a premium that would be higher than an even less volatile sector…say, for example, a utility sector ETF or stock.

The price of the shares relative to the strike price of the option is a major factor. If the price of the QQQ is $30 per share, it only needs to trade $3 per share lower to reach a $27 strike price, while it would need to trade $5 lower to reach a $25 strike price (strike prices are established in $1 increments for the QQQ). Since the likelihood is obviously much greater of the QQQ price reaching $27 by the end of the same expiration period than $25, the price of the option for a $27 strike will be significantly higher than the $25 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 will be.

If it is now June and you are writing an option, you will want a larger premium for a put that will expire, say, in November than one that will expire in September. If you are granting the put buyer the option to sell his QQQ shares at a specific price until November, 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 November 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 option premiums tend to be. 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, with the prospect that increased volatility in the future may provide better returns from option writing.

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

The put option contracts, just like the underlying shares they represent, continue to be traded on the open market after he purchases them. In the short run, if the price of the QQQ 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 the QQQ 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 the QQQ would be to initiate a **"short sale"** for 1,000 shares. Instead, in this case, for a price of $700 Mike has control, for a three month time period, of 1,000 shares of the QQQ worth $30,000. If the QQQ would fall from $30 to $27 the next day after the trade, a short seller of QQQ shares would have a gain for that day of 10%. The put option, however, might in turn rise to $1.60 or a gain of $900, almost 130% 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 QQQ shares. Had Mike shorted 1,000 shares of the QQQ at $30 and repurchased them at $27 his investment risk would have been $30,000 and his profit $3,000, for a return of 10%. By buying the option contracts instead, he realized almost a 130% profit on his investment but tied up only $700 of his capital in the process. This sounds terrific, but what is the downside? If the QQQ had risen by 10% from $30 to $33 the value of his options would decline, perhaps going from $.70 to $.15. This would represent a loss of $550 or almost 80% of his investment. Had he sold short the QQQ itself and it increased to $33, the percentage loss would only be 10%.

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 the QQQ going down and by how much, he has to be right about *when* it goes down!

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" 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 the QQQ is trading at $28.50 per share and the strike price of a put option is $30, then the intrinsic value of the option is $1.50. If the QQQ price 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 the QQQ 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 the QQQ. The strike price is $32, the current market value of the QQQ is $29 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 the QQQ. The strike price is $27, the current market value of the QQQ is $28 and the current price of the option is $2.50. The option is out-of-the-money, so there is no intrinsic value. Thus, the entire market price of the option premium of $2.50 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 QQQ put purchase. Mike 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 the QQQ. Let's examine what will happen if Mike continues to hold his option until the expiration date in September. You will recall that the strike price of the option contract Mike bought was $27. This means that on the expiration date if the price of the QQQ is greater than $27 the options expire with no value. Mike has lost his entire investment. Why? Mike would be foolish to exercise his options and sell his shares for $27 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 on the open market.

But, in this case we are assuming Mike has not sold his option contracts and the September expiration date has just passed. What happens if after the expiration date the QQQ is below $27 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, Mike would exercise his options and sell the QQQ shares at expiration because the options have intrinsic value. Let's say the price of the QQQ is $26.50 at the close of the market on the expiration date. Mike may already own 1,000 shares of the QQQ, or he may not own any shares. If he owns the shares, his put option allows him to sell them for $27 per share when the current market price is only $26.50 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 $27 that are only worth $26.50 today…still a benefit of $0.50 per share to him. In either situation he is ahead by $500, so that is why he wants to exercise his put options. But, don't forget that Mike paid $700 for the options, so he still has a net loss on the overall transaction of $200 ($500 investment gain - $700 premium loss = $200 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 the QQQ 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 the QQQ was trading at $26.50 towards the end of the day on the last day of trading before expiration, the $27 QQQ 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 (except for commissions).

When you remember that about eighty-percent of options contracts on all securities that are out-of-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 QQQ options again. We will say the price of the QQQ falls from $30 to $27.05 at expiration and Mike still holds his options. Even though the price of the QQQ has declined by $2.95, or 9.8% in three months (over 39% annualized), Mike has still lost his entire investment. He would not exercise his option to sell shares at $27 that can be sold on the open market for $27.05. He has lost the premium he paid for the options. What is Mike's breakeven point on the expiration date? If he paid $.70 per share premium to sell

each contract, and if the strike price is $27, then Mike's breakeven is $26.30 per share ($.70 - $27 = $26.30). In other words, if Mike holds the options through the expiration date, unless the price of the QQQ has declined to at least $26.30 per share, or 12.3% lower (49.3% 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 the QQQ 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 the QQQ, but you are interested in purchasing 1,000 shares. It is the third Friday in June, and the QQQ is currently trading at $30 per share. You would like to be able to buy at $27 per share. In fact, you are willing to contractually obligate yourself to purchase 1,000 shares at $27 per share. Rather than simply waiting to see if they go down to that price, you start checking out the premiums for QQQ put option contracts with a $27 strike price at various expiration dates. You see that the September $27 QQQ put is trading at $.70 per contract. For receiving a premium of $.70 per share you decide you would be willing to contract to buy 1,000 shares of the QQQ at $27, which would happen if the per share price should be less than $27 on the September 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 spreadsheet mentioned earlier (file name "puts") and read the information on the following page.

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.

TODAY'S DATE IS ---------->	20-Jun

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.
QQQ	19-Sep	10	$30.00	$27.00	$0.70	$0.00	$0.70	$10,000

# OF DAYS	PREM. INCOME	$ RTN. OF CAPITAL	NET PREM. INC.	% ANNUAL RETURN	COVERED CASH LESS RTN. OF CAPITAL	% COV. RETURN
91	$700	$0	$700	28.08%	$27,000	10.40%

From this transaction you will collect $700 in option writing premium income ($.70 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 $10,000 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 28.08% based upon the margin requirement on the day of the transaction for a three month period ending September 19, the third Friday in September. 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 3% rate of interest, for example, the rate quoted is on an annual basis. They do not say that the CD has a 1 ½% 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 the QQQ would go to, say, $33 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 $700, 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 $30,000. Yet you realized an annualized return well into double digits and earned $700 of income in three months from an

investment of only $10,000 instead of investing $30,000. 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 $700, but you have also purchased 1,000 shares of the QQQ at a price per share $3 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 $26.30 for the QQQ 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 $27 (net cost to you of $26.30 considering the put premium income) instead of purchasing them initially at $30.

Here is another way of looking at this transaction. Even if the QQQ had gone down by 10% (40% annualized) at the expiration date, you would still earn your $700 and your 28.08% annualized return. In fact, the QQQ would have to go down by more than 12.3% (49.3% annualized) before you would have a loss.

You decide to go ahead and place an order to **"sell-to-open"** ten contracts of the QQQ September $27 puts at $.70. 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 transaction. Again, this is seldom recommended except in some situations when writing in-the-money puts, which, although discussed later, is not a 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 $700. The deal is settled and you get

the money placed into your brokerage account *the next 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 the QQQ remains at $30 on the expiration date. What happens? Since a put buyer would not sell his shares to you at the lower strike price of $27 when they are trading at $30 on the open market, the options expire unexercised. You have previously pocketed the buyer's $700. 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 QQQ shares would remain at $30 at the end of the year, you would have received a return of over 28% from your premium income based upon your margin requirement…a terrific gain in a flat market. An owner of QQQ shares would have no gain at all. This is how put option writing can work its magic in a flat to slowly rising or slightly declining market.

If the QQQ closed between $27 and $30…say $28…you still get to keep all of your option premium income, but you will not be called upon to buy the QQQ shares, as the price of the QQQ was not below the $27 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 $27 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 spreadsheet:

TODAY'S DATE IS ---------->	19-Sep

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.
QQQ	19-Dec	10	$28.00	$27.00	$1.30	$0.00	$1.30	$10,000

# OF DAYS	PREM. INCOME	$ RTN. OF CAPITAL	NET PREM. INC.	% ANNUAL RETURN	COVERED CASH LESS RTN. OF CAPITAL	% COV. RETURN
91	$1,300	$0	$1,300	52.14%	$27,000	19.31%

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 $1,300 of premium income and an annualized return of over 52%, with the same margin requirement.

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 $25 contract instead of the $27 contract. This would reduce your premium income because the strike price is lower, but it would allow you to purchase QQQ shares at an even lower price if they were to decline below the $25 level by the next selected expiration date. The strike price you select will largely be based on 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 you hear and read. In Chapter 6 we will discuss **"technical analysis"** and provide a number of tools that may assist you in making an assessment about future market directions.

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.

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 rather than individual stocks can go a long way to mitigate the risk of a sudden huge downward price movement.

~ CHAPTER 3 ~

Calculating Put Option Writing Opportunities

Have you sent us an e-mail message yet requesting your Excel® file template to assist you with your put option decision making? The use of this template will greatly assist you with the calculations necessary to make quality decisions using the put writing program. If you have not already done so, please send an e-mail now to arrowpublicationsUSA@gmail.com requesting the "put file."

The template is a Microsoft Excel® spreadsheet file named "puts." You will find it 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 spreadsheet example that was used earlier is duplicated on the next page. 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.

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.

TODAY'S DATE IS ---------->	20-Jun

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.
QQQ	19-Sep	10	$30.00	$27.00	$0.70	$0.00	$0.70	$10,000

# OF DAYS	PREM. INCOME	$ RTN. OF CAPITAL	NET PREM. INC.	% ANNUAL RETURN	COVERED CASH LESS RTN. OF CAPITAL	% COV. RETURN
91	$700	$0	$700	28.08%	$27,000	10.40%

Note the row towards the top with the small "**x**"s in the first six columns. 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 SPREADSHEET

Security Symbol ("Sec. Symbol")**:** Many of the columns are obvious. The first column is the ticker symbol, in this case the QQQ. You could use the full option symbol if this would be helpful to you.

Expiration Date ("Expir. Date")**:** The second column is the put option expiration date you are considering. This needs more detailed discussion. There are typically a wide variety of option expiration dates to choose from on most stocks and ETFs. As of the month of June for the QQQ there were options available expiring in June, July, August, September, December and the LEAPS the following January, and a year from that January…from the current month to over 1 ½ years away. Weekly options are also available. 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. For all stocks and ETFs, there is an assigned **"option cycle"** which means that generally there are options expiring the same four months every year plus at least the current and the next following month. Some stocks and ETFs also offer LEAPS and weekly expirations.

There are three different cycles, and they are set as follows:

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

The QQQ is Cycle 3. Regardless of which option cycle is assigned for any given security, there is always an option created with an expiration date for the current and the following month too. Enter the expiration date of the option you are considering, remembering to use the third Friday as the day of the month.

Number of Contracts ("# Of Cont.")**:** The third column is the number of put contracts you wish to write. An option contract always applies to one hundred shares, also called a **"round lot."** You cannot write an option contract for an **"odd lot,"** which is less than one hundred shares. Therefore, the number of contracts you write must be in multiples of 100 shares. For example, 3 contracts represent 300 shares, 5 contracts 500 shares, and, in this example, the 10 contracts represent

1,000 shares. While contracts can be written for any multiple of 100 shares, the larger the number of contracts sold, the more cost efficiency there is in brokerage commissions on option trades.

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

Strike Price ("Strike Price")**:** The fifth column also deserves some extensive discussion. The strike price is the part of the option contract that specifies the price at which the option buyer has the right to sell the underlying shares to you from the date of the option trade through the expiration date. When the market price of the QQQ 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 the QQQ have traded recently from a low of $23 per share to a high of $30, there would be strike prices offered in $1 increments (in the case of the QQQ) from $23 through $30, and probably some below and above that range. On occasion you will find that there are gaps between the strike prices offered. In some cases a given strike price may be offered for one expiration date, but not for another. The put writer should simply focus on those strike prices and expiration dates that are available at the time the research is being done. In any event, the QQQ, SPY and DIA offer the broadest array of strike prices and expiration dates available of all securities on which put options can be written.

Premium ("Prem.")**:** Column six is your final entry. Plug in the current quote for the option, which you will get from your broker (much more about this will follow in Chapter 7). Sometimes there can be a significant 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. As the seller of the put option, you want this number to be as high as possible. 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 $.55 and the ask is $.75, use the midpoint of $.65, or perhaps even a little less for conservatism if the spread is wider, and plug that figure into the worksheet under the "Prem." column. This is the premium per share that you could reasonably expect to receive if you placed an order. 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 contracts (SPY and QQQ, for example) trade in penny increments for many of the strike prices, particularly those close to the current market price.

CALCULATIONS AUTOMATICALLY MADE FOR YOU ON THE SPREADSHEET

The rest of the data on the spreadsheet 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 the stock market, 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 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 $27 = $4.05
- $4.05 + $.70 = $4.75
- $4.75 x 100 = $475
- $475 x 10 = **$4,750**

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 $27 = $8.10
- $8.10 + $.70 = $8.80
- $8.80-$3.00 = $5.80
- $5.80 x 100 = $580
- $580 x 10 = **$5,800**

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 $10,000, 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 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 spreadsheet 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 QQQ option expiring September 19 there are 91 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 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 QQQ put options expiring on September 19, 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 28.08%, not including commissions. This would mean that at the September 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 the QQQ 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 that requirement 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.
QQQ	19-Sep	10	$32.00	$28.00	$0.35	$0.00	$0.35	$10,000
QQQ	19-Sep	10	$31.00	$28.00	$0.50	$0.00	$0.50	$10,000
QQQ	19-Sep	10	$30.00	$28.00	$0.70	$0.00	$0.70	$10,000
QQQ	19-Sep	10	$29.00	$28.00	$0.90	$0.00	$0.90	$10,000
QQQ	19-Sep	10	$28.00	$28.00	$1.25	$0.00	$1.25	$10,000
QQQ	19-Sep	10	$27.00	$28.00	$2.10	$1.00	$1.10	$11,200
QQQ	19-Sep	10	$26.00	$28.00	$2.75	$2.00	$0.75	$12,550
QQQ	19-Sep	10	$25.00	$28.00	$3.50	$3.00	$0.50	$14,000

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 (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. 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.

~ CHAPTER 4 ~

The Put Option Writing Strategy

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 dates 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. As to the latter, Chapter 6 will give you a number of short-term technical analysis tools that may be helpful in assessing stock market direction. These should not be looked at in isolation, but rather in conjunction with **"fundamental analysis"** in making your equity investment and put writing decisions.

ASSESSING YOUR RISK TOLERANCE

While writing put options is generally considered to be one of the most conservative option strategies and can even be more conservative than simply owning equities alone if done on a cash covered basis, there are other 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.

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 1.8, 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 (e.g., ConAgra at .6) 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. In fact, the best test of all may be whether you are sleeping well at night or are worrying about your investment portfolio. If it is causing you loss of sleep, it is definitely time to ratchet down your risk by one means or another.

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. Let's look at a specific example of this using the QQQ.

You can see on the next page that with both the annual return % and the covered return % the highest rate of return is at the strike price closest to the market price. As the strike prices increase and decrease from the market price, the rate of return decreases as a bell-shaped curve. This is particularly noticeable with the QQQ since it offers strike prices in dollar increments. The same results

should occur with any expiration date selected, although the numbers would obviously be different.

TODAY'S DATE IS ---------->	20-Jun

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.
QQQ	15-Aug	10	$30.38	$25.00	$0.10	$0.00	$0.10	$10,000
QQQ	15-Aug	10	$30.38	$26.00	$0.20	$0.00	$0.20	$10,000
QQQ	15-Aug	10	$30.38	$27.00	$0.30	$0.00	$0.30	$10,000
QQQ	15-Aug	10	$30.38	$28.00	$0.50	$0.00	$0.50	$10,000
QQQ	15-Aug	10	$30.38	$29.00	$0.75	$0.00	$0.75	$10,000
QQQ	15-Aug	10	$30.38	$30.00	$1.15	$0.00	$1.15	$10,000
QQQ	15-Aug	10	$30.38	$31.00	$1.65	$0.62	$1.03	$11,384
QQQ	15-Aug	10	$30.38	$32.00	$2.30	$1.62	$0.68	$13,034
QQQ	15-Aug	10	$30.38	$33.00	$3.00	$2.62	$0.38	$14,734
QQQ	15-Aug	10	$30.38	$34.00	$3.80	$3.62	$0.18	$16,534
QQQ	15-Aug	10	$30.38	$35.00	$4.70	$4.62	$0.08	$18,434

# OF DAYS	PREM. INCOME	$ RTN. OF CAPITAL	NET PREM. INC.	% ANNUAL RETURN	COVERED CASH LESS RTN. OF CAPITAL	% COV. RETURN
56	$100	$0	$100	6.52%	$25,000	2.61%
56	$200	$0	$200	13.04%	$26,000	5.01%
56	$300	$0	$300	19.55%	$27,000	7.24%
56	$500	$0	$500	32.59%	$28,000	11.64%
56	$750	$0	$750	48.88%	$29,000	16.86%
56	$1,150	$0	$1,150	74.96%	$30,000	24.99%
56	$1,650	$620	$1,030	58.97%	$31,000	21.66%
56	$2,300	$1,620	$680	34.00%	$32,000	13.85%
56	$3,000	$2,620	$380	16.81%	$33,000	7.51%
56	$3,800	$3,620	$180	7.10%	$34,000	3.45%
56	$4,700	$4,620	$80	2.83%	$35,000	1.49%

Why do the returns decline in both directions? For different but equally valid reasons. In the case of the lower, out-of-the-money strike prices, it is less likely that the put writer would be called upon to purchase the underlying shares. Therefore the return is less. Even though the margin requirement declines with the lower strike prices, the premium income declines disproportionately by a greater amount so that the overall return is less. For the higher, in-the-money strike prices, it is a given that the put writer will be called upon to purchase the underlying shares if the price simply remains the same at the expiration date. The increasingly greater premiums help compensate for this. The spreadsheet breaks down the premium into two components, the intrinsic value and the time

value. The intrinsic value component, regarded as a return of capital, provides much more downside protection. But for purposes of comparing investment returns, the focus should be on the time value component, which becomes less as the strike price becomes greater. As with the out-of-the-money puts, this component decreases as the strike prices move further away from the closest strike price to at-the-money. With in-the-money puts the margin requirement increases, also causing a lowered investment return.

In summary, the out-of-the-money puts provide a lower investment return due to the lessening likelihood that the investor will be called upon to purchase the underlying shares. The 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 the higher margin requirement.

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

The strategy recommended in this book is to write out-of-the-money puts on securities that are compatible with your risk tolerance. Why out-of-the-money puts? Because a fundamental premise in this 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 on 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 XYZ 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 stock if it is 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 stock during the option contract period. Alternatively, investors not wishing to acquire the underlying 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 stocks 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!

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. In some cases, weekly contract expirations can still provide excellent returns, albeit with increased commissions due to the frequency of rewriting. 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 8, 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" discussed on page 42, a broker might assign a 30% margin requirement for ETFs such as the Qs and Diamonds, 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.

~ CHAPTER 5 ~

Out-Of-The-Money Put Writing and In-The-Money Put Writing

Our first focus in this chapter will be on the primary put writing strategy…where the strike price is lower than the current market price…the out-of-the-money puts.

OUT-OF-THE-MONEY PUT WRITING

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. 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, puts with strike prices that are out-of-the-money should be reviewed on your spreadsheet 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 spreadsheets for several different securities where data has been input to make decisions on out-of-the-money put writing.

As you look at the spreadsheet of the out-of-the-money puts, 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 Bed, Bath & Beyond $37 ½ 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 $35 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 $37 ½ put than on the $35 put (105.52% vs. 52.14% for the August expiration).

Bed, Bath & Beyond (BBBY) – Beta: 1.2

TODAY'S DATE IS ---------->	20-Jun

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.
BBBY	15-Aug	10	$39.15	$35.00	$0.80	$0.00	$0.80	$10,000
BBBY	15-Aug	10	$39.15	$37.50	$1.95	$0.00	$1.95	$12,045
BBBY	21-Nov	10	$39.15	$35.00	$1.95	$0.00	$1.95	$10,000
BBBY	21-Nov	10	$39.15	$37.50	$2.80	$0.00	$2.80	$12,895

# OF DAYS	PREM. INCOME	$ RTN. OF CAPITAL	NET PREM. INC.	% ANNUAL RETURN	COVERED CASH LESS RTN. OF CAPITAL	% COV. RETURN
56	$800	$0	$800	52.14%	$35,000	14.90%
56	$1,950	$0	$1,950	105.52%	$37,500	33.89%
154	$1,950	$0	$1,950	46.22%	$35,000	13.21%
154	$2,800	$0	$2,800	51.46%	$37,500	17.70%

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.

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 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. Chapter 6 provides you with a host of technical tools to assist you in assessing the possible short-term direction

of the market. In the meantime, we will study the put writing alternatives and the implications of selecting one of several different opportunities.

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 security.

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 ability to forecast market direction comes importantly into play. If you write puts at the $35 strike price and the market price is $37.40 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. You also could have obtained a greater return on investment had you written the $37 ½ puts. Nonetheless, you have obtained an excellent return and can now write new put contracts based upon your expectations going forward.

If your technical analysis does not provide you with any strong indicators for an upward or downward price movement in BBBY, then it might be best to write the lower strike price…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, the results of your technical analysis and fundamental analysis of economic conditions and your penchant for risk.

What if your technical indicators point to an uptrend in the market? We will examine put writing opportunities next that will fill that need.

IN-THE-MONEY PUT OPTION WRITING

As we have seen, the out-of-the-money puts provide premium income as well as an opportunity to purchase shares at a price below the current market. Unlike this, the in-the-money puts will place you immediately in a potential loss position, as you would be required to purchase shares at a higher price than the current market price if the market price remains about the same on the expiration date. An obvious question needs to be answered. Why would anyone want to put themselves in a situation where they are likely to realize a capital loss on their investment? The answer is simple. Because the premium received is so large, it compensates for the likelihood that the investor may be required to purchase the shares at a loss. As previously explained, the intrinsic value portion of the premium should be considered a return of capital, which fully compensates you for this loss at the time the put contracts are written. When considering the very substantial premium income and subtracting the capital loss in the shares (market price compared to strike price) from it, the net gain can still generate double-digit returns as well as provide significantly greater downside protection than out-of-the-money puts. This spreadsheet shows in-the-money calculations.

SPDR® Dow Jones® Industrial Average ETF (DIA) – Beta .98

TODAY'S DATE IS ---------->	20-Jun

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.
DIA	15-Aug	5	$91.84	$92.00	$2.70	$0.16	$2.54	$15,206
DIA	15-Aug	5	$91.84	$94.00	$3.70	$2.16	$1.54	$16,706
DIA	15-Aug	5	$91.84	$96.00	$5.10	$4.16	$0.94	$18,406
DIA	19-Sep	5	$91.84	$92.00	$3.50	$0.16	$3.34	$15,606
DIA	19-Sep	5	$91.84	$94.00	$4.50	$2.16	$2.34	$17,106
DIA	19-Sep	5	$91.84	$96.00	$5.70	$4.16	$1.54	$18,706

# OF DAYS	PREM. INCOME	$ RTN. OF CAPITAL	NET PREM. INC.	% ANNUAL RETURN	COVERED CASH LESS RTN. OF CAPITAL	% COV. RETURN

56	$1,350	$80	$1,270	54.44%	$45,920	18.03%
56	$1,850	$1,080	$770	30.04%	$45,920	10.93%
56	$2,550	$2,080	$470	16.64%	$45,920	6.67%
91	$1,750	$80	$1,670	42.92%	$46,000	14.56%
91	$2,250	$1,080	$1,170	27.43%	$47,000	9.98%
91	$2,850	$2,080	$770	16.51%	$48,000	6.43%

Writing in-the-money puts provides the best results when the price of the underlying security--in this case the DIA--increases, especially if it increases above the strike price from the date the puts were written to the expiration date. Any closing price at expiration that is greater than the market price at the time the contracts were written would provide the investor with a greater return than was initially projected. For purposes of calculating the investment return, the spreadsheet assumes that the market price will remain flat at expiration (we have to assume something, and the current price is all we know at the time the contracts are written). Since the spreadsheet calculates the investment return only on the time value portion of the premium, if the market price has moved up on expiration, some of the intrinsic value portion of the premium will have been converted to additional time value. The most optimistic scenario that can occur for the in-the-money put writer is if the market price rises above the strike price at expiration, leaving no intrinsic value.

As you look at the spreadsheet, note the following:

> **For in-the-money puts, the more the strike price of the underlying security is above the market price, the larger the total premium, the less the time value portion of the premium, and the less the annual return.**

This sounds like a contradiction. How can the annual return become less when the total premium becomes greater? If you write in-the-money puts, you are putting yourself in a situation where there is a good likelihood that the puts will be exercised (the shares sold to you) if you do not buy back the put prior to expiration. You are writing puts with a strike price that is actually above the current market value of the shares. Also, you will always be in an initial loss position on the shares when considering what their value was on the day the option contracts were written compared with their value if they are put to you at the strike price. This will remain true regardless of what happens to the share price, unless it rises above the strike price at expiration.

On the plus side, the premium increases with each increase in strike price to compensate you for the built-in loss you will incur at the time the contracts are written. However, the more the put is in-the-money the less the increase in premium compensates for the built-in loss. In other words, as the amount by which the price is in-the-money increases, the built-in loss 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. This makes sense, because the greater the premium the more you benefit from the downside protection you receive.

THE ESSENTIAL QUESTION REVISITED

As stated previously, the most important question the put writer must try to answer to make the best put writing decision 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 has not become any easier by introducing in-the-money puts into the equation. Again, the technical tools provided in Chapter 6 will assist you in assessing the possible short-term direction of the market.

But for now, here is what can be said regarding the merits of writing in-the-money puts vs. out-of-the-money puts:

> **If you are examining two different opportunities to write puts 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 return of both is approximately the same; then**
>
> **if the price of the underlying security declines, your option investment return will always be better with an out-of-the-money put compared with an in-the-money put,**
>
> **and**
>
> **if the price of the underlying security rises, your investment return will always be better with an in-the-money put compared with an out-of-the-money put.**

Therefore, in-the-money puts could be considered if you have strong expectations for a rising market. In writing in-the-money puts, however, keep in mind that the only instances in which the underlying shares would not be put to you would be if the market price on the expiration date closed above the strike price, or if you bought back your options prior to their expiration. For these reasons, the author has a bias for out-of-the-money put writing to reduce the risk of assignment of the shares.

In computing the annual return, the amount by which the underlying security is already in-the-money is subtracted from the current market price. The reason for this is that at the time the put contracts are written the portion of the premium that is in-the-money (the intrinsic value) is a return of capital, with only the time value portion used to compute the return. This would be consistent

with the computation for out-of-the-money puts where the entire premium is time value and there is no intrinsic value.

To help clarify the potential use of in-the-money vs. out-of-the-money puts, let's look at several different scenarios where assumptions are made about the price of the QQQ on the expiration date to see what the consequences would be and what would have been the best put writing strategy. We will take all of the put writing opportunities from the QQQ spreadsheet used in the previous chapter:

IN-THE-MONEY AND OUT-OF-THE-MONEY QQQ PUTS

TODAY'S DATE IS ---------->	20-Jun

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.
QQQ	15-Aug	10	$30.38	$25.00	$0.10	$0.00	$0.10	$10,000
QQQ	15-Aug	10	$30.38	$26.00	$0.20	$0.00	$0.20	$10,000
QQQ	15-Aug	10	$30.38	$27.00	$0.30	$0.00	$0.30	$10,000
QQQ	15-Aug	10	$30.38	$28.00	$0.50	$0.00	$0.50	$10,000
QQQ	15-Aug	10	$30.38	$29.00	$0.75	$0.00	$0.75	$10,000
QQQ	15-Aug	10	$30.38	$30.00	$1.15	$0.00	$1.15	$10,000
QQQ	15-Aug	10	$30.38	$31.00	$1.65	$0.62	$1.03	$11,384
QQQ	15-Aug	10	$30.38	$32.00	$2.30	$1.62	$0.68	$13,034
QQQ	15-Aug	10	$30.38	$33.00	$3.00	$2.62	$0.38	$14,734
QQQ	15-Aug	10	$30.38	$34.00	$3.80	$3.62	$0.18	$16,534
QQQ	15-Aug	10	$30.38	$35.00	$4.70	$4.62	$0.08	$18,434

# OF DAYS	PREM. INCOME	$ RTN. OF CAPITAL	NET PREM. INC.	% ANNUAL RETURN	COVERED CASH LESS RTN. OF CAPITAL	% COV. RETURN
56	$100	$0	$100	6.52%	$25,000	2.61%
56	$200	$0	$200	13.04%	$26,000	5.01%
56	$300	$0	$300	19.55%	$27,000	7.24%
56	$500	$0	$500	32.59%	$28,000	11.64%
56	$750	$0	$750	48.88%	$29,000	16.86%
56	$1,150	$0	$1,150	74.96%	$30,000	24.99%
56	$1,650	$620	$1,030	58.97%	$31,000	21.66%
56	$2,300	$1,620	$680	34.00%	$32,000	13.85%
56	$3,000	$2,620	$380	16.81%	$33,000	7.51%
56	$3,800	$3,620	$180	7.10%	$34,000	3.45%
56	$4,700	$4,620	$80	2.83%	$35,000	1.49%

Note that the largest annual return is achieved by writing the put that is approximately at-the-money. As discussed previously, going from there to the

strike prices that are above and below, you can again see how the return resembles a bell curve, declining in either direction. Even though the returns are lower on both ends of this bell curve, they are lower for far different reasons. In the case of in-the-money puts, it is because the large premium received from writing these puts consists of a substantial amount of intrinsic value and provides substantial downside protection, which significantly reduces investment risk. In the case of out-of-the-money puts, the smaller return is due to the opportunity the put writer may have to purchase the underlying shares at a lower price if the underlying shares should decline to the contracted strike price. A lower return can be accepted either to reduce risk or to increase reward.

> **Whether the tradeoff is warranted for accepting a lower return to increase downside protection or a lower return for the opportunity to purchase shares at a lower price rests on your ability to predict which way the market will go over the term of the put contract. Absent an ability to make such a prediction, the best course of action would be to select the strike price which most completely aligns with the investor's investment goals and willingness to assume risk.**

Investors prepared to take more risk can always gravitate toward the strike price closest to the current market value when writing puts (which will provide the greatest investment return opportunity) if they are prepared to purchase the underlying shares at that strike price.

OUTCOMES AT EXPIRATION FOR VARIOUS STRIKE PRICES AND MARKET PRICES

Assume that you were writing puts on June 20 when the QQQ was trading at $30.38 and that all of the contracts we are considering (strike prices from $25 to $35) are for an August 15 expiration, as shown on the previous spreadsheet. What might have been the possible outcomes on the expiration date at various prices for the QQQ if you wrote 10 put contracts at each strike price and waited until the contracts either expired or were exercised? How would these results compare with those of an investor who simply owned shares in the QQQ and was not a put writer?

The following is a broad look at the end result of these put selection decisions.

OUT-OF-THE-MONEY PUT WRITING RESULTS

Strike Price Of Puts ----->	$25	$26	$27	$28	$29	$30
QQQ price at expiration: $32						
Premium income from put writing	$100	$200	$300	$500	$750	$1,150
Capital loss on stock put to investor	$0	$0	$0	$0	$0	$0
Total gain / (loss) for put writer	$100	$200	$300	$500	$750	$1,150
QQQ share owner	$1,620	$1,620	$1,620	$1,620	$1,620	$1,620
QQQ price at expiration: $31						
Premium income from put writing	$100	$200	$300	$500	$750	$1,150
Capital loss on stock put to investor	$0	$0	$0	$0	$0	$0
Total gain / (loss) for put writer	$100	$200	$300	$500	$750	$1,150
QQQ share owner	$620	$620	$620	$620	$620	$620
QQQ price at expiration: $30						
Premium income from put writing	$100	$200	$300	$500	$750	$1,150
Capital loss on stock put to investor	$0	$0	$0	$0	$0	$0
Total gain / (loss) for put writer	$100	$200	$300	$500	$750	$1,150
QQQ share owner	-$380	-$380	-$380	-$380	-$380	-$380
QQQ price at expiration: $29						
Premium income from put writing	$100	$200	$300	$500	$750	$1,150
Capital loss on stock put to investor	$0	$0	$0	$0	$0	-$1,000
Total gain / (loss) for put writer	$100	$200	$300	$500	$750	$150
QQQ share owner	-$1,380	-$1,380	-$1,380	-$1,380	-$1,380	-$1,380
QQQ price at expiration: $28						
Premium income from put writing	$100	$200	$300	$500	$750	$1,150
Capital loss on stock put to investor	$0	$0	$0	$0	-$1,000	-$2,000
Total gain / (loss) for put writer	$100	$200	$300	$500	-$250	-$850
QQQ share owner	-$2,380	-$2,380	-$2,380	-$2,380	-$2,380	-$2,380
QQQ price at expiration: $27						
Premium income from put writing	$100	$200	$300	$500	$750	$1,150
Capital loss on stock put to investor	$0	$0	$0	-$1,000	-$2,000	-$3,000
Total gain / (loss) for put writer	$100	$200	$300	-$500	-$1,250	-$1,850
QQQ share owner	-$3,380	-$3,380	-$3,380	-$3,380	-$3,380	-$3,380

Strike Price Of Puts ----->	$25	$26	$27	$28	$29	$30
QQQ price at expiration:$ 26						
Premium income from put writing	$100	$200	$300	$500	$750	$1,150
Capital loss on stock put to investor	$0	$0	-$1,000	-$2,000	-$3,000	-$4,000
Total gain / (loss) for put writer	$100	$200	-$700	-$1,500	-$2,250	-$2,850
QQQ share owner	-$4,380	-$4,380	-$4,380	-$4,380	-$4,380	-$4,380
QQQ price at expiration:$ 25						
Premium income from put writing	$100	$200	$300	$500	$750	$1,150
Capital loss on stock put to investor	$0	-$1,000	-$2,000	-$3,000	-$4,000	-$5,000
Total gain / (loss) for put writer	$100	-$800	-$1,700	-$2,500	-$3,250	-$3,850
QQQ share owner	-$5,380	-$5,380	-$5,380	-$5,380	-$5,380	-$5,380

As visibly depicted, the put writer will *always* be in a better financial position by writing puts compared to the owner of the number of shares represented by the contract obligation if the share price declines, regardless of what strike price and expiration date is selected. It can also be clearly seen that the put writer's ability to assess short-term market direction can dramatically influence the results of a put writing program. The owner of QQQ shares equal to the number of shares represented by the put contracts would outperform the put writer if the price of the QQQ at expiration were $32 or above. It should be noted that a price of $32 would be a 5.33% return in two months, or 32% on an annualized basis. So the QQQ would have to grow by that much to outperform the put writer (measure this against the experts' belief that we will only see from 6% to 7% annualized returns in the stock market in the future).

In the case of in-the-money put writing, the outright owner of QQQ shares will outperform the put writer if the price of the QQQ at expiration is above $35. The put writer will outperform the QQQ owner if the price is $32 or below. For strike prices of $33 to $35, the winner depends on which strike price the put writer selected.

There is one more positive attribute of writing in-the-money puts. Since these contracts 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 use this cash as additional margin upon which more puts can be written, or for other investments, to produce even more income. Whether this is a significant factor in increasing overall returns in your portfolio depends on whether the amount is sufficient margin to support writing additional contracts.

IN-THE-MONEY PUT WRITING RESULTS

Strike Price Of Puts ----->	$31	$32	$33	$34	$35
QQQ price at expiration:$35					
Premium income from put writing	$1,650	$2,300	$3,000	$3,800	$4,700
Capital loss on stock put to investor	$0	$0	$0	$0	$0
Total gain / (loss) for put writer	$1,650	$2,300	$3,000	$3,800	$4,700
QQQ share owner	$4,620	$4,620	$4,620	$4,620	$4,620
QQQ price at expiration:$34					
Premium income from put writing	$1,650	$2,300	$3,000	$3,800	$4,700
Capital loss on stock put to investor	$0	$0	$0	$0	-$1,000
Total gain / (loss) for put writer	$1,650	$2,300	$3,000	$3,800	$3,700
QQQ share owner	$3,620	$3,620	$3,620	$3,620	$3,620
QQQ price at expiration:$33					
Premium income from put writing	$1,650	$2,300	$3,000	$3,800	$4,700
Capital loss on stock put to investor	$0	$0	$0	-$1,000	-$2,000
Total gain / (loss) for put writer	$1,650	$2,300	$3,000	$2,800	$2,700
QQQ share owner	$2,620	$2,620	$2,620	$2,620	$2,620
QQQ price at expiration:$32					
Premium income from put writing	$1,650	$2,300	$3,000	$3,800	$4,700
Capital loss on stock put to investor	$0	$0	-$1,000	-$2,000	-$3,000
Total gain / (loss) for put writer	$1,650	$2,300	$2,000	$1,800	$1,700
QQQ share owner	$1,620	$1,620	$1,620	$1,620	$1,620
QQQ price at expiration:$31					
Premium income from put writing	$1,650	$2,300	$3,000	$3,800	$4,700
Capital loss on stock put to investor	$0	-$1,000	-$2,000	-$3,000	-$4,000
Total gain / (loss) for put writer	$1,650	$1,300	$1,000	$800	$700
QQQ share owner	$620	$620	$620	$620	$620
QQQ price at expiration:$30					
Premium income from put writing	$1,650	$2,300	$3,000	$3,800	$4,700
Capital loss on stock put to investor	-$1,000	-$2,000	-$3,000	-$4,000	-$5,000
Total gain / (loss) for put writer	$650	$300	$0	-$200	-$300
QQQ share owner	-$380	-$380	-$380	-$380	-$380

Strike Price Of Puts ----->	$31	$32	$33	$34	$35
QQQ price at expiration:$29					
Premium income from put writing	$1,650	$2,300	$3,000	$3,800	$4,700
Capital loss on stock put to investor	-$2,000	-$3,000	-$4,000	-$5,000	-$6,000
Total gain / (loss) for put writer	-$350	-$700	-$1,000	-$1,200	-$1,300
QQQ share owner	-$1,380	-$1,380	-$1,380	-$1,380	-$1,380
QQQ price at expiration:$28					
Premium income from put writing	$1,650	$2,300	$3,000	$3,800	$4,700
Capital loss on stock put to investor	-$3,000	-$4,000	-$5,000	-$6,000	-$7,000
Total gain / (loss) for put writer	-$1,350	-$1,700	-$2,000	-$2,200	-$2,300
QQQ share owner	-$2,380	-$2,380	-$2,380	-$2,380	-$2,380
QQQ price at expiration:$27					
Premium income from put writing	$1,650	$2,300	$3,000	$3,800	$4,700
Capital loss on stock put to investor	-$4,000	-$5,000	-$6,000	-$7,000	-$8,000
Total gain / (loss) for put writer	-$2,350	-$2,700	-$3,000	-$3,200	-$3,300
QQQ share owner	-$3,380	-$3,380	-$3,380	-$3,380	-$3,380
QQQ price at expiration:$26					
Premium income from put writing	$1,650	$2,300	$3,000	$3,800	$4,700
Capital loss on stock put to investor	-$5,000	-$6,000	-$7,000	-$8,000	-$9,000
Total gain / (loss) for put writer	-$3,350	-$3,700	-$4,000	-$4,200	-$4,300
QQQ share owner	-$4,380	-$4,380	-$4,380	-$4,380	-$4,380
QQQ price at expiration:$25					
Premium income from put writing	$1,650	$2,300	$3,000	$3,800	$4,700
Capital loss on stock put to investor	-$6,000	-$7,000	-$8,000	-$9,000	-$10,000
Total gain / (loss) for put writer	-$4,350	-$4,700	-$5,000	-$5,200	-$5,300
QQQ share owner	-$5,380	-$5,380	-$5,380	-$5,380	-$5,380

It has been mentioned previously that the author generally recommends the investor not take any further action after writing a put until the option contracts expire. An exception to this could be when in-the-money puts are written. Why? First, if the share price is in-the-money at expiration, the shares will be put to the writer at a loss. Buying back the puts to close prior to expiration means the investor avoids acquiring the shares at a 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.

A case can be made that it would make sense to buy back in-the-money puts 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 existing put option and write a new one. You have achieved your objective. See Chapter 7 for detailed information on how to exit existing put writing positions and still maintain profitability without having the underlying shares put to you.

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, whether in-the-money or out-of-the-money, there is always an upward progression in the price of a put option premium as the length of the 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 October than you would be for one expiring two months earlier in August. That is because with the October 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 one of the out-of-the-money General Electric (GE) puts. With these puts the entire premium consists of time value and no intrinsic value:

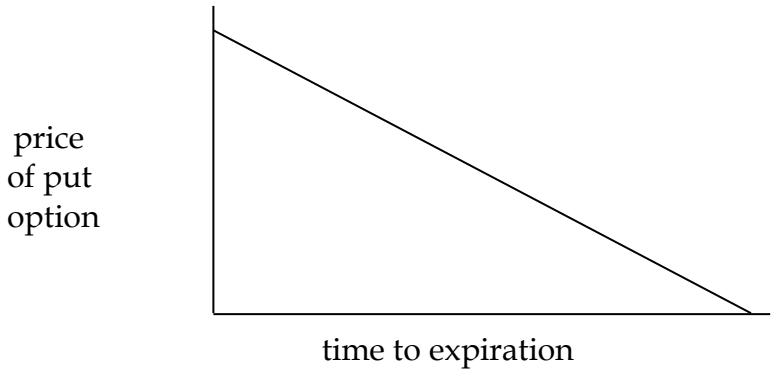
TODAY'S DATE IS ---------->	20-Jun

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.
GE	18-Jul	10	$30.01	$27.50	$0.20	$0.00	$0.20	$10,000
GE	19-Sep	10	$30.01	$27.50	$0.65	$0.00	$0.65	$10,000
GE	19-Dec	10	$30.01	$27.50	$1.25	$0.00	$1.25	$10,000
GE	16-Jan	10	$30.01	$27.50	$1.45	$0.00	$1.45	$10,000
GE	18-Jul	10	$30.01	$30.00	$0.85	$0.00	$0.85	$10,000
GE	19-Sep	10	$30.01	$30.00	$1.55	$0.00	$1.55	$10,543
GE	19-Dec	10	$30.01	$30.00	$2.50	$0.00	$2.50	$11,493
GE	16-Jan	10	$30.01	$30.00	$2.70	$0.00	$2.70	$11,693

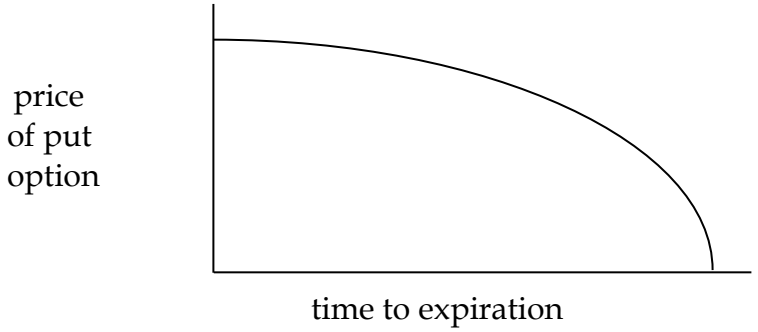
# OF DAYS	PREM. INCOME	$ RTN. OF CAPITAL	NET PREM. INC.	% ANNUAL RETURN	COVERED CASH LESS RTN. OF CAPITAL	% COV. RETURN
28	$200	$0	$200	26.07%	$27,500	9.48%
91	$650	$0	$650	26.07%	$27,500	9.48%
182	$1,250	$0	$1,250	25.07%	$27,500	9.12%
210	$1,450	$0	$1,450	25.20%	$27,500	9.16%
28	$850	$0	$850	110.80%	$30,000	36.93%
91	$1,550	$0	$1,550	58.97%	$30,000	20.72%
182	$2,500	$0	$2,500	43.62%	$30,000	16.71%
210	$2,700	$0	$2,700	40.13%	$30,000	15.64%

As you can see when looking at the same strike price, the premium for the September put contract is significantly less than the July contract. Yet the annual return is comparable to the July contract. The same is true in comparing the September contract with the December contract. Note the $30 strike price, which is at-the-money. The greatest annual return will almost always come from the shortest term option that is closest to being at-the-money.

Let's say you have just written an out-of-the-money put on GE. 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 will never happen, but will help make an important point). Since the time value of options is a decaying asset, one might expect that the price of the option would decline in a straight line progression day by day over its life until it expires without value on the expiration date…like this.



That is 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 GE's stock price were to remain exactly the same, for a three month put option, for example, the decay in the price of the option as it gets closer and closer to the date of expiration might look something more like this.



As you can see, with a flat price for GE the put option holds more if its value until closer to expiration. An option writer could take some advantage of this by buying back puts 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 would not 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 is the reason why holding the options until expiration is usually recommended. Some brokers, however, reduce their commission costs for option trades when the price on them is very low, which helps investors desiring to buy to close.

What, in summary, are the advantages of writing shorter-term puts versus the advantages of writing longer-term puts? Let's do an assessment:

Advantages of writing shorter-term puts

- Less likelihood of your shares being put to you at expiration because there is less time for the price to go down below the strike price.
- Greater return on investment, given the time period of the transaction.
- Greater opportunity to purchase the underlying shares at a lower price, as you may be able to reduce the strike price in future option writing opportunities if the share price declines gradually but does not reach your strike price at expiration.

Advantages of writing longer-term puts

- Larger total premium that you will receive.
- Less brokerage commissions, because you will not be writing new contracts as often. 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 below your strike price 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 options expire.
- Ability to do some tax planning by selecting options that expire in the next tax year (more in Chapter 8).

Given the advantages of each, what should a put writing investor do? Writing short-term puts with expiration dates from one to two months generally makes the most sense. 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.

~ CHAPTER 6 ~

Using Technical Analysis With Put Writing Decisions

Double-digit returns from put writing can likely be achieved on a consistent basis without the use of either fundamental or technical analysis by writing puts on diversified ETFs such as the QQQ, SPY and DIA. This would be the simplest possible world for the investor, involving no decision making for the equity portfolio. An investor could simply follow these steps: (1) write puts at the lowest strike price, using expiration dates with which he is comfortable, that will achieve his investment return objective; (2) following the expiration date, if the shares are not assigned, start over with step (1); (3) if the shares are assigned so that the investor is required to purchase them, write covered calls on the shares (see Chapter 9) until the shares are called away, then start over with step (1).

Some investors would like to increase their investment returns by trying to time their put writing. Evaluating technical indicators, in addition to following the fundamentals of what is going on in the market and the economy, can potentially enhance overall returns. The investor may benefit on a short-term basis by studying the use of technical indicators and applying the results to decisions about when to be in the market, when to be out of the market, when to write puts, when not to write puts, selling in-the-money puts vs. out-of-the-money puts (including the degree of spread between the strike price and the market price of the underlying shares) and choice of expiration dates.

The value of technical analysis depends on whether you are able to use it in a way that makes you more money than if you did not take the time to use it…and it does take some time. Some investors regard it as smoke and mirrors while others rely on it exclusively for all of the decisions they make.

The purpose in presenting it here is to give the investor some additional tools to potentially enhance returns. You can decide whether or not it is worth the time and effort.

If you believed you knew what the direction of the market was going to be for the short-term future, you would probably want to take some action. Here is the action you would likely take if you could forecast the following events:

<u>A significant market downturn</u>

- sell any shares you may own
- write deep out-of-the-money puts to acquire shares at much lower prices

- write puts with longer expirations to provide larger premiums for greater downside protection

A significant market upturn

- buy/hold shares
- write in-the-money puts for greater premium income

A flat or slightly increasing market

- write puts with the strike price somewhere below or at the current market price, depending on your personal preference and the price at which you would be willing to buy the underlying securities
- write puts with expirations that suit your personal preference
- buy stocks or ETFs and write covered calls (see Chapter 9)

KEY SHORT-TERM TECHNICAL INDICATORS

Technical analysis has to do with the interrelationships between a group of elements relating to a security, such as price level, price movement, volume of trading, and perhaps other factors. Essentially it deals only with perceived demand and supply issues relating to the security. Some investors use it exclusively in their decision making. Others use the technical indicators associated with this analysis along with fundamental analysis.

What would it be worth to you if you could reasonably predict such market conditions? Probably a lot. What follows are some of the more widely recognized tools market technicians often use to try to make those predictions. Use them as much or as little as you like depending on your willingness to devote time to it and the results it produces for you. No representation is made as to their effectiveness.

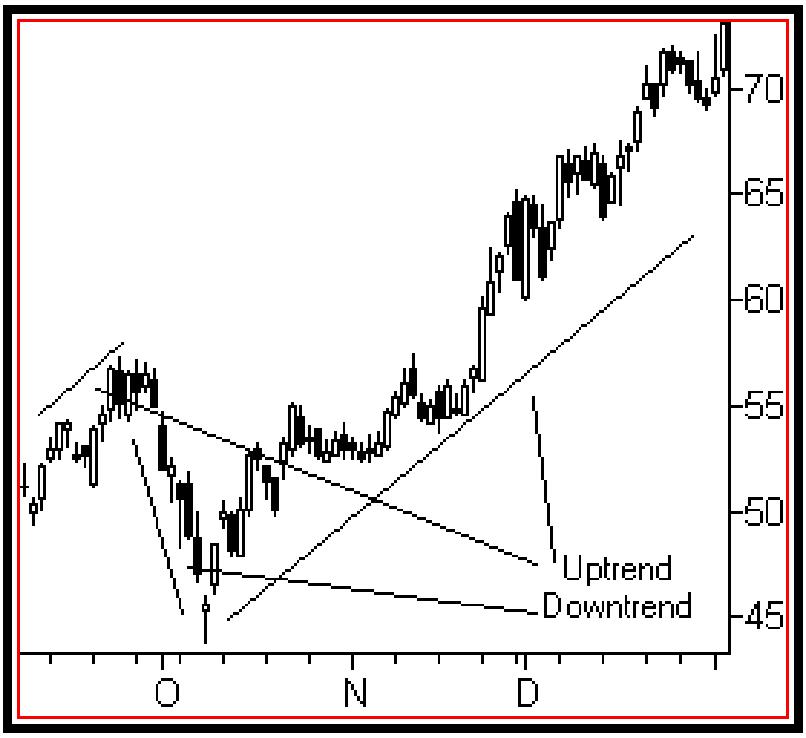
TRENDS

A trend reflects the direction of change in a stock's price over time. Trends exist in all time frames…minutes for day traders and years for long-term investors. For purposes of put writing, trends over a period of up to several months may be the most useful. Trends are classified as an "uptrend," a "downtrend" or "range-bound."

In an uptrend, a stock's price rises, often with intermediate periods of consolidation or movement against the trend. In doing so, it produces a series of higher highs and higher lows on the stock chart. In an uptrend, there will be a *positive* price change over time.

In a downtrend, a stock's price declines, often with intermediate periods of consolidation or movement against the trend. In doing so, it produces a series of

lower highs and lower lows on the stock chart. In a downtrend, there will be a *negative* price change over time.



Price Trends

If the stock is range-bound, its price swings back and forth for long periods between readily seen upper and lower limits. There is no apparent direction to the price movement on the stock chart and there will be little to no price change over time.

A stock in an uptrend or downtrend will typically continue to rise or fall respectively until some change in conditions occurs. Stock chart readers try to locate the tops and bottoms, which are those points where a price rise or decline ends.

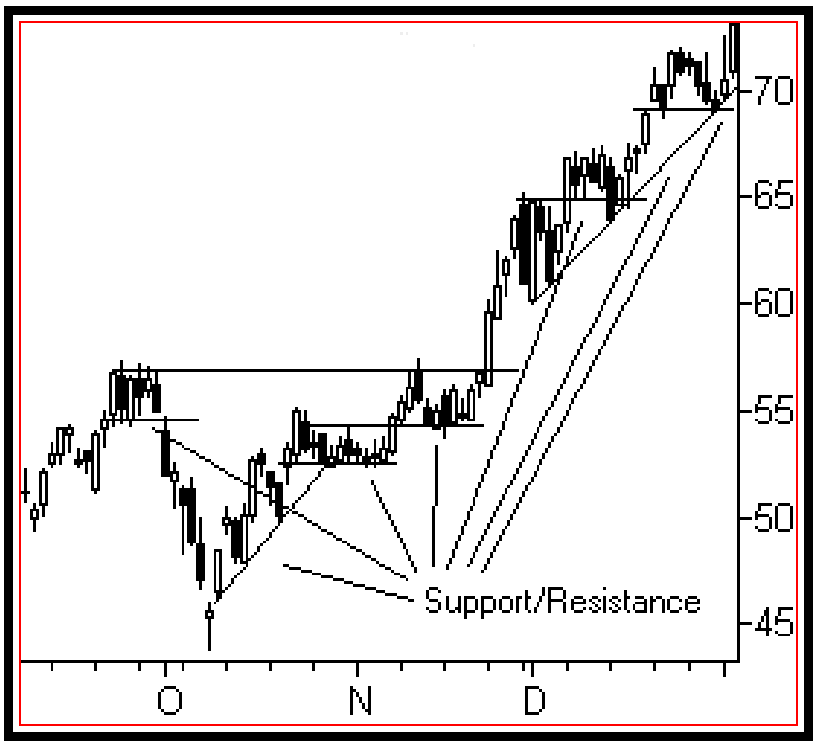
It is often said that "the trend is your friend." This bit of wisdom means that you will typically have more success taking stock positions in the direction of the prevailing trend than against it. Appropriate option decisions can be made using the trend to help determine the strike prices and expiration dates for the puts you wish to write.

SUPPORT AND RESISTANCE LEVELS

"Support" and **"resistance"** deal with the supply and demand for stock. Too much available supply means more stock than investors want to purchase,

so the stock price goes down. The opposite is true of demand. Demand for more shares than is available means upward pressure on the price of the stock. If the available supply and the current demand for shares are equal, then the price essentially moves sideways.

Support has to do with a declining share price, and a chart is necessary to determine support area prices. If a chart for a given stock shows that the price has declined to a certain level more than once--preferably several times--in the past where the decline halted and reversed, this would be considered a support area for the stock.



Support and Resistance Levels

In other words, the supply of stock dried up relative to the demand for it. If the price has been above this support area and it declined down to it again, we might expect that this support area would hold and that the price would either remain at about that level for awhile or head up. So, if we were looking at a put strike price at which we would be willing to purchase shares, we might be more attracted to a strike price near a support area. If in the past the price had held several times at this level and then reversed upward significantly, it might be an excellent time to write puts, possibly selecting those that are at-the-money or conceivably even in-the-money for higher risk takers. If the shares decline to slightly in-the-money on the expiration date and the shares are assigned to you, you might benefit from an immediate technical upswing in the price. None of

this is to say that the price cannot just keep going downward. If it does, it simply means that the sellers won the battle over the buyers for the stock, and a new support level would have to be looked for in the chart.

Resistance, on the other hand, has to do with a rising share price. Again, a chart is necessary. If a chart for a given stock shows that the price has risen to a certain level more than once--preferably several times--in the past where the rise halted and reversed, this would be considered a resistance area for the stock. Here the supply of stock increased in relationship to the demand. If the price has been below this support area and it rose up to it again, we might expect that this resistance area would hold and that the price would either remain at that level for awhile or head down. So, if we were looking at selling shares that we owned, we might be more attracted to take such action when they reached a resistance area. If in the past the price had held several times at this level and then reversed downward significantly, we might be inclined to either sell the stock if we owned it, avoid writing puts, or write deep out-of-the-money puts (very low strike prices). This would not give us a great deal of premium income, however it might allow us to purchase shares at a significant discount. Of course, the price could just keep going upward. If it does, it simply means that the buyers won the battle over the sellers for the stock, and a new resistance level would have to be looked for in the chart.

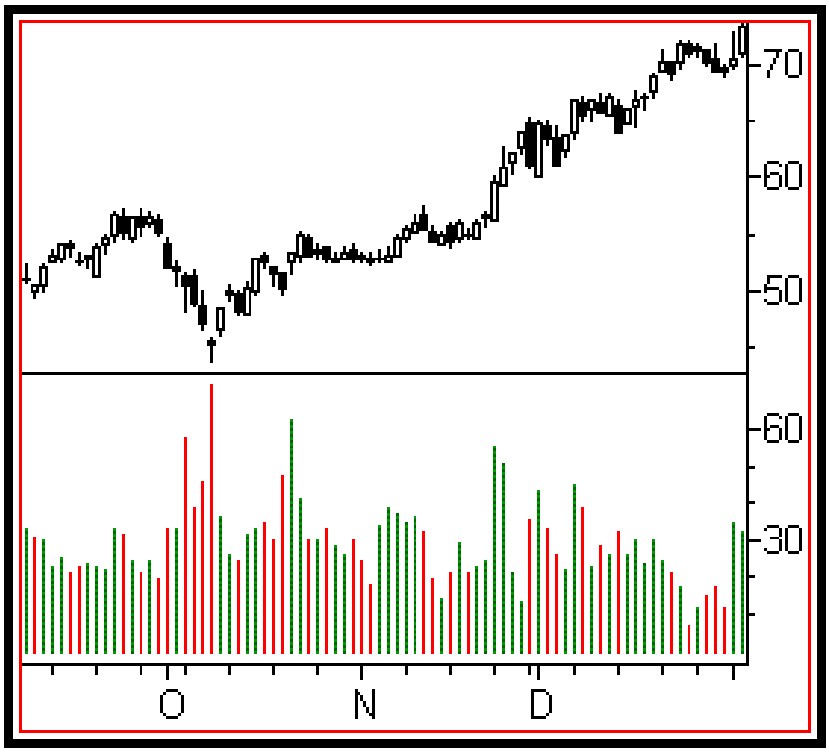
We often see stocks trade within a price range, with both support and resistance levels being established. When the price eventually breaks out of that range, either on the upside or the downside, it may give us a signal as to which direction the stock will trend at that point.

VOLUME

Volume measures the degree of participation, or ownership, in a security. Stock charts display volume with bar type graphs known as "histograms," usually located at the bottom of the chart below the price graph. You can measure buying and selling interest by watching how many up or down days in a row occur and how volume on those days compares with days when the price moves in the opposite direction. The charts are often color coordinated. For example, a green bar may be used to indicate the volume for a day when the stock closes higher than the previous trading day, and a red bar may be used when the stock closes lower than the previous trading day.

Stocks that are bought with greater interest than they are being sold are said to be under "accumulation" (high volume on days when the stock is moving up). Stocks that are sold with greater interest than they are being bought are said to be under "distribution" (high volume on days when the stock is moving down). Accumulation and distribution often occur in advance of price movement. In other words, stocks under accumulation often will rise for some time after the buying begins. Alternatively, stocks under distribution will often fall some time

after selling begins. Stock chart analysis works best on highly liquid securities, such as the QQQ, SPY and DIA.



Volume

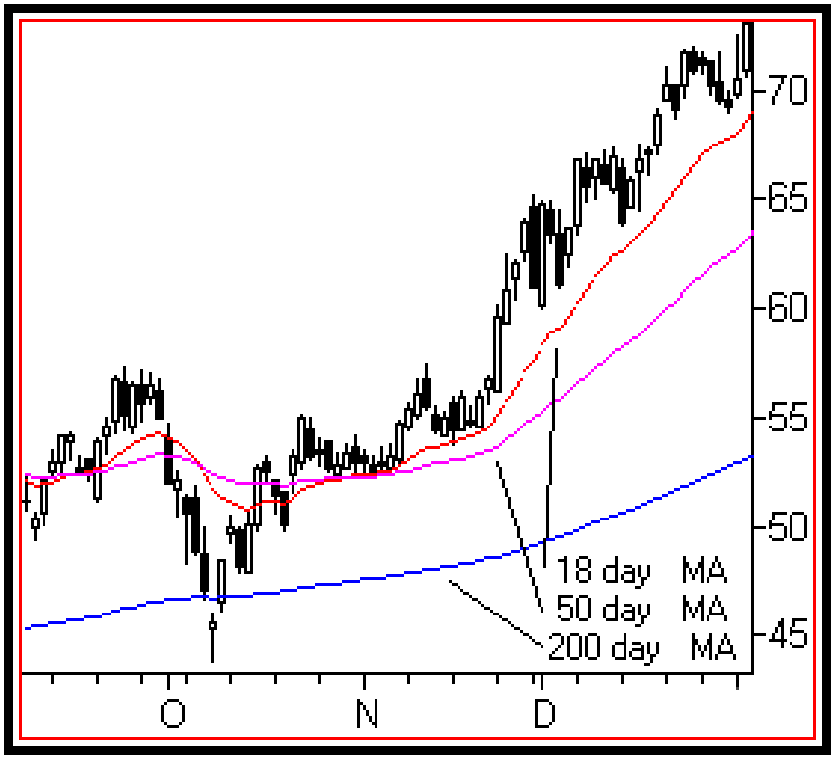
MOVING AVERAGES

A **"moving average"** shows the trend in the *average* price of a stock or market index over a specific period of time. As the name indicates, the time period "moves." For example, moving averages usually make use of a 10, 30, 50, 100, or 200 day calculation period, depending on the whims of the user.

The longer the time period, the more the average gets smoothed out. And, when a new day is added, the last day drops off. So, if you were calculating a 50 day moving average for a stock, you would take the price--usually the closing price--at the end of each of these fifty consecutive trading days, add them all up, and divide by fifty. That would be the moving average for the first point on your chart. The next day you would add the closing price for that day and delete the first day's price, make the same calculation for the second point, and so on.

If the moving average line is moving in an upward direction and the current price of the stock crosses above the moving average, then a buy signal may be indicated. Conversely, if the moving average is moving in a downward direction and the current price crosses below the moving average, it may be generating a sell signal. Again, there is no assurance that either of these would be

the case, so technicians usually give consideration to other indicators as well to strengthen their case.



Moving Average

A different twist on this would be a "weighted" moving average. This is calculated in the same way as what we just discussed, except that a higher weight is assigned to the most recent day and a progressively lesser weight to previous days. For example, if you were calculating a 10 day moving average, you would multiply the closing price on the first day by 1, the closing price on the second day by 2, and so on until you multiply the tenth day price by 10. You would add up all of these numbers and divide by the sum of the weights. This would give you a weighted moving average. In this case, a simple upward or downward turn in this average is believed to indicate a buy or sell signal.

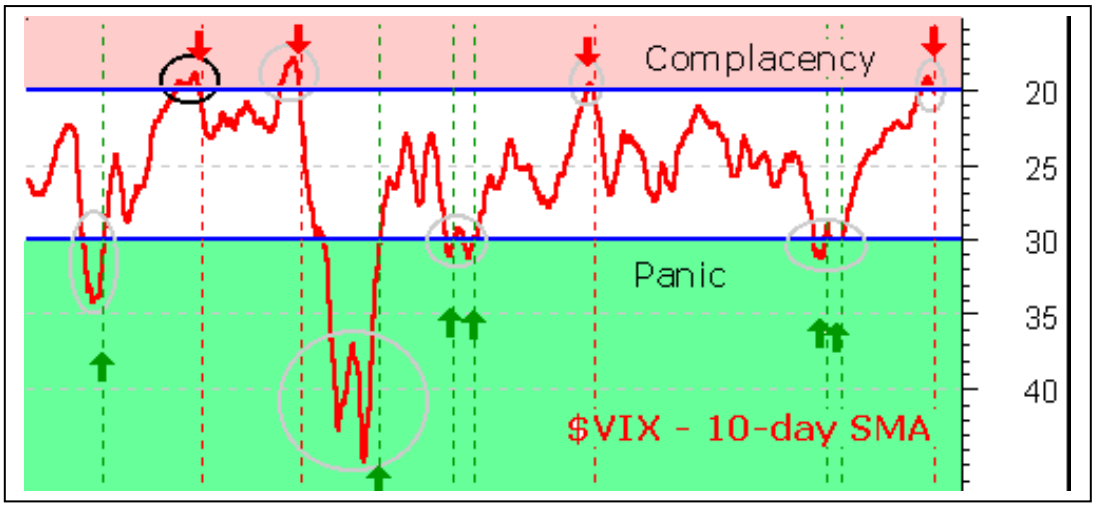
THE VIX

The VIX can be viewed as a "fear and greed" index. It measures the implied volatility of S&P® 500 Index options and is therefore the best possible fit to measure expected volatility of SPY, the S&P® 500 ETF. The VIX is calculated and disseminated in real time by the Chicago Board options Exchange (CBOE). It is a weighted blend of prices for a range of options on the S&P® 500 Index. A high value means a more volatile market and correspondingly higher priced options,

and conversely. It represents a measure of the market expectation for volatility over the next thirty days.

The following chart depicts a 10-day moving average of the VIX during a point in time. While the VIX over the years has ranged from a low of under 10 to a high in the 80s during the highly volatile market in late 2008, the long-term average for the VIX has been about 20. Extreme readings greater than 30 may constitute a buy signal (possibly a better time to write puts) and less than 20 a sell signal (perhaps a better time to write calls). Readings above 30 may indicate excessive bearishness, panic or an extremely high implied volatility (the up arrows). Readings below 20 may indicate excessive bullishness, complacency or low implied volatility (the down arrows).

The further the VIX increases, the more panic there is in the market. The further the VIX decreases, the more complacency there is in the market. As a measure of complacency and panic, the VIX is often used as a contrarian indicator. Prolonged and/or extremely low VIX readings indicate a high degree of complacency and are generally regarded at bearish. Some contrarians view readings below 20 as excessively bearish. Conversely, prolonged and/or extremely high VIX readings indicate a high degree of anxiety or even panic and are regarded at bullish. High VIX readings usually occur after an extended or sharp decline and sentiment is still quite bearish. Some contrarians view readings above 30 as bullish. The VIX Index can be found by requesting a quote and entering ".VIX" through many online brokerage accounts. It is also available on a daily basis by going to www.cboe.com and selecting "Market Data."



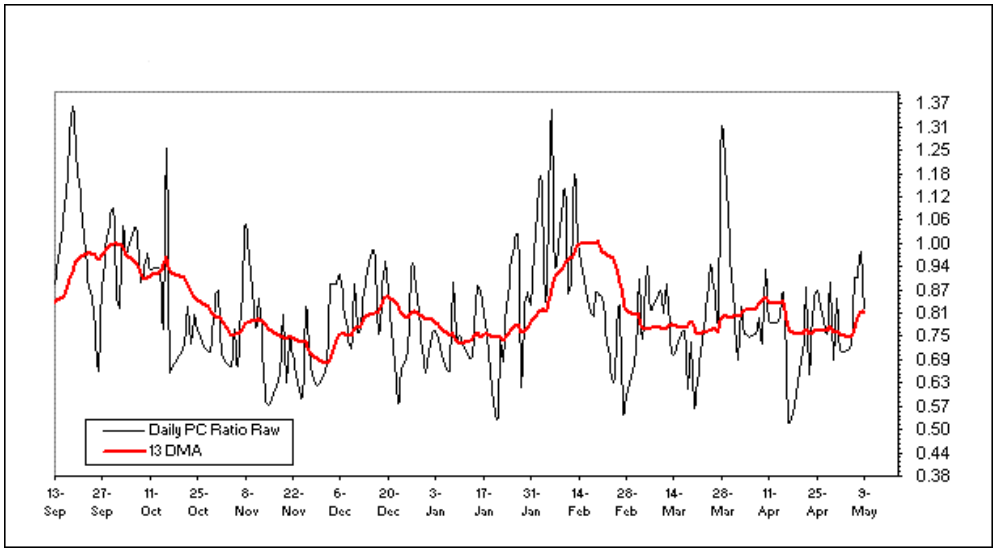
The VIX

THE PUT/CALL RATIO

Based on Chicago Board Options Exchange (CBOE) statistics, the Put/Call Ratio equals the total number of puts divided by the total number of calls. All stock and index options traded on the CBOE are included in the calculation. Typically, there are more calls traded than puts and the ratio is usually below 1. When more puts are traded than calls, the ratio will exceed 1.

As an indicator, the Put/Call Ratio is used to measure market sentiment and is also regarded by many to be a contrary indictor. When the ratio gets too low, it indicates that call volume is high relative to put volume and the market may be overly bullish or complacent. When the ratio gets too high, it indicates that put volume is high relative to call volume and the market may be overly bearish or in panic. The ratio is often calculated as a moving average.

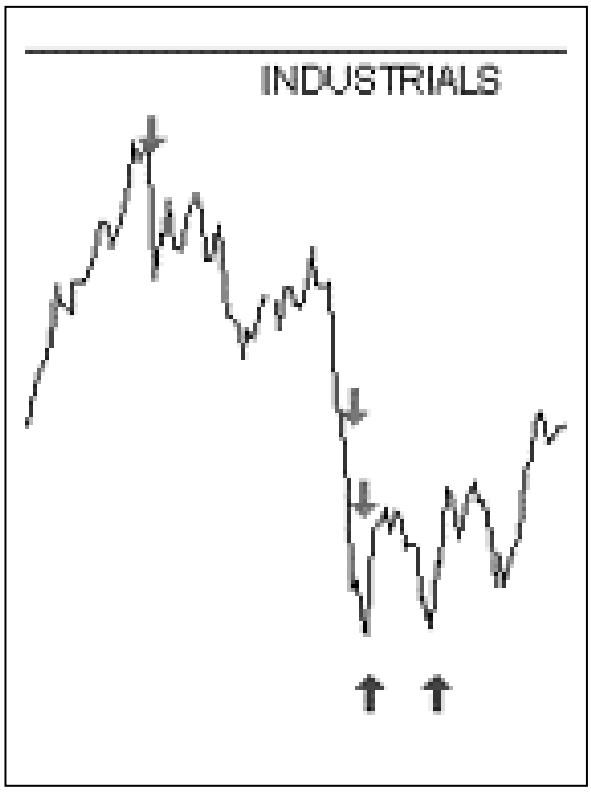
The Put/Call Ratio can be found on a daily basis by going to www.cboe.com and selecting "Market Data."



Put/Call Ratio

UPSIDE DOWNSIDE RATIO

The upside downside ratio is intended as a broad indicator of market direction in general. It takes the volume of the New York Stock Exchange stocks that are advancing and divides this by the volume of New York Stock Exchange stocks that are declining. A moving average of 10 to 20 days should be used. A result above 4 is thought to be a positive buy signal and a result below .75 is thought to be a negative sell signal. Here is an example of several buy signals (up arrows) and sell signals (down arrows) generated by this ratio:



Upside Downside Ratio

BOLLINGER BANDS

Bollinger Bands are volatility based bands used to help identify situations where prices may be too high or too low on a relative basis. The base for the bands is a moving average and the band's width is determined by volatility.

Bollinger Bands

When prices reach or rise above the upper band, they are thought to be too high. When prices reach or drop below the lower band, they are thought to be too low. Some technicians wait until the price has broken a band and then

reversed price direction before considering the move a signal. According to its founder, John Bollinger, Bollinger Bands can be used for about any financial instrument, including individual stocks and ETFs.

There are many other tools for technical analysis too numerous to mention. Obviously it would be a full-time job for an investor to try to assemble the data from which these indicators are formed. Fortunately that is not necessary.

Most online brokers allow you to build custom charts of securities and to add many of these technical indicators to the charts. There is no additional charge for this service. StockCharts.com (www.stockcharts.com) provides this as a free service, in case you do not have an online brokerage account. Whether through an online broker or through StockCharts.com you can build a chart and incorporate one or more technical indicators of your choice into the charts to assist in analyzing the potential for short-term price directions. You can usually save the charts for future reference, updating any changes if desired. On the next page is what a chart might look like on the QQQ that incorporates several different technical indicators within one chart. Of course, separate charts could be developed for each indicator to avoid confusion.

The charting features available for free on BigCharts.com (www.bigcharts.com) can also be very useful. There are many services that offer technical analysis through charting and commentary in greater detail for a fee, both over the Internet as well as published periodicals. Never before has there been this level of data available to the individual investor to assist in timing decisions.

Multiple Technical Indicators

Investors who use technical analysis usually take a number of indicators into consideration to see if most are pointing in the same direction. If there is no pattern developing, it might be best just to ignore them and go solely with fundamental analysis.

USING TECHNICAL INDICATORS FOR PUT WRITING DECISIONS

Technical indicators are typically used by investors to assist them in timing buy and sell decisions for stocks. While the indicators discussed in this chapter may be of use for that purpose, it is suggested that they also be considered for decisions on (1) when to write puts, (2) whether puts are written in-the-money, at-the-money or out-of-the-money, and (3) expiration dates selected. It is the author's belief that use of technical indicators may be of equal if not greater value in making option writing decisions than stock buy and sell decisions. The list on the next page shows how these indicators may be useful in conjunction with put writing to potentially increase your investment returns, depending on the investor's risk tolerance.

Each individual investor will develop his own style of put writing. Many investors will never write in-the-money puts out of personal discomfort for that particular strategy, even if they have a good feel for technical turns in the market and for individual stocks and ETFs. Others may be willing to try anything and are prepared to take more risk to obtain greater returns. Taking more risk is not advocated, since even the most conservative put writing (deep out-of-the-money puts on low beta stocks and ETFs) can often provide double-digit returns. It is recognized, however, that different individuals have a varied willingness to assume risk in writing put options, just as many investors in stocks assume greatly varied risk, as witnessed by the type of stocks they purchase. The broad spectrum of put writing has been provided so that all needs can be accommodated.

Technical indications:	**Possible action to take:**
Stock/ETF may have hit bottom and may be about to rise.	Write at-the-money puts. Write in-the-money puts.
Stock/ETF may have hit a top and may be about to decline.	Avoid put writing on this stock for now. Write deep out-of-the-money puts.
Stock/ETF outlook is neutral.	Write at-the-money puts. Write out-of-the-money puts.

~ CHAPTER 7 ~

Brokerage Accounts and Put Option Writing

As stated earlier, purchases and sales of ETFs as well as put writing transactions can be done through either a discount broker or a full-service broker. If you have an investment advisor or broker who is performing miracles for you, 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 use of an online discount broker. Although there are exceptions, most representatives of full-service brokerage firms are not trained to manage accounts for put writing.

You are encouraged to review some of the discount brokers listed in the Appendix of this book and compare commission costs for equity trades and option trades as well as compare services offered. If you become a serious put writer, you will be incurring commissions from your writing activities on a regular basis. It is therefore important to keep your commission costs down in order to maximize the opportunity to realize your investment return objective. This chapter operates under the assumption that you are trading through an online discount broker. Covered call writing can be done online with most online brokers. Many also allow put writing transactions to be completed online while others offer it only to their "active traders" and large investors. Some brokers do not allow any online trading for put writing, so one of their telephone representatives must be contacted. By phoning the brokers of your choice you should be able to determine whether put writing is available to you online, and if not, what the procedures and commission schedule will be to conduct your trades.

The author's view is that it is best to trade online if at all possible, and the following assumes that you are doing your put writing online.

ONLINE DISCOUNT BROKERS

With just a little experience you will find that trading put options online is much quicker, easier and less expensive than dealing with humans. For example, it is very cumbersome to have to call a human broker to find out what option strike prices and expiration dates are offered for the underlying shares you are interested in so that you can make decisions on your put 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. 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 will not have any need to work with an individual unless you have some kind of problem with your account or if you simply do not wish to be involved with the mechanics of trading.

You need to do your option trading with the broker where you have an approved margin account and where you plan to hold shares on deposit that you may have put to you in the future from your put writing activities.

COMMISSIONS

The discount brokers generally charge far less than full-service brokers, but even among the discounters there is a great deal of difference. Most of all you want to be sure you are dealing with a substantial brokerage firm who will be around for at least as long as you are.

Typically discount brokers 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 contracts, as this component does not change regardless of how many contracts are traded. Second, there is usually also a fee per option contract as well. This component tends to make it more expensive on a relative basis to trade a large number of option contracts on a lower priced underlying security or one with a small premium.

These two components are added together and charged as one fee per trade. As an example, let's say there is a $7 flat fee plus $1.50 per contract. If an investor sells 10 put contracts 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 put options, as they will always have more premium income per contract than shorter-term options.

Commissions on option trades tend to be higher than the discount broker commissions charged for share purchases or sales, which often run between $7 and $30, depending on the broker. But in recent years, fees on option trades have come down significantly and usually represent only a very small percentage of the put option writing income you will be collecting.

There are many online brokers such as TD Ameritrade, Charles Schwab & Company, E-Trade, Fidelity Investments, Scottrade, and on and on. An investor should be able to go to the Web site of any of the online brokers and check out the fees for stock and option trades very easily. Or, a phone call could be made to get the same information. Sometimes brokers charge you more to acquire shares that have been put to you through an assignment of a put than they charge for a

regular purchase transaction. It would be a good idea to check this out when you are researching brokers so there are no surprises.

The "puts" template used to select option alternatives can be easily customized to include option fees charged by your broker in the return calculations. Just add the appropriate charges your broker assesses on the spreadsheet to the right of the calculations.

There are two things important to focus on in conjunction with writing 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 puts to write. Second is the process of executing the option transactions. The rest of it takes care of itself. When you write puts your broker will credit the cash to your brokerage account the next day. All of the mechanics occur automatically. Not only will the cash be put into your brokerage account the next day, but with a cash management account they should automatically invest the cash in the money market fund you have selected for your account. That way your premium income is earning some interest until you decide to withdraw it or to reinvest it in something else.

THE OPTION AGREEMENT

You must be approved for option writing for the "uncovered" ("naked") put writing level by your broker through an application process. This critical piece of paperwork will need to be completed before any option writing can be done. You need to sign an **"Option Agreement"** for each personal account you have with your broker so that you can trade uncovered put options. The forms may be available online through the broker's Web site. If not, you need to call or write them, tell them that you want to write puts in your accounts, 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 options 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 put writing, can be very conservative. This booklet reviews it all. It is also available online at www.cboe.com.

The purpose of the agreement is to help the broker 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 book, you will be very knowledgeable about writing puts. But you should go ahead and request the Option Agreement now to get the account set up so you are ready.

The Option Agreement covers a wide variety of option strategies, so when you complete the paperwork you should indicate that you want to write put options (this will also automatically qualify you for covered call writing). 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 puts and covered calls, in addition to other investment objectives you may have.

Once you see the paperwork you will 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 WORKSHEET DATA

As you know, you need to enter data in all of the columns on the Excel® template that have an "**x**" at the top. The columns are ordered for readability after the worksheet is complete, so you will not necessarily enter the data in the order of the columns. If you look down to the lower-left hand corner of the worksheet you will see a tab labeled "Expiration Dates." By clicking on this tab you will have available to you a progressive list of monthly option expiration dates that you will need in column B. You should select the dates you want, one at a time, by placing your cursor over the first date and clicking on the "Copy" button. Then click on the "puts" tab and place the cursor in the appropriate cell under the "Expir. Date" column. Finally, click on 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 additional rows and replicate the information for the same security if you have multiple expiration dates and strike prices you want to consider.

It is unlikely you will know the number of put contracts you wish to write at this point. After the other data has been entered and the calculation data (especially the margin requirement) can be reviewed, you can go back and enter or change the number of contracts.

Once you have this information in the template, you are ready to begin looking up quotes. This may be done somewhat differently with various online brokers, but typically what you do is request a quote on the underlying security by typing in its ticker symbol. When you have the quote for the option, 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 an online quote, you should find the words **"option chain"** near the quote. By clicking on this, the brokerage firm's system should take you to a listing of all of the expiration dates and strike prices offered. Then scrolling up and down, you should be able to see the option ticker symbol for each option you wish to consider. Below is a sample of a typical online option chain. This one is for the QQQ.

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

As you scroll down, note the ticker symbol for those you want and type in that information in a row under the first column 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 obtaining quotations from an online broker, Yahoo! Finance, BigCharts.com and the Chicago Board Options Exchange Web site (www.cboe.com) also 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 quotations.

After you have entered the put option symbol for the security of your choice from the option chain and have entered that information onto the spreadsheet, your row should be filled up to the premium column on the template. Now you can get the premium quotes on the option symbols you wish to review and enter that information.

The option chain should give you a number of pieces of information about the quote you are looking for. Most importantly, it should give you the current bid and ask prices. That is even more important that the last price at which the option has traded. It may have been some time since the last option trade, and the underlying shares have probably gone up or down. This would mean that the bid and ask for the option have also gone up or down, sometimes causing the last trade price to be out of date.

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 and make a decision on which option you wish to write.

We will not review the decision making process again, as this was discussed in detail earlier. Of course your goal is to achieve your total return objective and basing your strike price and expiration date decisions on how you think the underlying shares will be performing between now and the time the option that you are considering will expire.

HOW MANY PUT CONTRACTS?

One of the most important decisions you will make is the number of put option contracts you write on any given underlying security. 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 leverage of 100 shares for each contract. 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 the 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 PUT OPTION TRADING

After considering the alternatives, you have made a decision on a put option to write. At this point you are now ready to use the online broker to execute the option transaction. When you are logged on to your brokerage account you need to go to the Web page that is used for option trades.

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.

Several choices should appear for the kind of option trade you wish to place. The buyer of an option would click on "buy" to purchase a put option or "sell" in order to close out his position. 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." 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 of the underlying shares. You then need to type in the option symbol in the appropriate place to be sure you get the right contract (note: if you use an option chain you should be able to simply click on the option of your choice and the symbol is entered for you).

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. If there is only a $.05 spread between the bid and ask ($.10 for options trading at $3 or more), it should be safe to enter a market order rather than a limit order. Some actively traded contracts have spreads that are only pennies apart.

Sometimes the difference between the bid and ask for some option contracts can be wide and can work 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 generally suggested that you *use limit orders and set a limit price* for your option trades unless the spread between the bid and the ask is very narrow as previously described. 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. Generally, when you are looking to do a trade on a put option, you can expect to have your order filled at about the midpoint between the bid and ask, or perhaps a little bit closer toward the bid side. For very illiquid options, however, it may not be possible to achieve more than the bid price.

You should click on "limit order" and then set a limit price you are willing to accept. For example, if the bid on your option transaction is $1.10 and the ask is $1.30, to have a reasonable assurance that your order will get filled, you should bid about $1.20. Or, you could plug $1.15 into your calculation template, and if that amount would result in a return that is acceptable, you could consider entering your limit order for $1.15. For some option contracts such as the QQQ there is sufficient liquidity that the spread between bid and ask will not be that wide. For other more thinly traded options, the spread may be much greater.

If you were to enter a limit price that is a bit higher than the midpoint between the bid and ask, it would probably take a rise in the price of the underlying shares, and correspondingly the option, before your trade would be executed. Since there is no assurance that the price would go up, your order might not be filled.

There is one risk you do run, however, when setting a limit price. If by the time you get your order placed the price of the underlying shares has risen, then the option price will have also declined and your order will not be filled unless the price of the shares declines and the option price rises again. 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 share price declines, 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 recovers to your price. 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. Through an online broker, this is readily accomplished simply by pointing and clicking.

Of course, if the bid price fulfills your return objective and is acceptable to you, you could actually enter the bid amount as your price, but you should typically try to do at least somewhat better than that unless the spread between bid and ask is very small (e.g., 10 cents or less). You can plug in quotes for various premium alternatives into your template to see what the returns look like compared with your objective.

There is 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 put 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.

The "all-or-none order" may be a good idea, particularly when you are dealing with options that are thinly traded. It is not always possible to know how liquid the market is for the options you are trading, although some online brokers will indicate the number of contracts offered at the bid and ask prices. 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. When you are initiating your transaction, either online, or through an automated voice response phone system, or with a live broker, 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 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." This would be entirely up to you. 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 on the following day. With a good-'til-canceled order, the order will remain on the broker's books until it is filled or until you cancel it.

The process of trading options is essentially 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 seem 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 get.

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 you may wish to wait it out to see if the market recovers 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. Some online accounts do not provide statements and confirmations by mail.

When you have written puts, the puts 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 underlying shares were to remain constant after the trade, the negative balance of the option on your brokerage statement would eventually diminish to zero as the time value decays on its journey to the expiration date.

~ CHAPTER 8 ~

Taxes and Put Option Writing

When you have success with a put option writing strategy in a taxable personal account it is 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.

The good news from a tax standpoint is that *even though you have the use of the premium income immediately, it is not 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 of the options you are writing.

DEFERRAL OF TAXES TO A LATER TAX YEAR

Let's say that you wrote put options on the QQQ with an October expiration date and the options expired without the shares being put to you. Now you are ready to write another option. You 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 put options with an expiration date in January or later of next year. By doing so, you have just deferred the income tax consequence into next year, even though the premium income is paid to you right now. And you can do this on as many 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 puts 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 put was outstanding. That means your option writing income is usually taxed at the same rate as if it were **"ordinary income."** You will need to report your option trades on Schedule D of Form 1040. If puts you have written are either bought back or if they expire unexercised, you report the amount of gain or loss as a separate item on this schedule. If the underlying shares are put to you at expiration, subtract the amount of premium income gain from the amount you pay for your stock. There is no immediate tax consequence to the put writer when the underlying shares

are assigned. The put writing gain reduces the cost basis in the underlying security and is reflected in the overall gain or loss when those shares are eventually sold. If you hold the shares for over one year (current tax law) any gain or loss on the sale of the shares at the adjusted cost basis is **"long term**."

If you 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 $2,000 in premium income. In November you bought back the options for $500. You would have a short-term capital gain of $1,500 for the tax year in which you bought back the options, not in the next tax year when the options would have otherwise expired.

CAPITAL GAIN VS. CAPITAL APPRECIATION

We have previously used the term "capital appreciation," but 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 a stock, ETF or an option. For example, if an ETF goes from $28 to $35, it has experienced capital appreciation of $7 per share. Capital gain is a tax term that comes into play only when a capital asset, such as a stock, ETF or 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 previously taken a **"capital loss"** on the sale of a security, you could use that loss to offset some of the gains you realize from your option writing income. If you had some gains from writing put 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 shares you may own, you could sell those shares and use the actual loss to offset option writing income.

ROLLING FORWARD

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. 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 XYZ 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 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

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 always 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.

ROLLING UP

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.

The use of technical indicators may be helpful in deciding when rolling up, rolling down, or rolling forward may be an appropriate strategy. Use of these strategies, however, is not 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.

It is always a good idea to consult your tax advisor about all of these tax matters. The laws are cumbersome and they can always change.

TAX DEFERRED ACCOUNTS

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. Most brokers now allow cash covered put writing in such accounts. And, with a ROTH IRA the premium income and any capital gains on the shares go untaxed.

~ CHAPTER 9 ~

Put Writing and Covered Call Writing: Two Complementary Strategies

Previously we 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 THE SIMILARITIES AND THE 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 underlying security increase in price (for calls), decrease in price (for puts) or remain flat.
- 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 commit. While the covered call writer must purchase 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 (see glossary) 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 gives 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 regardless of what happens to the price of the security and he may have an opportunity to pick up the shares at a more reasonable price if it declines. 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. It is beyond the scope of this book to discuss covered call writing in detail. It can share similar risk/reward characteristics with put writing. Investors are referred to the following other books by this author that provide education and implementation programs specifically geared to covered call writing. They are all available through Arrow Publications at a discount (www.arrowpublications.net) or Amazon.com:

Covered Call Writing Demystified: Double-Digit Returns on Stocks in a Slower Growth Market for the Conservative Investor
(ISBN 0-9715514-0-5) – for covered call writing on individual stocks

Covered Call Writing With Exchange Traded Funds: Double-Digit Returns, Diversification, Downside Protection
(ISBN 0-9715514-2-1) – for covered call writing on Exchange Traded Funds

Covered Call Writing With Qs and Diamonds: Double-Digit Returns on Ready-Made Portfolios
(ISBN 0-9715514-3-X) – for covered call writing on two of the most liquid Exchange Traded Funds that are especially suitable for writing calls due to liquidity and dollar increment strike prices

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.

~ CHAPTER 10 ~

Conclusion

It has been over three decades since fungible 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 that the average investor remains largely confused and unaware of their use. In particular it is amazing that the most conservative option strategies of all…writing puts and writing covered calls on stocks and Exchange Traded Funds…remains a mystery to the masses while its 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 put writing and covered call writing. Articles are appearing in magazines, guests are invited to speak on CNBC TV on the subject, and Web sites are being created, sometimes offering outlandish claims of investment success.

Clearly past 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 over the years. Moreover, hearing from some of the country's best known and most respected investors, economists, and educators that stock market returns may be paltry in the future when compared with the past for perhaps two or three decades to come is most unsettling for those who were looking forward to early retirement, or even normal retirement, especially for the huge number of so-called baby boomers. The big issue for the boomers in the future will be how to generate sufficient income in their retirement, given the low interest rate environment that may pervade for many years.

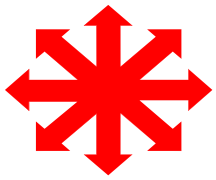
Few new investment ideas are apparent. While writing put options is certainly not new, it is new to most individual investors. If the flat to slow-growth market predictions of Warren Buffett, John Templeton and many other knowledgeable professionals hold up, it would appear that the returns achievable from writing puts on equities may well be one of the few ways to achieve double-digit investment returns for many years to come.

While there are literally thousands of stocks and ETFs on which puts can be written, writing puts on three of the most prominent ETFs, the QQQ, SPY and DIA, offer particular advantages to the investor. These ETFs are highly liquid

and trade tens of millions of shares per day. Their put options also are highly liquid, particularly when compared with many other stocks and ETFs offering options. The underlying shares representing the QQQ, SPY and DIA are some of the most attractive securities available to investors because of the diversification they offer. They also offer strike prices in dollar increments…a significant positive for put writers seeking many alternatives. By using these securities investors can eliminate the time consuming process of researching individual companies for investment ideas and especially have the diversification so necessary for an equity portfolio.

Time saved by selecting ETFs for put writing rather than researching individual stocks can be well spent in doing some technical analysis to assist in timing decisions. It has the potential to improve upon the returns that investors can already expect to realize from put writing.

For investors who are prepared to buy shares in the underlying security at a discounted price of their choosing, the consistent double-digit income from put option writing presents a viable strategy and useful addition to your investment arsenal.



~ 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 a stock, ETF or an option.

ASSIGNED – The requirement by the writer of a put option to perform according to the terms of the contract by purchasing the underlying shares of the holder (buyer) of the option. The option writer's broker handles the purchase.

AT-THE-MONEY – The strike price and the market price of the underlying shares 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 a stock, 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 a stock or ETF at a predetermined price until a certain date. For example, an investor may purchase a call option giving the investor the right to buy 100 shares (for each option contract) at $50 per share until September 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 a stock, ETF or an option sale is greater than its cost. When writing puts, for example, if you receive $3 per share in premium income and the puts expire worthless, your cost is $0 per share and the capital gain is $3 per share.

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

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

CASH COVERED – Means that enough cash has been set aside by the broker in the account to cover the full purchase price of shares subject to an option contract.

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 shares they own. There is also the opportunity for a defined amount of capital appreciation (for out-of-the-money calls) and the shareowner 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.

EXCHANGE TRADED FUND (ETF) - ETFs represent shares of ownership in portfolios of common stocks which are designed to generally correspond to the price and return 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 put options, to require the sale of the underlying shares by the holder (buyer) of the options to the seller (writer).

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

FUNDAMENTAL ANALYSIS – An attempt to determine the true value of a security based upon factors such as management quality, earnings, balance sheet statistics, and other elements of financial statements.

FUNGIBLE – Relates to assets that are identical and are interchangeable. For example, shares of the QQQ (the NASDAQ-100 Index Tracking Stock) or the April $30 QQQ puts are both fungible. All QQQ shares are the same and are interchangeable and all of the QQQ April $30 put 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.

HISTOGRAM – A bar chart representing a frequency distribution. The heights of the bars represent observed frequencies.

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

IN-THE-MONEY – The strike price of a put option is above the market price of the underlying shares. For example, the put option for a security with a strike price of $50 when the security is trading at $48 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, using low margin requirements to write a larger number of put option contracts 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 puts, 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. The term also refers to the amount of equity in an account (securities or cash) a broker requires to support an uncovered option position.

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.

MOVING AVERAGE – A series of successive averages in a set of numbers. As a new number is added, the last number in the series is deleted.

NAKED – An option transaction that is opened whereby the investor does not own underlying security (also called "uncovered"). An investor writing a put option on 100 shares of the QQQ, 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 a stock or ETF option that are in existence at any given time.

OPTION – A contract permitting the holder (buyer) to purchase (call) or sell (put) a stock or 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 trading experience and/or knowledge (such as the knowledge contained in this book in the case of writing puts) 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 stock or ETF which includes every expiration date and strike price available for options on that

security. 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 (call) or buy (put) a given security 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 stock and ETF is given a series of up to four months during which option contracts expire. Options for a stock or 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 put option is below the market price of the underlying shares. For example, the put option for a security with a strike price of $55 when the shares are trading at $58 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 shares, and interest rates.

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

RESISTANCE – Increased supply in the shares of a security, which may cause its price to top out at a certain level.

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

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

ROLLING UP – Buying back a put option position and then writing a new put with the same expiration, 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.

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 put option can sell the underlying shares. Also sometimes referred to as the "exercise price."

SUPPORT – Increased demand for the shares of a security, which may cause its price to bottom out at a certain level.

TECHNICAL ANALYSIS – An attempt to identify trends in supply and demand for a security through analysis of variables such as price levels, price movements and trading volume.

TECHNICAL INDICATORS – Chart formations used in technical analysis to determine the timing of investments and the selection of investments.

TICKER SYMBOL – The abbreviation for a stock, ETF or option used on securities quotation machines. For example, "FFF" 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 – An option transaction that is opened whereby the investor does not own the underlying security (also called "naked"). An investor writing a put option on 100 shares of the QQQ, for example, does not own the shares.

UNDERLYING SHARES – The stock or ETF that, in the case of a put contract, the option holder (buyer) has the right, but not the obligation, to sell to the option writer 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."

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

~ OPTION, BROKERAGE & ETF WEB SITES ON THE INTERNET ~

The following Web sites may be useful to those desiring basic information about options, discount brokers, charts, technical analysis and ETFs.

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. Delayed quotes on ETFs and ETF option chains are also available.

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 (including the QQQ and the DIA), bonds, mutual funds, and other types of investments. Some provide general business news, company specific news, investment research, charts (many including sophisticated technical analysis) 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

www.scottrade.com – Scottrade; 800-619-save

CHARTS AND TECHNICAL ANALYSIS

www.bigcharts.com – BigCharts.com

www.stockcharts.com – StockCharts.com

Note: All online broker sites offer varying degrees of charting and technical analysis to their customers.

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."

~ BOOKS BY PAUL D. KADAVY ~

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

Put Option Writing Demystified: *Earn Double-Digit Cash Returns While Waiting to Buy Stocks at a Discount*

Writing Uncovered Put and Call Combinations: *Earn Two Option Premiums from One Margin Requirement on Individual Stocks and Exchange Traded Funds (ETFs) Without Owning Them*

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*

Finding Financial Freedom: *A Step-By-Step Program for Everyone to Repair or Prevent Personal Financial Ruin*

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 *Put Option Writing Demystified*, 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*, *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*.

Have you been tempted at times to buy a particular stock, but decided not to take the plunge because you thought it might be overpriced...or, just on a hunch, you thought you might be able to pick up the shares at a lower price? 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 return 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 stocks and Exchange Traded Funds (ETFs).

This book provides a complete education and implementation program for individual investors desiring to achieve double-digit returns in a stock market that many experts, including Warren Buffett, John Templeton, Jeremy Siegel, John Bollinger and Peter Lynch, say will grow much more slowly than the past for perhaps decades to come.

Put option writing has almost the exact same risk/reward characteristics as covered call writing. Used appropriately, both are conservative investment strategies, unlike other uses of options...more conservative than simply owning common stocks or ETFs alone.

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