# *Covered Call Writing*

## with

# Qs and DIAMONDS

## DOUBLE-DIGIT RETURNS ON READY-MADE PORTFOLIOS


**Paul D. Kadavy**

# COVERED CALL WRITING WITH Qs AND DIAMONDS

## Double-Digit Returns On Ready-Made Portfolios

**OUT-OF-THE-MONEY CALL WRITING**
**IN-THE-MONEY CALL WRITING**
**SHORT-TERM TECHNICAL ANALYSIS**

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# COVERED CALL WRITING WITH Qs AND DIAMONDS

# 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

The purpose of this book is to chart an easy-to-execute course for investors desiring to achieve double-digit investment returns, but who have little appetite for investment research. It employs these investment strategies that are readily implemented: utilizing two specific Exchange Traded Funds (similar in some respects to mutual funds, but bought and sold like a stock) coupled with writing covered calls (selling the right to someone to buy your shares from you at a pre-determined price for a defined period of time in exchange for a cash payment to you). More specifically it involves:

- Establishment of an equity portfolio exclusively utilizing two highly popular, liquid and diversified Exchange Traded Funds (ETFs): PowerShares QQQ Trust Series 1™, which seeks to replicate the NASDAQ-100 Index® of the 100 largest non-financial companies that trade on the NASDAQ Stock Market®, also known by its nicknames of "Qs" and "Cubes" (ticker symbol QQQ); and the SPDR DJ Industrial Average ETF Trust, also known as the "Diamonds," based on the Dow Jones Industrial Average (ticker symbol DIA).

- Writing covered calls on the QQQ and the DIA, utilizing both out-of-the-money and in-the-money opportunities to suit individual investors' needs.

For improved total returns, tools for technical analysis are presented to assist the investor in identifying short-term market directions.

Many investment experts and economists have been making public statements warning about investor stock market 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 five to six-percent 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.

Software using Microsoft Excel® to assist the user in formulating investment decisions on covered call writing opportunities and for tracking results will be sent to you by e-mail. Simply request the "QQQ/DIA files" by sending an e-mail to arrowpublicationsUSA@gmail.com.

By writing (selling) call option contracts on the QQQ and the DIA, the investor receives current income from option premiums (which will be discussed in detail later in this book), in addition to any net dividends on the stocks owned by the ETF, and a defined maximum amount of capital appreciation potential on the ETF, depending on the particular call option selected. This program is more conservative than simply owning equity investments alone. It can provide more stable, predictable, and higher investment returns in a slower growth stock market with the diversification that could otherwise only be obtained by owning a large number of individual stocks. It also provides the diversification that has long been the hallmark of mutual funds with the added advantage, as we will see, of earning significant additional income from option premiums. Covered calls can be written on ETFs such as the QQQ and the DIA, but not on mutual funds.

Given market expectations, covered call writing provides what may be one of the best opportunities to achieve double-digit investment returns in the future. Owning equities on which covered calls are written will outperform simple ownership of equities under *all* market conditions except a market that is rising strongly…and few professionals of national stature have been predicting a sustained strong market for a long time.

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The reader should be aware that brokerage commissions and other transaction costs have not been included in the investment calculations for the examples to simplify the subject matter presented. Such costs are discussed in detail and would need to be considered by investors in their actual calculations. The Excel® software can be customized 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® TEMPLATES DISCUSSED IN THIS BOOK

In this book three Excel® file templates are utilized that will facilitate your use of the QQQ/DIA covered call writing program. Your own use of these templates will greatly assist you with the calculations necessary to make quality decisions using the covered call writing program. Now, or when you are ready to use these Excel® files, please send an e-mail to arrowpublicationsUSA@gmail.com requesting the "QQQ/DIA files." We will promptly provide the files to you 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 do not have a computer, many libraries have them available for your use at no charge. Their computers often have Excel® software installed on them which will enable you to run the above-mentioned templates.

If you have a computer but do not have Microsoft Excel® 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.

# 1

## *INVESTMENT RETURNS: THE FUTURE ISN'T WHAT IT USED TO BE*

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 (Chairman of Berkshire Hathaway) and John Templeton, now deceased, (a pioneer in the mutual fund industry and founder of the Templeton Funds).

Many of these experts have been warning us that the generous stock market returns of the past should not be expected in the future. Warren Buffett, "The Oracle of Omaha," 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 6% 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:

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

*If you own equities, over the next twenty or thirty years you'll get a reasonable return…maybe it's 5%, maybe it's 6%. People who expect 15% a year are doomed to disappointment.*[6]

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?

- 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.

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

- 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.

For owners of stocks and ETFs, a simple strategy unknown to the vast majority of individual investors--writing covered call options--may be the best opportunity to achieve double-digit returns in this projected future. And two of the most liquid and noteworthy ETFs available to us, the Qs and Diamonds, are as we shall see among the most attractive for writing covered calls.

*COVERED CALL WRITING:*
*WHAT IT IS*

# 2

If you believe that the experts who are predicting a slow growth stock market for the long-term future are correct, there is a scarcity of good alternatives for achieving double-digit returns.

With this as a backdrop, what is an investor to do? The time has come for the average investor, whether wealthy or currently accumulating wealth, to consider using a powerful investment strategy…covered call option writing. And there are no better securities with which to utilize this strategy than the QQQ and the DIA. Covered call writing is widely used by savvy **"institutional investors"**…pension funds, insurance companies, hedge funds, trust departments, endowment funds and some mutual funds. It is little known and often misunderstood by individual investors.

Using standardized, exchange-traded options for covered call writing on the QQQ and the DIA, the combined return to the investor from potential capital appreciation, dividends and the additional income an investor receives from writing covered calls can result in double-digit yields…more predictably, consistently and conservatively than with common stocks or ETFs alone.

Many investors think of "options" and "calls" as being high risk, speculative strategies where large losses can be incurred. While this is true of some option strategies, covered call writing is *more conservative* than investing in stocks or ETFs alone, can provide significant *protection in a down market*, and can be a key component for an investor to *achieve double-digit returns in a flat or slow-growth market*.

The program outlined in *Covered Call Writing With Qs And Diamonds*, a combination of prudent ownership of these two preeminent ETFs coupled with writing covered call options on them, provides what may be one of the best opportunities to achieve double-digit investment returns in the future.

## BACKGROUND INFORMATION ON COVERED CALL WRITING

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 **"covered call option writing"** on your QQQ and DIA shares.

What comes to mind with the words **"call"** or **"option"**? Many investors would say they think of high risk, where they might lose their entire investment. Actually, that can be very true for some types of option investments. But that has

*nothing* to do with the investment program provided in this book. Quite the opposite. In fact, the covered call option writing program outlined here can take big losses by others and turn them into your profits! The investment for them may be high risk, but your investment by comparison is very conservative as you will soon see.

What is meant by the term **"covered"**? This simply means that you own shares of the QQQ and the DIA that stand behind the options…that you have the shares to deliver if they are sold.

The term **"writing"** when used in conjunction with covered calls simply means selling…you are selling calls on the QQQ and DIA shares you own.

## THE KEY DISCUSSION TOPICS

Our program will revolve around these subjects: what covered call options are and how they work; how and where they are traded; how to decide which covered calls to write; using short-term technical indicators to assess market direction; how to use Excel® spreadsheet templates available to you at no cost through e-mail (see the page following the Preface) to assist you in those decisions; how to select and use a broker to execute your transactions; how to evaluate your success in meeting your investment program goals; and some information on tax matters.

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

- Purchase shares in the QQQ and/or the DIA.
- Select the specific covered call option contracts to be written.
- Initiate call option trades.

This cycle is then repeated over and over as needed.

This program, covered call 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 covered calls. They provide brokerage services not only for stocks and ETFs, but also for options as part of what they do for their customers.

## COVERED CALL WRITING IN A NUTSHELL

Here is a highly abridged version of what this is all about. You will not be *buying* call options, which is a potentially high-risk strategy, but rather you will be *selling* call options on the QQQ or the DIA you already own or will acquire,

also known as *writing*. This is a conservative, yet potentially lucrative option investing strategy.

When you sell an option on shares you own you are selling a window of time in which the buyer has the right to buy your shares at a set price of your choice. The buyer is hoping that the price of your shares is going to go up significantly during this window of time that the option is active…in other words, before the option expires. By writing covered calls, you can reduce the downside risk on your investment, you can predict with greater accuracy how much money you will make, and you can help stabilize your profits. Selling the right to buy your shares to others gives you the ability to make consistent and significant returns from call writing on your investments, and the buyer immediately pays you money 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 (for purposes of this book in the QQQ or the DIA) 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 an ETF owner to *sell* the shares…like putting them into your hands. The investor who purchases an option, whether it is a call or a put, is the option buyer. Conversely, the person who initiates a transaction by selling a call is the call option *seller* or *writer*. The buyer of the option is *not* obligated to buy the shares, but the seller *is* obligated to sell if the buyer decides to **"exercise"** his right of purchase under the option. When the buyer of a call exercises the option, the seller's shares are said to be **"assigned,"** meaning they will be sold. In the case of our investment program, you will *always* be the seller of options. And with this program you will only be dealing with calls, not puts. The subject of puts will not be brought up again in this book, but is the subject of another book by the author titled, "*Put Option Writing Demystified*."

## WHERE ARE COVERED CALL OPTIONS TRADED?

Option contracts are considered to be securities. As such, they are bought and sold through a brokerage firm. Either a full-service brokerage or a discount

brokerage can be used, although option trades through a discount broker are usually much less expensive. Option contracts trade on U.S. securities exchanges, such as the Chicago Board Options Exchange (CBOE), the New York Stock Exchange (NYSE), 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 COVERED CALLS?

An investor can make money three ways. First, you are always paid cash, called a "**premium**," for giving someone the right to buy your QQQ or DIA shares from you at a specific price, which is called the "**strike price**," on or before the "**expiration date**" when the option expires. You get to keep the premium money whether or not the shares are actually bought from you later. There are typically a variety of strike prices available, some of which will be below the current market price of the shares and some of which will be above it. There are also a variety of option expiration dates available that extend out as short as the current and the next month to about two years for options on the QQQ and the DIA. These very long-term options, whose expirations range from one to as long as three years, are referred to as **"LEAPS,"** which stands for "Long-Term Equity Anticipation Securities." They are traded through your broker the same as other options and are available on many stocks. LEAPS have a January expiration date. There are also a growing number of stocks and ETFs on which weekly options are available, including the QQQ and DIA.

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

Third, if you own the DIA your shares pay dividends, so you have that source of income as well. You are the owner of the shares during the option

period, so any dividends that are declared with an ex-dividend date taking place when you own the DIA belong to you…and that obviously enhances your yield as you combine it with the option writing income and any capital appreciation to calculate your total yield.

If you were to write an option with a strike price *lower* than the current price of your shares, the option is said to be **"in-the-money."** For example, if the current price of the QQQ is $30 and you write an option with a $28 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 could actually incur a loss on your ETF compared with its price on the date you wrote the option if you write an in-the-money call. This can still be an effective way of obtaining double-digit returns, as we will see. If the price in this example remained the same until expiration, you would receive only $28 per share for an ETF that was worth $30 at the time you wrote the option, or a loss of $2 per share. However, due to the very large premium collected, the net gain (premium less capital loss on the shares) can still be significant while providing greater downside protection than writing out-of-the-money calls.

Finally, when the market price of your 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 a call option with a strike price of $28 and the **"underlying shares,"** that is to say the shares you own on which you would be writing the call options, was selling at about $28 per share.

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 price at which the buyer of the option has the right to purchase the shares covered by the option contract. The QQQ and the DIA both trade options that offer many different strike prices for each expiration date. Strike prices are established when the underlying shares either advance or decline to a certain price level and trade consistently around that level. Let's say for example that the QQQ was trading at a high of $29, then went on to hit a price of $30 and traded consistently at this level. A new and higher 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. Two notable exceptions to this are the QQQ and the DIA. These highly popular ETFs trade in huge volume and so do many of the call 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 many other securities.

## WHEN DOES THE CALL WRITER RECEIVE THE PREMIUM INCOME MONEY?

Once you have written a call 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 covered call 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 options, 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 on the last day of the month. Weekly option contracts expire on Friday.

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

Obviously a decline in the price of QQQ or DIA shares can happen to anyone in a bad market. If it couldn't, everyone in the world would invest everything they have in these ETFs. When you write call options on QQQ or DIA shares and the prices go down, the prices of the options go down too. 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 calls would be worthless, as call option values gradually decay the closer the time comes to the expiration date. Then you have realized the entire premium income as gain. That is how downside protection comes into play when you write covered calls. A declining share price should not be considered a downside to writing covered calls. This is a risk to equity ownership, not to covered call writing. In fact, the premium you receive mitigates the equity ownership risk by giving you some protection against a declining share price. By writing calls you are better off than if you just owned the shares alone.

Just like ETFs, call options are traded continuously on the exchanges. This is because option contracts, like the QQQ and the DIA, are **"fungible"** securities. That means you can buy and sell the same option contract at any time prior to

expiration, because the contracts are identical and are interchangeable with other investors on the exchanges where they are traded.

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

## WHAT IF THE SHARES A CALL IS WRITTEN ON MOVE WAY UP IN PRICE?

This is the only downside to covered call writing. The downside for the option writer occurs when the share price shoots up way above your strike price plus the option premium received and is in that position on the expiration date. In such a case, the option writer would have been better off just owning QQQ or DIA shares and not writing the options. But, while the option writer may have lost in the sense that the call writing transaction did not capture the entire rise in the shares, by receiving the premium income plus the gain up to the strike price, the investor has obtained the maximum objective sought when the calls were initially written. That is a downside with an upside!

If your QQQ or DIA shares go up, you can wait to see if your shares remain in that position and get called away from you at expiration. Another choice is to buy back the call at what could be a higher price than you initially sold it for. By doing this you release your obligation to sell the shares. That strategy is generally only used, and not always, when you write in-the-money calls, which we will discuss in Chapter 7.

## WHAT IF THE SHARES DO NOT GET CALLED AWAY AT EXPIRATION?

It varies, but about eighty-percent of the time options that are written out-of-the-money expire without being exercised. If the expiration date comes and goes and your shares were not called away, this means you still own the shares and you have earned the premium. You can then sell the shares at their current market price, continue to hold them, or write another call and collect another premium.

## UNDER WHAT CIRCUMSTANCES WILL MY SHARES LIKELY BE CALLED AWAY?

You can anticipate having your shares called away, referred to as being "assigned," any time your option becomes in-the-money. This almost always

occurs at expiration if the market price of the shares is greater than the strike price, although it could possibly happen at any time during the term of the option contract if the buyer of the option wanted to exercise the right earlier (highly unusual).

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

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

The following is a summary of the benefits and risks.

## THE BENEFITS AND FEATURES OF COVERED CALL WRITING

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

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

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

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

5. **Cash dividends –** As a writer of covered calls, you will continue to be entitled to cash dividends, if any, for as long as you own your shares.

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

7. **Ease of trading -** Since options are actively traded on the open market, call option transactions can 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.

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

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

## THE RISKS OF COVERED CALL WRITING

1. **Investing in the stock market –** Writing covered call options requires that the investor own stocks or Exchange Traded Funds, in this case shares of the QQQ and the DIA, which are stock market investments that are subject to market risk. Writing covered calls, however, provides some downside protection in declining markets. Therefore, the investor who writes covered calls is always better off in a declining market for these shares than the investor who owns the same securities but does not write covered call options.

2. **Limited gains in a rising market –** An option writer's potential gain is limited to the amount of call writing income received plus any gain in the

price of the underlying shares from the time the option was written up to the dollar amount of the strike price. Depending on the strike price and the extent of a rise in the underlying shares prior to the expiration date, in a rapidly rising market the option writer may not benefit from all of the rise in the QQQ or DIA shares. While still profitable, an option writer faces the risk that he might have been better off financially to have simply held the shares and not written covered call options in a rapidly rising market.

3. **Unanticipated exercise of call options –** The holder (buyer) of a call option has the right, but not the obligation, to buy (exercise) the option writer's shares at the strike price at any time through the expiration date. A writer can expect that his shares will not be subject to exercise if the market price of the shares is less than the strike price of the call option written. If, however, the market price rises above the strike price, it is possible that the holder could exercise the call option at any time, thus requiring the option writer to sell the underlying shares at the strike price. Exercise of options generally occurs at the expiration date, and then usually only if the market price exceeds the strike price. On occasion, however, a holder will exercise an option prior to the expiration date, especially if a dividend is payable soon before the expiration date of the option contract. This is beneficial in some respects for the option writer, as the writer is paid the strike price early and can decide how to deploy the funds immediately instead of having to wait until the expiration date. The most likely occasion on which this might occur is if the investor has written a call on a high dividend paying stock and the stock is in-the-money. If the ex-dividend record date occurs reasonably close in time before the expiration date of the call option, the holder of the call may find it beneficial financially to exercise the option prior to the expiration date so he is the owner of the shares on the ex-dividend record date.

4. **Potential lack of option market liquidity –** Options generally trade in much smaller quantities than common stock or ETF shares. Options for some ETFs, such as the QQQ and the DIA, are very actively traded. For other ETFs there are usually fewer option contracts traded. 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. Fortunately the options on the QQQ and the DIA that we will utilize in the program described in this book are highly liquid, which is another advantage of utilizing the QQQ and the DIA.

5. **Possibility of a decrease in option premiums –** The price of a covered call writing option premium is determined by market forces and mathematical

models. During periods of market volatility, option premiums tend to be greater than during periods of stable markets. It is not possible to predict future volatility. Should markets become less volatile, or should 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 on covered call writing less attractive than they have been during periods of larger option premiums.

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

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

# 3

## *Qs AND DIAMONDS: THE BEST OF BOTH WORLDS*

This book is very narrow in scope: it presents a simplified (meaning easy to understand and implement yourself) covered call writing strategy beginning in the next chapter to achieve double-digit investment returns in most stock market environments utilizing only two securities--Exchange Traded Funds called the PowerShares QQQ Trust Series 1™ **("ticker symbol"**: QQQ), also known as "Qs" and "Cubes," and the SPDR DJ Industrial Average ETF Trust (ticker symbol: DIA, also known as the "Diamonds").

Would an investor want to direct an entire equity investment portfolio into the QQQ and the DIA? Perhaps. Perhaps not. Why this narrow focus?

There are several reasons why the QQQ and the DIA are attractive to own and uniquely suitable for covered call writing. Whether you choose to orient your entire portfolio to the QQQ and the DIA, or just a portion of it, the purpose of this book is (1) to provide the investor with a quick means of implementing and maintaining a covered call writing program with the expectation of achieving consistent double-digit returns, so that (2) no stock selection decisions are necessary, as the investment of your principal will be in the broadly based QQQ and the DIA. Simplicity personified…and effective.

The ongoing administrative time needed to examine your call writing choices for this program should be less than twenty minutes per month…unless you purposely want to make more out of it by analyzing issues of market timing, which we will also address. In our busy world, who wouldn't be willing to spend so little time for the possibility of getting double-digit investment returns?

The QQQ and the DIA are examples--and very unique ones as we will see--of Exchange Traded Funds, more commonly referred to simply as ETFs.

### WHAT IS AN ETF?

An ETF is a hybrid between a listed corporate common stock, other investment instruments and a mutual fund that is open-ended (continually offering new shares). From a legal perspective, ETFs are "investment companies" under the U.S. Tax Code and are regulated by the Securities and Exchange Commission. ETFs consist of a broad spectrum of securities (typically stocks, although bond and currency ETFs also exist) designed to correspond to the price and yield performance of the underlying portfolio of securities that make up each ETF. In addition to what we will discuss, you may wish to visit the Web

sites at www.bloomberg.com and www.nasdaq.com, then click on their tab labeled "ETFs" for additional information.

ETFs have been created to mirror many different themes: the broad market (Dow Jones®, S&P 500®, Wilshire 5000®, Fortune 500®); industry sectors (cyclical, retail, transportation, natural resources, oil service, basic materials, chemical, technology, financial, pharmaceutical, real estate); size (small cap, mid cap, large cap), region (Pacific, Europe), investment style (value, growth), and international markets. Some ETFs utilize more than one theme; for example, broad market international, small cap growth, large cap value, and so on. More recently separate ETFs have been created that are designed to produce a return equal to 100%, -100%, 200%, -200%, 300% or -300% of an index or other established benchmark by the use of derivatives. Needless to say, some of these are quite controversial. Options are available on some of them, which requires a very different way of thinking.

## WHY NOT BUY INDIVIDUAL STOCKS RATHER THAN AN ETF ?

The purchase of a small number of stocks in individual companies does not give the investor the diversification that can be achieved by owning shares in an ETF containing a large number of stocks. An investor with a concentration in only a few individual stocks faces enormous loss potential if the price of one or more of these stocks should decline significantly in value. While diversification can also be obtained by owning mutual funds, one of the advantages offered by ETFs, unlike mutual funds, is that covered calls can be written on many of them, including the QQQ and the DIA.

## WHAT IS THE QQQ?

The PowerShares QQQ represents ownership in the NASDAQ-100 Trust, a unit investment trust established to accumulate and hold a portfolio of the stocks that comprise the NASDAQ-100 Index. It trades on the NASDAQ under the symbol QQQ. The QQQ is intended to provide investment results that generally correspond to the price and yield performance of the NASDAQ-100 Index. It is one of the most actively traded ETF in the world with more than 35 million shares traded daily on average. The **"market capitalization"** (total number of shares multiplied by the current market value of each share) of the QQQ is approximately $43 billion.

## WHAT IS THE NASDAQ-100 INDEX?

The NASDAQ-100 Index includes 100 of the largest non-financial companies in the United States that are listed on the NASDAQ Stock Exchange. This index was established in January 1985. Each stock in the index is

proportionately represented by its market capitalization in relation to the total market value of the index.

The index reflects the NASDAQ's largest growth companies across major industry groups. Each stock included in the index has a minimum market capitalization of $500 million, and an average daily trading volume of at least 100,000 shares.

You can buy or sell QQQ shares just as you buy or sell shares of individual stocks, yet by owning this one security you have ownership in each of the 100 stocks in the NASDAQ-100 Index.

## WHAT IS THE DIA?

SPDR DJ Industrial Average ETF Trust, more commonly referred to simply as "Diamonds," is a unit investment trust established to accumulate and hold a portfolio of the stocks that comprise the Dow Jones Industrial Average (DJIA). The Diamonds Trust is intended to provide investment results that generally correspond to the price and yield performance of the DJIA, an index of stocks that has been the most visible representation of the broader stock market since July, 1884. The DIA is one of the more actively traded ETFs in the world with more than 6 million shares traded daily. Its market capitalization is approximately $13 billion.

## HOW ARE THE QQQ AND THE DIA TRADED COMPARED TO MUTUAL FUNDS?

As with shares of individual common stocks, ETFs including, the QQQ and the DIA, can be bought and sold at intra-day prices throughout the trading day. Their pricing is continuous as they trade. This gives the investor a great deal of flexibility when compared with mutual funds, which are purchased or sold only at an end-of-day closing price based upon their net asset value.

## WHAT COSTS ARE INVOLVED IN TRADING THE QQQ AND THE DIA?

The QQQ and the DIA are not "managed" portfolios, as they simply track the NASDAQ-100 Index and the Dow Jones Industrial Average respectively. Because this tracking means less portfolio turnover than actively managed portfolios, the administrative costs charged to the ETF are considerably less than an actively managed portfolio. Currently this charge for the QQQ is 0.2% (two-tenths of one percent) and for the DIA is 0.17% (seventeen hundredths of one percent). The charges are assessed against the dividends and other assets of the funds. As with individual stocks, investors also pay commissions when shares of the QQQ and the DIA are traded according to each investor's brokerage account

commission schedule. Accordingly, the ability of an investor to keep commission costs low trading the QQQ and the DIA, as well as for covered call writing transactions, is a very important consideration. Chapter 11 is devoted to the subject of brokerages.

## WHAT SECTORS MAKE UP THE QQQ AND THE DIA?

At the present time, the QQQ is represented by the following business sectors in the proportions indicated:

| | |
|---|---|
| • Consumer discretionary | 17.45% |
| • Consumer staples | 4.69% |
| • Health care | 14.83% |
| • Industrials | 1.64% |
| • Information technology | 60.15% |
| • Materials | .34% |
| • Telecommunication services | .90% |
| Total | 100.00% |

(Source: Invesco PowerShares)

At the present time, the DIA is represented by the following business sectors in the proportions indicated:

| | |
|---|---|
| • Financials | 25.22% |
| • Industrials | 18.95% |
| • Consumer Services | 13.25% |
| • Health Care | 10.73% |
| • Technology | 9.96% |
| • Consumer Goods | 8.20% |
| • Oil and Gas | 8.00% |
| • Telecommunications | 3.14% |
| • Basic Materials | 2.55% |
| Total | 100.00% |

(Source: McGraw Hill Financial)

## WHAT SPECIFIC STOCKS ARE IN THE QQQ AND DIA?

Currently the following 100 stocks comprise the QQQ, followed by their ticker symbols:

| Company Name | Ticker |
|---|---|
| Activision Blizzard Inc | ATVI |
| Adobe Systems Inc | ADBE |
| Akamai Technologies Inc | AKAM |
| Alexion Pharmaceuticals Inc | ALXN |
| Altera Corp | ALTR |
| Amazon.com Inc | AMZN |
| Amgen Inc | AMGN |
| Analog Devices Inc | ADI |
| Apple Inc | AAPL |
| Applied Materials Inc | AMAT |
| Autodesk Inc | ADSK |
| Automatic Data Processing Inc | ADP |
| Avago Technologies Ltd | AVGO |
| Baidu Inc | BIDU |
| Bed Bath & Beyond Inc | BBBY |
| Biogen Idec Inc | BIIB |
| Broadcom Corp | BRCM |
| C.H. Robinson Worldwide Inc | CHRW |
| CA Inc | CA |
| Catamaran Corp | CTRX |
| Celgene Corp | CELG |
| Cerner Corp | CERN |
| Charter Communications Inc | CHTR |
| Check Point Software Technologies Ltd | CHKP |
| Cisco Systems Inc | CSCO |
| Citrix Systems Inc | CTXS |
| Cognizant Technology Solutions Corp | CTSH |
| Comcast Corp | CMCSA |
| Costco Wholesale Corp | COST |
| DIRECTV | DTV |
| Discovery Communications Inc | DISCA |
| Discovery Communications Inc | DISCK |
| DISH Network Corp | DISH |
| Dollar Tree Inc | DLTR |
| eBay Inc | EBAY |
| Equinix Inc | EQIX |
| Expedia Inc | EXPE |
| Expeditors International of Washington Inc | EXPD |
| Express Scripts Holding Co | ESRX |
| F5 Networks Inc | FFIV |
| Facebook Inc | FB |

| | |
|---|---|
| Fastenal Co | FAST |
| Fiserv Inc | FISV |
| Garmin Ltd | GRMN |
| Gilead Sciences Inc | GILD |
| Google Inc | GOOG |
| Google Inc | GOOGL |
| Henry Schein Inc | HSIC |
| Illumina Inc | ILMN |
| Intel Corp | INTC |
| Intuit Inc | INTU |
| Intuitive Surgical Inc | ISRG |
| Keurig Green Mountain Inc | GMCR |
| KLA-Tencor Corp | KLAC |
| Kraft Foods Group Inc | KRFT |
| Liberty Global PLC | LBTYA |
| Liberty Interactive Corp | QVCA |
| Liberty Interactive Corp | LVNTA |
| Liberty Media Corp | LMCK |
| Liberty Media Corp | LMCA |
| Linear Technology Corp | LLTC |
| Marriott International Inc | MAR |
| Mattel Inc | MAT |
| Maxim Integrated Products Inc | MXIM |
| Micron Technology Inc | MU |
| Microsoft Corp | MSFT |
| Mondelez International Inc | MDLZ |
| Monster Beverage Corp | MNST |
| Mylan Inc | MYL |
| NetApp Inc | NTAP |
| Netflix Inc | NFLX |
| NVIDIA Corp | NVDA |
| NXP Semiconductors NV | NXPI |
| O'Reilly Automotive Inc | ORLY |
| PACCAR Inc | PCAR |
| Paychex Inc | PAYX |
| Priceline Group Inc | PCLN |
| Qualcomm Inc | QCOM |
| Regeneron Pharmaceuticals Inc | REGN |
| Ross Stores Inc | ROST |
| SanDisk Corp | SNDK |
| SBA Communications Corp | SBAC |
| Seagate Technology PLC | STX |
| Sigma-Aldrich Corp | SIAL |

| | |
|---|---|
| Sirius XM Holdings Inc | SIRI |
| Staples Inc | SPLS |
| Starbucks Corp | SBUX |
| Stericycle Inc | SRCL |
| Symantec Corp | SYMC |
| Tesla Motors Inc | TSLA |
| Texas Instruments Inc | TXN |
| Tractor Supply Co | TSCO |
| TripAdvisor Inc | TRIP |
| Twenty-First Century Fox Inc | FOXA |
| Verisk Analytics Inc | VRSK |
| Vertex Pharmaceuticals Inc | VRTX |
| Viacom Inc | VIAB |
| VimpelCom Ltd | VIP |
| Vodafone Group PLC | VOD |
| Western Digital Corp | WDC |
| Whole Foods Market Inc | WFM |
| Wynn Resorts Ltd | WYNN |
| Xilinx Inc | XLNX |
| Yahoo! Inc | YHOO |

Currently the following 30 stocks comprise the DIA, followed by their ticker symbols:

| **Company Name** | **Ticker** |
|---|---|
| 3M Co. | MMM |
| American Express Co. | AXP |
| AT&T | T |
| Boeing Co. | BA |
| Caterpillar Inc. | CAT |
| Chevron | CVX |
| Cisco Systems | CSCO |
| Coca Cola | KO |
| E.I. DuPont de Nemours & Co. | DD |
| Exxon Mobil Corp. | XOM |
| General Electric Co. | GE |
| Goldman Sachs Group | GS |
| Home Depot Inc. | HD |
| Intel Corp. | INTC |
| International Business Machines Corp. | IBM |
| J.P. Morgan Chase & Co. | JPM |

| | |
|---|---|
| Johnson & Johnson | JNJ |
| McDonald's Corp. | MCD |
| Merck & Co. Inc. | MRK |
| Microsoft Corp. | MSFT |
| Nike Inc | NKE |
| Pfizer Inc. | PFE |
| Procter & Gamble Co. | PG |
| Travelers Corp. | TRV |
| United Health Group Inc. | UNH |
| United Technologies Corp. | UTX |
| Verizon Communications Inc. | VZ |
| Visa Inc. | V |
| Wal-Mart Stores Inc. | WMT |
| Walt Disney Co. | DIS |

## WHAT ARE THE RISKS ASSOCIATED WITH OWNING SHARES IN THE QQQ AND DIA?

Holders of the QQQ and DIA are subject to risks similar to that of investors who hold other diversified stock portfolios. If the general level of stock prices declines, the value of the QQQ and the DIA, because they represent interests in broadly based stock portfolios, would also decline.

The QQQ, despite its diversification among 100 of the largest NASDAQ stocks, is also subject to the risks of high concentration in the technology sector, even though it also includes biotechnology, retail and stocks in other industries. It may also be concentrated in sectors characterized by relatively higher volatility in price performance and may therefore be more volatile when compared to other broad-based stock indexes. The QQQ is also subject to the risks specific to the performance of a few individual component securities that represent a highly concentrated weighting in the Index (e.g., Apple Inc. and Microsoft Corporation).

The DIA consists of thirty leading companies. It tends to track the entire stock market quite closely even though only thirty stocks are included in the DJIA index.

One of the best indicators of risk for a security is a measurement known as **"beta."** The beta is a mathematical measure assigned to a stock or an ETF (based on the stocks that compose 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 is less volatile and a beta of over 1.0 implies more volatility, and therefore a riskier security. The further away from 1.0 the beta gets under and over, the less and more volatile that stock is 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 the QQQ is currently 1.10, which means that it is 10% more volatile than the overall stock market. In an up market, therefore, the QQQ could be expected to rise over 10% more than the market in general, and in a down market the converse would be true. The beta for the DIA is currently .88, which tracks quite closely to the overall market in terms of volatility and risk. The significance of the beta for the QQQ and DIA call writer is this: the QQQ share price will be more volatile than the DIA share price, both in up and down markets. Due to this greater share price volatility, the prices for call options on the QQQ will be greater than those for the DIA. Therefore the call writer of QQQ shares is compensated somewhat for the additional risk through higher premium income compared with the DIA.

Some individual stocks have a beta of less than .25, while the beta of others can be well over 3.0. 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.

Among the many advantages of covered call writing is that it can provide a reasonable amount of downside price protection "insurance" during unfavorable market conditions, as will be demonstrated shortly.

## DO THE QQQ AND THE DIA PAY DIVIDENDS?

The QQQ is not expected to pay quarterly dividends because the dividend yield of the NASDAQ-100 Index portfolio is lower than the expected 0.20% expenses of the Trust. After expenses, there is no net dividend to be distributed. In the future, if the dividend yield of the NASDAQ-100 Index portfolio were to increase above the expenses of the Trust by more than .05% in any quarter, then a net dividend distribution to shareholders would be made at that time.

The DIA currently pays a dividend investment return to shareholders of approximately 2% after the 0.17% expense charge.

## WHY USE THE QQQ AND THE DIA EXCLUSIVELY?

The QQQ and the DIA are among the very best securities for purposes of writing covered call options due to their trading volume and wide choice of call option alternatives. In addition to this, however, the QQQ and the DIA can fundamentally be excellent holdings whether an investor is writing call covered calls or simply desiring long-term exposure to the equity markets. The following are key points:

- Both the QQQ and the DIA, as Exchange Traded Funds, offer broad diversification of common stock ownership when compared with the ownership of individual issues of stocks, an important consideration in mitigating risk when investing in equities. While some might argue that they are not diversified enough to use them exclusively, a case can be made that for most investors in individual stocks the use of these two ETFs will provide diversification far greater than their present portfolios.

- Many economists and securities analysts believe that in the long run the technology sector will provide investors with one of the most attractive areas of investment, despite the bubble and its breaking that began to occur in the late 1990s and lasted into the early years of the new century. The QQQ has significant exposure to that sector, but also provides balance through other important sectors, such as biotechnology, retailing and healthcare.

- The stocks comprising the DIA are a known quantity to investors, as the Dow Jones Industrial Average has been a leading index for approximately 120 years.

One additional ETF needs to be mentioned that could easily be a substitute for the Diamonds…a broad-based Exchange Traded Fund (ETF) known as the SPDR S&P 500 Trust® (known as the "Spiders," ticker symbol "SPY"). This ETF mirrors the performance of the highly diversified Standard & Poors® 500 Stock Index. SPY, with about $200 billion in assets, is the most actively traded ETF currently in existence, which also provides significant liquidity for option trading. This ETF was launched in 1992 and is the first ETF whose shares are still traded in the United States. For some time, options were not available on this ETF, but that has been rectified and they are now available for covered call writing and other option strategies. All aspects of the covered call writing program described in this book can be equally adapted for use of this broadly based ETF.

# 4

## *COVERED CALL WRITING: HOW IT WORKS*

If you are new to covered call writing, we need to start by looking first at a typical call 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 11 we will discuss how you can keep commissions down to a reasonable minimum. But for now, just remember that there will be some commissions involved that will affect these numbers a bit.

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

We will be using examples with the QQQ frequently in this book; however the same principles would apply using the DIA. Let's say that the QQQ is selling for $28 per share on the third Friday in April (which means that April calls just expired). "Max," as we will call the buyer, thinks the QQQ may be poised to rise, so he buys ten QQQ call contracts with a July expiration date and with a strike price of $30 per share. For this he pays a premium of $1.00 per share. Each call contract covers 100 of the underlying shares. So during the term of this option Max controls 1,000 shares of the QQQ. The price he pays for this, the option premium, is $1,000 ($1.00 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 in the marketplace, the higher the premium a call will command. For example, all other things being equal, a call on an ETF with significant technology exposure, such as the QQQ, would typically have a premium greater than an ETF concentrated in the health care sector. In turn, the health care sector ETF's options would logically have a premium that would be higher than an even less volatile sector…say, for example, a utility sector ETF.

The price of the ETF relative to the strike price of the option is a major factor. If the price of the QQQ is $28 per share, it only needs to trade $2 per share

higher to reach a $30 strike price, while it would need to trade $4 higher to reach a $32 strike price. Since the likelihood is obviously much greater of the QQQ price reaching $30 by the end of the same expiration period than $32, the price of the option for a $30 strike will be significantly higher than the $32 strike. In other words, for out-of-the-money calls, the further the strike price is from the current market price of the ETF, the smaller the call option premium will be. Correspondingly, the more the market price approaches the strike price or is in-the-money (higher than the strike price) the greater the call option premium.

If it is now April and you are writing an option, you will want a larger premium for a call that will expire, say, in September than one that will expire in July. If you are granting the call buyer the option to buy your QQQ shares at a specific price until September, the buyer has a lot more time for the price to go up than if the option expires in July. For that reason, the buyer will have to pay more for the September expiration than for the July expiration.

Another factor that can affect the level of option premiums is the economic environment. For example, let's say there has been a rough market where prices have declined, recovered a bit, declined, and so on. There is not much "visibility" going forward regarding when the economy will improve and equity prices will recover. That scenario is reflected not only in the price of the QQQ and the DIA, but also in their option premiums. Option premiums for the QQQ and the DIA, when compared with different economic times, have sometimes trended lower during these times of market uncertainty. The premiums you receive from writing options in that economic climate may not be quite as large as they were when the economy was headier and the markets were performing better. Option premiums have come down since the bursting of the bubble, but have increased somewhat again during the financial crisis. The good news is that an investor can still find very acceptable option premiums to reach target investment objectives, and it is possible that when the economy improves and markets recover option premiums will improve further as well, providing even better returns from option writing.

Back to the QQQ example, how does this work for Max? The buyer of a call is a speculator. In this case Max is speculating that the price of the QQQ will rise fairly quickly so he can make his profit. The call he has purchased will go up and down with the price of QQQ.

The option contracts, just like the underlying shares, continue to be traded on the open market. In the short run, if the price of the QQQ would rise, then the price of the call contract should rise as well. And the price of the option would rise at a higher percentage rate than the QQQ itself, because the purchase of an option provides **"leverage"**…100 shares for one contract. In this case, for a price of $1,000 Max has control, for a three month time period, of 1,000 shares of the QQQ worth $28,000. If the QQQ would rise from $28.00 to $30.80 the next day after the trade, an owner of the QQQ would have a gain for that day of 10%. The call option, however, might in turn rise to $1.50 or a gain of about 50% above the

option purchase price. The buyer, if he wished to, could then sell his option contracts on the open market and pocket his gain on the transaction. This really does not affect you and your option strategy. You will almost always just sit on your covered call options and wait for the expiration date to pass.

If Max decides to sell his calls, this does not affect you at all. Specific buyers and sellers of calls are not matched together unless calls are assigned at expiration. Either party can get out of his call 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 buy the actual QQQ shares. Had Max purchased 1,000 shares of the QQQ at $28 and sold it at $30.80 his investment would have been $28,000 and his profit $2,800, for a return of 10%. By buying the option contracts instead, he realized a 50% profit on his investment but tied up only $1,000 of his capital in the process. This sounds terrific, but what is the downside? If the QQQ had declined by 10% from $28 to $25.20 the value of his options would also decline, perhaps going from $1.00 to $.50. This would represent a loss of $500 or 50% of his investment. Had he bought the QQQ itself and it declined to $25.20, the percentage loss would only be 10%.

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

This is a good time to introduce two more terms…**"intrinsic value"** and **"time value"** of options. The terms "in-the-money," "out-of-the-money" and "at-the-money" were discussed previously, which have to do with the relationship between the option strike price and the current market value of the underlying shares on which options are being written. The "intrinsic value" of an option's price is the dollar amount by which the strike price is less than the market price of the underlying shares. For example, if the QQQ is trading at $29.50 per share and the strike price of an option is $28, 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 strike price is any amount greater than the market 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 above the strike price and have no intrinsic value at times as well.

The "time value" of an 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 call option on the DIA. The strike price is $85, the current market value of the DIA is $88 and the current price of the option is $4. Since the market value is higher than the strike price, the intrinsic value is determined by subtracting the strike price from the market price, which gives an intrinsic value of $3 for the premium. 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 call option on the QQQ. The strike price is $30, 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 Max's QQQ call purchase bet again. Max stands to realize a substantial percentage profit or loss on his call option investment if there are short-term swings up or down in the market value of the QQQ. Let's examine what will happen if Max continues to hold his option until the expiration date in July. You will recall that the strike price of the option contract Max bought was $30. This means that on the expiration date if the price of the QQQ is less than $30 the options expire with no value. Max has lost his entire investment. Why? Max's option contracts give him the right, but not the obligation, to buy 1,000 shares of QQQ for $30 per share at any time through the July expiration date. Max would be foolish to exercise his options and pay $30 for shares that he could buy on the open market for less than that.

Generally options are not exercised until the expiration date and then, of course, only if they have intrinsic value (they are in-the-money). Option buyers are often speculators who really do not want to own 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 option contracts on the open market rather than exercise the options and then wait to sell the shares after they are delivered to his broker.

But, in this case we are assuming Max has not sold his option contracts and the July expiration date has just passed. We have said that if the price of the QQQ is below $30 he has lost his entire investment. What happens if after the

expiration date the QQQ is above $30 per share? As we just said, Max would have typically sold his contracts before expiration, but if the expiration date passes and the market price of the underlying shares is greater than the strike price, Max would exercise his options and buy the QQQ shares because the options have intrinsic value. Let's say the price of the QQQ is $30.60 at the close of the market on the expiration date. If Max exercises his options he will pay $30,000 for his 1,000 shares of the QQQ. By exercising his options he will have $30,600 worth of the QQQ which he can sell for a $600 profit.

But didn't Max pay $1,000 for the options and won't he still have a net loss by exercising the options and selling the QQQ shares? Yes, but the gain on the sale of the shares will partially offset the loss of the premium he paid ($600 investment gain - $1,000 premium loss = $400 net loss).

Again, if Max had held his options until around the expiration date he would have most likely sold the contracts themselves rather than exercise the options by purchasing the shares and then selling them to get his cash. Why? It is a much simpler transaction. By the time he could take delivery of the shares and sell them, the market price could possibly go down, especially if there was news over the weekend following the expiration that could negatively affect the market on the following Monday. If the QQQ was trading at $30.60 towards the end of the day on the last day of trading before expiration, the $30 QQQ call option would be trading at about $.60 per contract (time is up, so there is only the $.60 intrinsic value and no time value is left). He would receive $600 when he sold his ten contracts ($.60 x 10 x 100), for the same result (except for commissions).

When you remember that as much as 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 occurring rather quickly 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 option buyer's investment can be lost, even if the price of the underlying shares rises somewhat before the expiration date.

Let's use the example of Max's QQQ options again. We will say the price of the QQQ increases from $28 to $29.95 at expiration and Max still holds his options. Even though the price of the QQQ has increased by $1.95, or 7% in three months (28% annualized), Max has still lost his entire investment. He would not exercise his option to buy shares at $30 that can be bought on the open market for $29.95. He has lost the premium he paid for the options. What is Max's breakeven point on the expiration date? If he paid $1.00 per share premium to buy each contract, and if the strike price is $30, then Max's breakeven is $31 per share ($1 + $30 = $31). In other words, if Max holds the options through the expiration date, unless the price of the QQQ is at least $31 per share, or 10.7%

higher (42.8% 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 of his time had run out before expiration.

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

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

Let's look at the same transaction from YOUR side now. You are the owner of 1,000 shares of the QQQ. The price of share will, of course, change, but the principles behind the transaction remain the same. You would like to increase your income by writing some call options on the shares you own. It is the third Friday in April and you start checking out the premiums for QQQ option contracts with various different strike prices and expiration dates. While you like the QQQ's long-term prospects, you think that the price of the shares may not be higher than $2 above its current market price of $28 at the end of the next three months. The July $30 QQQ call is trading at $1 per contract. For receiving a premium of $1 per share you decide you would be willing to let go of your 1,000 shares of the QQQ at $30 per share if the price should be greater than $30 on the expiration date. Remember that the option buyer could call your shares away from you at any time up to and including the expiration date, but this rarely ever happens before the expiration date, even if the market price of the shares goes above the strike price.

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

| | | 18-Apr | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| X | X | X | | X | X | | X | | CAPITAL | | ANNUAL | BREAK- |
| CO. SYM. | # SHS. | SHARE PRICE | MARKET VALUE | OPTION EXPIR. | STRIKE | DAYS | PREM. | $ PREM. INC. | APPR. OR (DEPR.) AT STRIKE | ANNUAL YIELD | YIELD W/ CAP APPR. OR (DEPR.) | EVEN PRICE OF QQQ |
| QQQ | 1,000 | $28.00 | $28,000 | 18-Jul | $30.00 | 91 | $1.00 | $1,000 | $2,000 | 14.32% | 42.97% | $27.00 |

From this transaction you will collect $1,000 in option writing income ($1 premium per share x 10 contracts x 100 shares per contract, not including commissions). You see that, on an annualized basis, the premium income at the current market price of the QQQ will yield 14.32% based upon that premium and the market price of the QQQ on the day of the transaction. Not bad! And it will be locked in until July 18 (the third Friday in July). The annualized yield is used for comparison purposes, as investors are used to thinking in annual terms. When you buy a six-month CD at the bank at a 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.

You also have the potential to realize an additional $2,000 of capital appreciation if the price of the QQQ exceeds $30 per share on the expiration date. You can see that the annualized yield with capital appreciation, which is the premium income plus additional capital appreciation if the QQQ is called away from you at expiration, is 42.97%.

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 some additional capital appreciation. You would only receive $30 per share plus your option premium of $1, or a total of $31 per share, so you would have missed out on receiving $2 per share that your shares would have been worth had you done nothing but hold them. Yet you realized an annualized return well into double digits. You also had $1 per share of downside protection if the QQQ's price had headed south. Some transactions will turn out like that. Just remember that as a covered call writer you are no longer in the business of maximizing capital appreciation on your shares. You are in the business of using covered call options to provide you a rate of return that will meet or exceed your objective on a consistent and predictable basis. If you keep that in mind, you will not be overly disappointed, even if your shares are called away from you at times. An analogy to a baseball player may be appropriate. As a covered call 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.

Another occurrence would be that your shares are called away, but the strike price plus the premium you receive is greater than the market value of the shares at expiration. This means you are better off than if you had just held the shares alone.

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

You decide to go ahead and place an order to **"sell-to-open"** ten contracts of the QQQ July $30 calls at $1. Since this is the opening of the transaction for you, it is referred to as "sell-to-open," or your broker may call it "sell covered call." If you decided later that you wanted to close out the transaction rather than wait for the options to expire or be exercised on the expiration date, you would then do the opposite and enter an order to **"buy-to-close."** That would close out the transaction. Again, this is generally not recommended except in some situations when writing in-the-money calls.

When you have entered your order, Max or some other buyer buys your contracts through his broker and pays $1,000. 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. 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 calls? 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 gradually decays. Every day that ticks off toward the expiration date means you are closer to the time you can either write a new option on your QQQ shares or you will receive cash for your shares at the strike price, which you can then reinvest.

Let's assume for a moment that the market price of the QQQ remains at $28 on the expiration date. What happens? Since a buyer would not pay the higher strike price for shares that he could buy at a lower price on the open market, the options expire unexercised. You have previously pocketed the buyer's $1,000 and you keep your shares. Now you can write more call options. With the share price the same, if you write more call 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 $28 at the end of the year, you would have received a return of over 14% from your premium income…a nice gain in a flat market. An owner of QQQ shares who did not write options would have no gain at all. This is how option writing works its magic in a flat to slowly rising market.

And if QQQ shares closed above $30 on the July expiration date you would receive $30,000 and could then use the proceeds as you please. Under the program in this book, you would buy more QQQ or DIA shares and then write more option contracts. The cycle goes on and on.

If the QQQ closed between $28 and $30…say $29.50…you still get to keep all of your option premium *and* your QQQ shares, as the price of the QQQ was still not above the $30 strike price on the expiration date. The nice thing about this is that you have kept your shares, but they are now worth more than when you wrote your option in April ($29.50 vs. $28). Not only do you have a gain in the ETF, but when you write your next option contracts, say the September contract, you will find that the $30 strike price contracts will be trading at a higher relative price, adjusted for the difference in time to expiration…perhaps $1.50. This is because the market price is closer to the strike price now than it was the last time you wrote the option contracts. Remember that for out-of-the-money calls, the closer the market price is to the strike price, the higher the option premium will be. This time your ten contracts would give you about $1,500 of premium income…and for even less time to expiration.

Another strategy that might be effectively used in this case if you have a positive market outlook would be to write contracts at a higher strike price…for

example the $32 contract instead of the $30 contract. This would reduce your premium income because the strike price is higher, but it would allow more room for the price to increase in the QQQ 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 next selected expiration date. Of course, that is very difficult to know, but the investor usually has some informed thoughts on the subject from what you hear and read. In Chapter 9 we will discuss **"technical analysis"** and provide a number of tools that may assist you in making an assessment about future market direction.

But what occurs if the price of the QQQ went down? That is when "bad" is really "not quite so bad." Let's say at the July expiration QQQ shares are trading at $27.40. You have the premium income of $1,000 to keep and obviously you get to keep your shares, because the buyer of the call would not pay you $30 per share for ETF that could be bought on the open market for $27.40. Since you received $1 per share in premium income, you have a $.40 net gain per share in the transaction from the date the contracts were written ($27.40 + $1 - $28). You have fared better than a shareholder who simply owned the ETF and did not write options on it. You have had $1 per share of downside protection, which is somewhat like insurance, during the entire term of the contract until expiration. Of course, if the QQQ had gone down even further than that, you could have experienced an overall loss, but a loss that would be less than if you had not written the option contracts.

Remember…it is still possible to lose money buying the QQQ and the DIA and writing call options if the price of your shares declines significantly. But if you are caught in a declining market where your shares are going down in price, you will *always* be better off if you have written calls on your shares compared with just owning the QQQ and the DIA alone, because the premium income gives you the added downside price protection "insurance." And by using the short-term technical analysis described in this book to help with timing and establish appropriate strike prices and expiration dates for your call option writing decisions, you may be able to achieve profitability even in a modest down market.

## *CALCULATING COVERED CALL WRITING OPPORTUNITIES ON Qs AND DIAMONDS*

# 5

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

Two of the templates are Microsoft Excel® spreadsheet files named "QQQ_calls" and "DIA_calls." You will find them to be a useful resource to assist in making decisions on which call options to write for your QQQ and DIA shares. They will provide excellent information to simplify decision-making and save a good deal of time in "crunching the numbers."

Let's repeat the spreadsheet example that was used earlier:

| DATE--------> | | 18-Apr | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| X | X | X | | X | X | | X | | CAPITAL | | ANNUAL | BREAK- |
| CO. SYM. | # SHS. | SHARE PRICE | MARKET VALUE | OPTION EXPIR. | STRIKE | DAYS | PREM. | $ PREM. INC. | APPR. OR (DEPR.) AT STRIKE | ANNUAL YIELD | YIELD W/ CAP. APPR. OR (DEPR.) | EVEN PRICE OF QQQ |
| QQQ | 1,000 | $28.00 | $28,000 | 18-Jul | $30.00 | 91 | $1.00 | $1,000 | $2,000 | 14.32% | 42.97% | $27.00 |

This example is what the QQQ_calls file template looks like when the data is completed. The use of this template for multiple strike prices and expiration dates is the primary tool you will use in making specific call writing selection decisions. Let's discuss the data on this worksheet in detail so you can become comfortable with it.

Note the row towards the top with the small "**x**"s. In any column where there is an "**x**," that means you need to supply the information. If there is no "**x**" in a column, the information in that column is automatically calculated for you.

Many of the columns are obvious. The first column is the ticker symbol, in this case the QQQ. The next column is the number of shares you own or are contemplating purchasing. An option contract always applies to one hundred shares, also called a **"round lot."** You cannot write options for an **"odd lot,"** which is less than one hundred shares. The dollar amount invested for covered call writing is not particularly material. Most importantly, you need to purchase in round lots, regardless of the amount you are investing. The more round lots you purchase, the more cost efficiency there is in brokerage commissions on option trades.

The current share price of the QQQ follows in the next column.

The market value column does not have an "**x**," so that means the calculation is automatic if you have entered the other information.

The column on option expiration deserves more detailed discussion. There are typically a wide variety of option expiration dates to choose from on the QQQ and the DIA. For both of them, as of this writing (the month of May) there were options available expiring in May, June, July, September, December and the LEAPS the following January, and a year from that January…from the current month to almost two years away. This gives investors quite a few choices to suit their own unique call 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 on the same four months every year plus at least the current and the next following month. Some also offer LEAPS, as do the QQQ and the DIA.

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 |

Both the QQQ and the DIA are Cycle 3. Regardless of which option cycle is assigned for any given security, in addition to the cycle months there is always an option created with an expiration date for the current and the following month.

The next column also deserves some extensive discussion…the strike price. The strike price is the part of the option contract that specifies the price at which the option buyer has the right to buy your shares from the date of the option trade through the expiration date. When the market price of the QQQ and the DIA 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 from $23 through $30, and probably some below and above that range. You will find that sometimes there are gaps between the strike prices offered. This is particularly true of the DIA, although it can also occur with the QQQ. In some cases a given strike price may be offered for one expiration date, but not for another. The call 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 and the DIA offer the broadest array of strike prices and expiration dates available of all securities on which covered calls can be written. It is unlikely that you will ever find a shortage of alternatives available to you.

The column titled "Days," which shows the number of days from the current date through the date of expiration, is automatically calculated, with the resulting number of days placed into this column. So, for example, for the QQQ option expiring July 18 there are 91 days remaining from the date the worksheet was prepared through the last trading day.

Your final entry is to plug in the current quote for the option, which you will get from your brokerage or the Internet. Sometimes there can be quite a bit of spread, or variance, between the bid and ask prices that are quoted for options. The bid price is what a buyer is currently bidding or willing to pay to buy the contract. The ask price is what a seller is currently asking or willing to sell the contract for. Actual trading will usually take place between those two figures. Generally it is best to take the bid and ask prices, add them together and divide by two to get the approximate midpoint. So, if the bid is $.95 and the ask is $1.05, use the midpoint of $1.00, 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, so it should be valid for your investment return calculation purposes. Keep in mind that for option contracts priced under $3.00 per share the contracts trade in increments of 5 cents. For contracts priced over $3.00 the increment is 10 cents. Because of the high volume, many of the QQQ and some of the DIA call contracts trade with a spread of only a few cents.

You will see the total premium income you would collect under the next column marked "$ Prem. Inc." The commissions obviously vary from broker to broker. 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 call calculation data cells.

The next column is "Capital Appr. or (Depr.) At Strike." This calculates the capital increase or decrease, if any, on the expiration date. It defines the maximum capital appreciation that can be made on the transaction if you are writing out-of-the-money calls, or the capital depreciation that will be incurred if you are writing in-the-money calls. In the QQQ example, the price of the QQQ was $28 per share when the calls were written and the strike price was $30…out-of-the-money calls. With $2 of room for growth and 1,000 shares owned, the maximum capital appreciation potential was therefore $2,000.

The next column, "Annual Yield," calculates the *premium yield on an annualized basis*. It is annualized because investors are used to thinking about our returns that way. For example, if you are seeking a 12% annual return you do not say you want a one-percent return per month, because people just do not think that way. So take the example of the QQQ options expiring on July 18. What this means is that if you could continue to write the same option at the same premium price and with the same frequency—days to expiration—you would realize an annualized yield on your investment, based on its current value, of 14.32%, not including commissions. This would mean that at the July expiration

date you would need to do the exact same deal again and again to get that precise yield. Obviously it is not going to happen that way, because the price of the QQQ will change, and that means the price of the options in the future will change too. But it is the best information we have at a given point in time, so that 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.

The next to the last column, "Annual Yield W/ Capital Appr. or (Depr.)," factors in both the premium income received as well as the capital appreciation or depreciation to compute the combined annual yield. In this example, $1,000 of premium income plus $2,000 of capital appreciation results in a total gain of $3,000, or a combined return of 42.97%. If you would say that doing this every 91 days, in the case of this option writing example, is extremely unlikely, you would be absolutely correct. But, again, making this total return computation simply allows us to make comparisons with other option writing opportunities, and for that purpose it is of great value to us.

The final column shows the "Breakeven Price of QQQ." This is simply the share price less the premium income per share, which is the price to which the shares would have to decline before you would begin to incur any loss on the overall transaction…a good comparison feature when a number of different alternatives are being examined.

## DEFINING YOUR INVESTMENT RETURN GOAL

Next we will be taking a close look at call option writing alternatives on the QQQ and the DIA. While it is human nature to simply dive in and start making your call writing decisions on the basis of what is available, a "Ready…fire…aim" approach is not the proper first step. First, it is time to set your goals.

No doubt you have other investment assets beyond what you devote to equities. These might include such assets as cash (bank accounts, CDs, money market funds), bonds, real estate, tangible investments (gold, coins, gemstones) and other assets. Presumably you have some ultimate goals in mind that require financial forethought. They might include such things as saving and investing to finance your children's education, asset accumulation for retirement, producing a desired level of income after retirement, leaving an inheritance to family or charities. These are only a few examples among many possibilities. All of us either are or should be seeking to build wealth and achieve investment returns for one or more reasons applicable to our own unique financial needs and desires.

Since all of us have finite and measurable sources for wealth accumulation (e.g., wage income, interest and dividend income, assets with capital appreciation potential), we should be able to make reasonably informed

predictions as to what value these sources will provide us over time as well as the cash flow they will generate.

Why is this important to know? What we will be assessing with the covered call writing program on the QQQ and the DIA are a variety of investment return alternatives available to us from these ETFs. These returns depend upon what strike prices and expiration dates we select. There will be considerable variances in investment returns depending on these variables, and it will also affect the amount of investment risk you will be assuming.

There is an old saying, "If you don't know where you are going, any road will take you there." Unless your plan is to hope for a lottery win or an unexpected inheritance to bail you out (amazingly, many people are counting on such a windfall), you are highly encouraged to develop your own personal net worth statement, complete with long-term projections of growth in value as well as production of cash flow based upon current and projected assets, investment returns, and anticipated future expenses.

If you do a reasonable job of developing it, such a plan will tell you what percentage investment return you need on your QQQ and DIA investments coupled with the covered call writing you will be doing on them. That number for you may be 8%...it may be 10%...it may be 12%...it may be more. But how would you know if you do not plan? In order to develop such a plan, you need to make assumptions (e.g., "How much will my house and the vacant lot next to it that I own grow in value between now and the time I retire?"; "Will I sell either or both when I retire?"; "If so, how will I invest the proceeds, where will I live, and what will it cost?"). These are only a few of many questions that might need to be asked to develop a meaningful plan. And, the plan should be on your computer (Microsoft Excel®, or a similar spreadsheet product, would be excellent to use for such purposes) so that you can update it over time and as your assumptions change.

If you have not developed such a plan, complete with long-term projections, please do so as you begin to utilize the covered call writing program. The plan will give real direction to your decision making.

## THE OPTION WRITING STRATEGY

What your overall strategy should be is to take the resources you are allocating to your QQQ and DIA portfolio and select option writing opportunities on them which will average out to an overall return at least equaling your objective. Depending on the rate of investment return you are seeking, there may be several different alternatives within the covered call writing strategy that could accomplish your objective. The right decision for you then comes down to two factors: your willingness to assume risk, and your short-term outlook for the stock market. We will address the first issue as we get into the specifics of the call writing program. As to the latter, Chapter 9 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 investment and call writing decisions.

## ASSUMED 12% OBJECTIVE

We need a benchmark from which to operate in discussing the QQQ and the DIA call writing alternatives that follow. We will assume for purposes of this program that your investment return objective on your QQQ/DIA investment portfolio is 12% annually. Your objective may vary significantly from this number based on your own needs and the risk you are willing to assume, but the philosophy of how you will reach your actual objective will be the same as what we will be discussing even if your number is different.

Let's now examine some covered call writing alternatives available to us on the QQQ and the DIA and use them on an ongoing basis with the 12% investment return figure as our objective. All of the numbers shown on the following page are from the real world, with the QQQ trading at $28.28. Nothing has been fabricated. The exact same principles remain intact even though the price changes.

## SELECTION OF STRIKE PRICES

When you are considering which strike prices to review, the following is suggested:

- The lowest strike price should be several dollars below the current market price.
- The highest strike price should be several dollars above the current market price.
- Also include the other strike prices between the lowest and the highest.
- Select at least several expiration dates, beginning with the shortest date that is approximately one month later than the current date. Then select the next two expiration dates (more if desired).

Then plug in the data. By examining the "Annual Yield" column, you will be able to determine if you have captured all of the strike prices that meet your return objective. With the 12% return objective we have established, the spreadsheet would look something like the following:

## QQQ CALL WRITING ALTERNATIVES

DATE--------> 6-May

| X CO. SYM. | X # SHS. | X SHARE PRICE | MARKET VALUE | X OPTION EXPIR. | X STRIKE | DAYS | X OPTION SYMBOL | X PREM. | $ PREM. INC. | CAPITAL APPR. OR (DEPR.) AT STRIKE | ANNUAL YIELD | ANNUAL YIELD W/ CAP. APPR. OR (DEPR.) | BREAK-EVEN PRICE OF QQQ |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| QQQ | 1,000 | $28.28 | $28,280 | 20-Jun | $25.00 | 45 | | $3.55 | $3,550 | ($3,280) | 8.76% | 8.76% | $24.73 |
| QQQ | 1,000 | $28.28 | $28,280 | 18-Jul | $25.00 | 73 | | $3.80 | $3,800 | ($3,280) | 10.40% | 10.40% | $24.48 |
| QQQ | 1,000 | $28.28 | $28,280 | 19-Sep | $25.00 | 136 | | $4.20 | $4,200 | ($3,280) | 9.88% | 9.88% | $24.08 |
| QQQ | 1,000 | $28.28 | $28,280 | 20-Jun | $26.00 | 45 | | $2.70 | $2,700 | ($2,280) | 13.10% | 13.10% | $25.58 |
| QQQ | 1,000 | $28.28 | $28,280 | 18-Jul | $26.00 | 73 | | $3.00 | $3,000 | ($2,280) | 13.85% | 13.85% | $25.28 |
| QQQ | 1,000 | $28.28 | $28,280 | 19-Sep | $26.00 | 136 | | $3.45 | $3,450 | ($2,280) | 12.08% | 12.08% | $24.83 |
| QQQ | 1,000 | $28.28 | $28,280 | 20-Jun | $27.00 | 45 | | $1.95 | $1,950 | ($1,280) | 20.13% | 20.13% | $26.33 |
| QQQ | 1,000 | $28.28 | $28,280 | 18-Jul | $27.00 | 73 | | $2.30 | $2,300 | ($1,280) | 18.89% | 18.89% | $25.98 |
| QQQ | 1,000 | $28.28 | $28,280 | 19-Sep | $27.00 | 136 | | $2.85 | $2,850 | ($1,280) | 15.61% | 15.61% | $25.43 |
| QQQ | 1,000 | $28.28 | $28,280 | 20-Jun | $28.00 | 45 | | $1.35 | $1,350 | ($280) | 31.00% | 31.00% | $26.93 |
| QQQ | 1,000 | $28.28 | $28,280 | 18-Jul | $28.00 | 73 | | $1.65 | $1,650 | ($280) | 24.46% | 24.46% | $26.63 |
| QQQ | 1,000 | $28.28 | $28,280 | 19-Sep | $28.00 | 136 | | $2.25 | $2,250 | ($280) | 18.88% | 18.88% | $26.03 |
| QQQ | 1,000 | $28.28 | $28,280 | 20-Jun | $29.00 | 45 | | $0.85 | $850 | $720 | 24.38% | 45.03% | $27.43 |
| QQQ | 1,000 | $28.28 | $28,280 | 18-Jul | $29.00 | 73 | | $1.15 | $1,150 | $720 | 20.33% | 33.06% | $27.13 |
| QQQ | 1,000 | $28.28 | $28,280 | 19-Sep | $29.00 | 136 | | $1.75 | $1,750 | $720 | 16.61% | 23.44% | $26.53 |
| QQQ | 1,000 | $28.28 | $28,280 | 20-Jun | $30.00 | 45 | | $0.50 | $500 | $1,720 | 14.34% | 63.67% | $27.78 |
| QQQ | 1,000 | $28.28 | $28,280 | 18-Jul | $30.00 | 73 | | $0.80 | $800 | $1,720 | 14.14% | 44.55% | $27.48 |
| QQQ | 1,000 | $28.28 | $28,280 | 19-Sep | $30.00 | 136 | | $1.35 | $1,350 | $1,720 | 12.81% | 29.13% | $26.93 |
| QQQ | 1,000 | $28.28 | $28,280 | 20-Jun | $31.00 | 45 | | $0.25 | $250 | $2,720 | 7.17% | 85.18% | $28.03 |
| QQQ | 1,000 | $28.28 | $28,280 | 18-Jul | $31.00 | 73 | | $0.50 | $500 | $2,720 | 8.84% | 56.93% | $27.78 |
| QQQ | 1,000 | $28.28 | $28,280 | 19-Sep | $31.00 | 136 | | $1.00 | $1,000 | $2,720 | 9.49% | 35.30% | $27.28 |

You can see that at the $25 and $31 strike prices the projected annual returns fall below the 12% objective. Therefore, we should consider writing calls with strike prices from $26 through $30.

Below is a spreadsheet showing some calculations that meet the 12% return criteria on shares of the DIA, which you may wish to study.

All of these strike prices and expiration dates for both the QQQ and the DIA meet or exceed our return objective. What then are the determining factors that should drive the decision on which strike price and which expiration date to select? The inexperienced investor might be tempted to simply select the choice that provides the greatest annual yield. The best decision, however, is seldom that simple. There are some very important considerations we need to examine.

# DIA CALL WRITING ALTERNATIVES

DATE--------> 6-May

| X CO. SYM. | X # SHS. | X SHARE PRICE | MARKET VALUE | X OPTION EXPIR. | X STRIKE | DAYS | X OPTION SYMBOL | X PREM. | $ PREM. INC. | CAPITAL APPR. OR (DEPR.) AT STRIKE | ANNUAL YIELD | ANNUAL YIELD W/ CAP. APPR. OR (DEPR.) | BREAK-EVEN PRICE OF DIA |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| DIA | 500 | $85.81 | $42,905 | 20-Jun | $83.00 | 45 | | $4.10 | $2,050 | ($1,405) | 12.61% | 12.61% | $81.71 |
| DIA | 500 | $85.81 | $42,905 | 20-Jun | $84.00 | 45 | | $3.40 | $1,700 | ($905) | 15.35% | 15.35% | $82.41 |
| DIA | 500 | $85.81 | $42,905 | 18-Jul | $84.00 | 73 | | $4.00 | $2,000 | ($905) | 13.04% | 13.04% | $81.81 |
| DIA | 500 | $85.81 | $42,905 | 20-Jun | $85.00 | 45 | | $2.80 | $1,400 | ($405) | 18.99% | 18.99% | $83.01 |
| DIA | 500 | $85.81 | $42,905 | 20-Jun | $86.00 | 45 | | $2.25 | $1,125 | $95 | 21.27% | 23.06% | $83.56 |
| DIA | 500 | $85.81 | $42,905 | 18-Jul | $86.00 | 73 | | $2.85 | $1,425 | $95 | 16.61% | 17.71% | $82.96 |
| DIA | 500 | $85.81 | $42,905 | 20-Jun | $88.00 | 45 | | $1.40 | $700 | $1,095 | 13.23% | 33.93% | $84.41 |
| DIA | 500 | $85.81 | $42,905 | 18-Jul | $88.00 | 73 | | $2.00 | $1,000 | $1,095 | 11.65% | 24.41% | $83.81 |

*WRITING OUT-OF-THE MONEY COVERED CALLS*

6

Our focus in this chapter will be on those strike prices where the current market price is less than the strike price…the out-of-the-money calls.

Writing out-of-the-money calls can provide excellent results when the price of the underlying security--in this case the QQQ--has remained relatively flat or has increased slightly from the time the calls are written up to the expiration date. Even a modest decrease in the price can often leave the investor in a profitable position. In all of these circumstances, the covered call writer will outperform the investor who simply owns the QQQ and does not write calls on the shares. So, if your market outlook is flat or for slow growth, out-of-the-money calls should be considered.

**OUT-OF-THE-MONEY QQQ CALLS**

DATE--------> 6-May-03

| X CO. SYM. | X # SHS. | X SHARE PRICE | MARKET VALUE | X OPTION EXPIR. | X STRIKE | DAYS | X OPTION SYMBOL | X PREM. | $ PREM. INC. | CAPITAL APPR. OR (DEPR.) AT STRIKE | ANNUAL YIELD | ANNUAL YIELD W/ CAP. APPR. OR (DEPR.) | BREAK-EVEN PRICE OF QQQ |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| QQQ | 1,000 | $28.28 | $28,280 | 20-Jun | $29.00 | 45 | | $0.85 | $850 | $720 | 24.38% | 45.03% | $27.43 |
| QQQ | 1,000 | $28.28 | $28,280 | 18-Jul | $29.00 | 73 | | $1.15 | $1,150 | $720 | 20.33% | 33.06% | $27.13 |
| QQQ | 1,000 | $28.28 | $28,280 | 19-Sep | $29.00 | 136 | | $1.75 | $1,750 | $720 | 16.61% | 23.44% | $26.53 |
| QQQ | 1,000 | $28.28 | $28,280 | 20-Jun | $30.00 | 45 | | $0.50 | $500 | $1,720 | 14.34% | 63.67% | $27.78 |
| QQQ | 1,000 | $28.28 | $28,280 | 18-Jul | $30.00 | 73 | | $0.80 | $800 | $1,720 | 14.14% | 44.55% | $27.48 |
| QQQ | 1,000 | $28.28 | $28,280 | 19-Sep | $30.00 | 136 | | $1.35 | $1,350 | $1,720 | 12.81% | 29.13% | $26.93 |

As you look at the spreadsheet of the out-of-the-money calls, something becomes apparent:

**UNIVERSAL TRUTH:**

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

This makes sense when you appreciate the perspective of the call *buyer*. If the buyer purchases the $29 strike price call, the price of the QQQ needs to increase 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 $30 call.

Therefore, he would expect to pay more for the call which has a strike price closer to the market price. As the call writer, you would expect a greater return on the $29 call (from 16.61% to 24.38%, depending on expiration selected) than on the $30 call (from 12.81% to 14.34%).

What then are the factors the call writer should take into consideration in making a call writing decision, other than the obvious attractiveness of selecting the one with the highest annual yield? All of these call writing opportunities exceed the 12% investment return objective, so we know we are on the right track. Let's take a closer look.

## THE ESSENTIAL QUESTION

The most important question the call writer must try to answer to make good call writing decisions is: ***What do I think is going to happen to the market price of my underlying security during the expiration date timeframes I am considering?*** The answer to this question 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, stock traders, as well as the "average" investor have trouble arriving at a correct answer to this question with any consistency. As an investor in equities you obviously have some faith that over the long term they will provide you with an investment return that will exceed other investment alternatives. By limiting one's investment portfolio to the QQQ and the DIA, an investor can obtain the requisite diversification so important to equity ownership. You also escape the time consuming requirement of managing a portfolio of individual stocks. Instead of having to research and study a whole host of fundamental analysis factors for individual stocks, you can concentrate solely on call selection and the direction of the broader market, because the QQQ and the DIA represent a good cross-section of the broader market.

One of the advantages you have as a covered call writer is this:

## UNIVERSAL TRUTH:

> **If you have written a call and the price of the underlying security goes down, you will always be better off than the investor who owns the security but does not write calls.**

The premium income you receive from writing the calls will give you some downside protection that the investor does not have who simply owns the security.

Earning premium income from writing out-of-the-money calls is not the only consideration, however. The next component to look at is the capital appreciation that can be realized if the QQQ price goes up and what your overall

yield will be if the shares are called away from you at expiration. For the $29 strike price, the maximum capital appreciation that can be realized is $720…the strike price per share of $29 minus the current market price of $28.28 times the number of shares, which is all figured into the spreadsheet. Your capital appreciation cannot be any more if you write the $29 strike price, since the shares will be called away from you at that price on expiration if the price is greater than that. If your shares are called away, the annual yield with the capital appreciation would be from 23.44% to 45.03%, depending on the expiration date you selected…a very solid double-digit return.

By stepping up to the $30 strike price the maximum potential capital appreciation is increased to $1,720. With lower premiums per share due to the strike price being further away from the market price, the annual yields are less. But, with the additional capital appreciation potential, should the option to acquire your shares be exercised at expiration, the annual yields with capital appreciation increase, depending on the expiration date selected, to a yield of from 29.13% to 63.67%.

If your technical analysis does not give you any strong indicators for an upward or downward price movement in the QQQ, then it might be best to just write the call with the higher premium, because that will give you more cash income up front and a bit more "insurance" toward the downside too.

Some option writers always go with the closest out-of-the-money option rather than a higher strike price to maximize the option writing income. Others prefer the higher strike price to get more of a balance between option writing income and capital appreciation opportunity. There is no single best way for everyone. Both can be good, depending on what your objectives and needs are…and your outlook for the QQQ and the DIA based on technical analysis and fundamental analysis of economic conditions.

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

It is important to remember that you are in the business of achieving your return objective by call option writing. If your shares were called away from you at every expiration, you might be missing some upside capital appreciation in some cases, yet you would be exceeding your objective all of the time, which is what you set out to do in the first place.

What if your technical indicators point to a flat market or market downtrend? We will examine call writing opportunities next to fill that need.

# *WRITING IN-THE-MONEY COVERED CALLS*

# 7

In this chapter we will focus on those strike prices where the current market price is greater than the strike price…the in-the-money calls.

As we saw in the previous chapter, the out-of-the-money calls provide premium income as well as an opportunity for additional capital appreciation. On the contrary, the in-the-money calls will typically result in capital depreciation. An obvious question needs to be answered. Why would anyone want to put themselves in a situation where they are likely to realize capital depreciation of their investment? The answer is simple. Because the premium received is so large, it more than compensates for the depreciation loss in the underlying shares. When considering the very substantial premium income and subtracting the capital depreciation of the shares, the net gain can still generate double-digit returns as well as provide significantly greater downside protection than out-of-the-money calls.

The spreadsheet on the next page consists of the in-the-money portion of the initial spreadsheet where the returns are greater than the 12% return objective.

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

As you look at the spreadsheet note the following:

**UNIVERSAL TRUTH:**

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

This sounds like a contradiction. How can the annual yield become less when the premium becomes greater? If you write in-the-money calls, you are putting yourself in a situation where there is a good likelihood that the calls will be exercised (your shares sold) if you do not buy back the call prior to expiration. You are writing calls with a strike price that is actually below the current market

value of the shares. Also, you will always experience a loss of capital (capital depreciation) on the shares when considering what their value was on the day the option contracts were written compared with their value if they are called away from you at the strike price. This will be true whether the QQQ price increases, decreases, or stays the same.

## IN-THE-MONEY QQQ CALLS

DATE--------> 6-May

| X CO. SYM. | X # SHS. | X SHARE PRICE | MARKET VALUE | X OPTION EXPIR. | X STRIKE | DAYS | X OPTION SYMBOL | X PREM. | $ PREM. INC. | CAPITAL APPR. OR (DEPR.) AT STRIKE | ANNUAL YIELD | ANNUAL YIELD W/ CAP. APPR. OR (DEPR.) | BREAK-EVEN PRICE OF QQQ |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| QQQ | 1,000 | $28.28 | $28,280 | 20-Jun | $26.00 | 45 | | $2.70 | $2,700 | ($2,280) | 13.10% | 13.10% | $25.58 |
| QQQ | 1,000 | $28.28 | $28,280 | 18-Jul | $26.00 | 73 | | $3.00 | $3,000 | ($2,280) | 13.85% | 13.85% | $25.28 |
| QQQ | 1,000 | $28.28 | $28,280 | 19-Sep | $26.00 | 136 | | $3.45 | $3,450 | ($2,280) | 12.08% | 12.08% | $24.83 |
| QQQ | 1,000 | $28.28 | $28,280 | 20-Jun | $27.00 | 45 | | $1.95 | $1,950 | ($1,280) | 20.13% | 20.13% | $26.33 |
| QQQ | 1,000 | $28.28 | $28,280 | 18-Jul | $27.00 | 73 | | $2.30 | $2,300 | ($1,280) | 18.89% | 18.89% | $25.98 |
| QQQ | 1,000 | $28.28 | $28,280 | 19-Sep | $27.00 | 136 | | $2.85 | $2,850 | ($1,280) | 15.61% | 15.61% | $25.43 |
| QQQ | 1,000 | $28.28 | $28,280 | 20-Jun | $28.00 | 45 | | $1.35 | $1,350 | ($280) | 31.00% | 31.00% | $26.93 |
| QQQ | 1,000 | $28.28 | $28,280 | 18-Jul | $28.00 | 73 | | $1.65 | $1,650 | ($280) | 24.46% | 24.46% | $26.63 |
| QQQ | 1,000 | $28.28 | $28,280 | 19-Sep | $28.00 | 136 | | $2.25 | $2,250 | ($280) | 18.88% | 18.88% | $26.03 |

On the plus side, the premium increases with each reduction in strike price. However, you will also note that the amount of the capital depreciation increases by an amount equal to the reduction in strike price times the number of shares. For example, writing a $26 strike price vs. a $27 strike price would result in an additional $1,000 in capital depreciation ($1 x 1,000 shares).

The bottom line is this. The more the call is in-the-money the less the increase in premium compensates for the increase in capital depreciation. In other words, as the amount by which the price is in-the-money increases, the capital depreciation increases at a faster rate than the increase in premium. The result is a lower annual return as the amount by which the price is in-the-money increases.

This makes sense, because the greater the premium the more downside protection you receive. It can be seen by looking at the last column "Breakeven Price Of QQQ." Just look at the difference between writing an out-of-the-money call with a $30 strike price compared with an in-the-money call with a $26 strike price for the June expiration. For the $30 strike price, if the market price of the QQQ were below $27.78 you would incur a loss. For the $26 strike price, the market price would have to decline below $25.58 before a loss would be realized. The lower in-the-money strike price provides additional downside protection of almost 8% of the current market price during just a 1 ½ month period of time. This is substantial additional downside "insurance."

## THE ESSENTIAL QUESTION REVISITED

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

The answer to this question has not become any easier by introducing in-the-money calls into the equation. Again, the technical tools provided in Chapter 9 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 calls vs. out-of-the-money calls.

**UNIVERSAL TRUTH:**

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

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

**if the price of the underlying security declines, your investment return will always be better with an in-the-money call compared with an out-of-the-money call.**

Therefore, in-the-money calls should be considered when expectations are for a declining market but you choose not to sell the shares.

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

To help clarify the potential use of in-the-money vs. out-of-the-money calls, let's look at several different scenarios where assumptions are made about the

price of the QQQ on the expiration date to see what the consequences would be and what would have been the best call writing strategy. We will take all of the call writing opportunities from the original spreadsheet using the June expiration date, as follows:

**IN-THE-MONEY QQQ CALLS AND OUT-OF-THE-MONEY CALLS WITH JUNE EXPIRATION**

DATE--------> 6-May

| X CO. SYM. | X # SHS. | X SHARE PRICE | MARKET VALUE | X OPTION EXPIR. | X STRIKE | DAYS | X OPTION SYMBOL | X PREM. | $ PREM. INC. | CAPITAL APPR. OR (DEPR.) AT STRIKE | ANNUAL YIELD | ANNUAL YIELD W/ CAP. APPR. OR (DEPR.) | BREAK-EVEN PRICE OF QQQ |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| QQQ | 1,000 | $28.28 | $28,280 | 20-Jun | $26.00 | 45 | | $2.70 | $2,700 | ($2,280) | 13.10% | 13.10% | $25.58 |
| QQQ | 1,000 | $28.28 | $28,280 | 20-Jun | $27.00 | 45 | | $1.95 | $1,950 | ($1,280) | 20.13% | 20.13% | $26.33 |
| QQQ | 1,000 | $28.28 | $28,280 | 20-Jun | $28.00 | 45 | | $1.35 | $1,350 | ($280) | 31.00% | 31.00% | $26.93 |
| QQQ | 1,000 | $28.28 | $28,280 | 20-Jun | $29.00 | 45 | | $0.85 | $850 | $720 | 24.38% | 45.03% | $27.43 |
| QQQ | 1,000 | $28.28 | $28,280 | 20-Jun | $30.00 | 45 | | $0.50 | $500 | $1,720 | 14.34% | 63.67% | $27.78 |

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

**UNIVERSAL TRUTH**

**Whether the tradeoff is warranted for accepting a lower yield to increase downside protection or a lower yield to increase capital appreciation, maximizing the opportunity rests on your ability to predict which way the market will go over the term of the call contract. Absent an ability to make such a prediction, data suggests that the best course of action may be to select the strike price closest to the current market value when writing calls.**

## ASSUMPTIONS ABOUT THE PRICE OF THE QQQ AT THE EXPIRATION DATE

Assume that you were writing calls on May 6 when the QQQ was trading at $28.28 and that all of the calls we are considering (strike prices from $26 to $30) are for a June 20 expiration (see previous spreadsheet). What might have been the possible outcomes on the expiration date at various prices for the QQQ if you wrote 10 call contracts at each strike price and waited until the contracts either expired or were exercised (sold to the call option buyer)?

What follows is a panoramic look at the end result of call selection decisions depending on the price of the QQQ at expiration. As visibly depicted, the covered call writer will *always* be in a better financial position by writing calls on the QQQ if it declines in price, regardless of what strike price and expiration date is selected, compared with the QQQ share owner who does not write calls. Nonetheless, it can also be clearly seen that the call writer's ability to assess short-term market direction can dramatically influence the results of a covered call writing program.

There is one more positive attribute of writing in-the-money calls. Since these calls can provide significantly more premium income, and since this income is credited to your account the next business day after the transaction is completed, there is an opportunity to reinvest this cash in additional shares upon which more covered calls can be written to produce even more income. Whether this is a significant factor in increasing overall returns in your portfolio depends on whether the amount is sufficient for reinvestment in round lots.

It has been mentioned previously that this covered call writing program generally provides that the investor not take any further action after writing a call until the option contracts expire. The exception to this could be when in-the-money calls are written. Why? First, if the share price is in-the-money at expiration, the shares will be called away at a loss when compared to the share price at the time the call contracts were written. Buying back the calls to close prior to expiration means the investor avoids selling the shares at this loss. Purchase of the options to close could result in a gain or loss on the option contracts, depending on their price, which obviously is also a consideration.

A case can be made that it would make sense to buy back in-the-money calls at any point when the time value is zero or very small. Subtract the strike price for your options from the current market price of the stock. Take that number and subtract it from the current price of the option. If the result of this calculation approaches zero, then it would make sense to buy back the call option and keep your shares. You have achieved your objective. Consider buying back the calls and writing a new call. This can also be done to avoid a potentially negative consequence known as the "wash sale rules" described in Chapter 13. See the sections on "rolling forward" and "rolling up" in that chapter for detailed

information on how to exit existing call writing positions and still maintain profitability without having your shares called away from you.

## OUTCOMES

| Strike Price Of Calls -----> | $30 | $29 | $28 | $27 | $26 |
|---|---|---|---|---|---|
| **QQQ price at expiration: $30** | | | | | |
| Premium income | $500 | $850 | $1,350 | $1,950 | $2,700 |
| Capital appreciation / (depreciation) | $1,720 | $720 | -$280 | -$1,280 | -$2,280 |
| Total gain / (loss) for call writer | $2,220 | $1,570 | $1,070 | $670 | $420 |
| QQQ owner with no calls written | $1,720 | $1,720 | $1,720 | $1,720 | $1,720 |
| **QQQ price at expiration: $29** | | | | | |
| Premium income | $500 | $850 | $1,350 | $1,950 | $2,700 |
| Capital appreciation / (depreciation) | $720 | $720 | -$280 | -$1,280 | -$2,280 |
| Total gain / (loss) for call writer | $1,220 | $1,570 | $1,070 | $670 | $420 |
| QQQ owner with no calls written | $720 | $720 | $720 | $720 | $720 |
| **QQQ price at expiration: $28** | | | | | |
| Premium income | $500 | $850 | $1,350 | $1,950 | $2,700 |
| Capital appreciation / (depreciation) | -$280 | -$280 | -$280 | -$1,280 | -$2,280 |
| Total gain / (loss) for call writer | $220 | $570 | $1,070 | $670 | $420 |
| QQQ owner with no calls written | -$280 | -$280 | -$280 | -$280 | -$280 |
| **QQQ price at expiration: $27** | | | | | |
| Premium income | $500 | $850 | $1,350 | $1,950 | $2,700 |
| Capital appreciation / (depreciation) | -$1,280 | -$1,280 | -$1,280 | -$1,280 | -$2,280 |
| Total gain / (loss) for call writer | -$780 | -$430 | $70 | $670 | $420 |
| QQQ owner with no calls written | -$1,280 | -$1,280 | -$1,280 | -$1,280 | -$1,280 |
| **QQQ price at expiration: $26** | | | | | |
| Premium income | $500 | $850 | $1,350 | $1,950 | $2,700 |
| Capital appreciation / (depreciation) | -$2,280 | -$2,280 | -$2,280 | -$2,280 | -$2,280 |
| Total gain / (loss) for call writer | -$1,780 | -$1,430 | -$930 | -$330 | $420 |
| QQQ owner with no calls written | -$2,280 | -$2,280 | -$2,280 | -$2,280 | -$2,280 |
| **QQQ price at expiration: $25** | | | | | |
| Premium income | $500 | $850 | $1,350 | $1,950 | $2,700 |
| Capital appreciation / (depreciation) | -$3,280 | -$3,280 | -$3,280 | -$3,280 | -$3,280 |
| Total gain / (loss) for call writer | -$2,780 | -$2,430 | -$1,930 | -$1,330 | -$580 |
| QQQ owner with no calls written | -$3,280 | -$3,280 | -$3,280 | -$3,280 | -$3,280 |

*SELECTING A COVERED CALL EXPIRATION DATE*

8

In addition to strike price selection, choosing an expiration date is the other decision the covered call writer faces.

## UNIVERSAL TRUTH

**For all strike prices, whether in-the-money or out-of-the-money, there is always an upward progression in the price of a call 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 call option you would be willing to pay more for one expiring in October than you would for one expiring two months earlier in August. That is because with the October contract the buyer has two more months for the shares to possibly go up so he can profitably sell his option contract or exercise it at expiration. And as an option writer, you should be willing to accept a lesser yield in return for a larger premium and locking up your yield 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 call option writers prefer to stick with the shorter term writing opportunities. Shorter-term call options will not give you as much downside protection, however, as longer-term calls. 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.

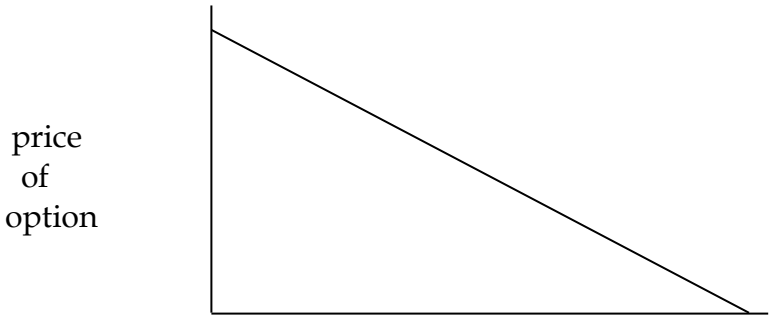
Let's look at one of the out-of-the-money QQQ calls again, since with these calls the entire premium consists of time value and no intrinsic value:

DATE--------> 6-May-03

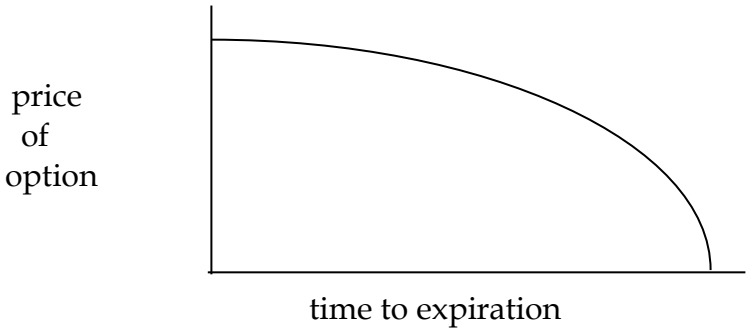
| X CO. SYM. | X # SHS. | X SHARE PRICE | MARKET VALUE | X OPTION EXPIR. | X STRIKE | DAYS | X OPTION SYMBOL | X PREM. | $ PREM. INC. | CAPITAL APPR. OR (DEPR.) AT STRIKE | ANNUAL YIELD | ANNUAL YIELD W/ CAP. APPR. OR (DEPR.) | BREAK-EVEN PRICE OF QQQ |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| QQQ | 1,000 | $28.28 | $28,280 | 20-Jun | $29.00 | 45 | | $0.85 | $850 | $720 | 24.38% | 45.03% | $27.43 |
| QQQ | 1,000 | $28.28 | $28,280 | 18-Jul | $29.00 | 73 | | $1.15 | $1,150 | $720 | 20.33% | 33.06% | $27.13 |
| QQQ | 1,000 | $28.28 | $28,280 | 19-Sep | $29.00 | 136 | | $1.75 | $1,750 | $720 | 16.61% | 23.44% | $26.53 |

As you can see, the premium for the June call contract is significantly less than the July contract. Yet the annual yield and the annual yield with capital appreciation are both greater for the June contract. The same is true in comparing the July contract with the September contract.

Let's say you have just written an out-of-the-money covered call on the QQQ. 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 over its life until it expires worthless 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 the QQQ price were to remain exactly the same, for a three month call option, for example, the decay in the time value 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 QQQ price the option holds more if its value until closer to expiration. An option writer could take some advantage of this by buying back calls to close just before expiration, say when the price of the option is only a small fraction of the original price when it was written (where the premium consists entirely of time value). 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 generally recommended. Some brokerages, 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 are the advantages of writing shorter-term covered calls and the advantages of writing longer-term covered calls? Let's do an assessment:

Advantages of writing shorter-term covered calls

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

Advantages of writing longer-term covered calls

- Larger total premium that will be available to you.
- Less brokerage commissions, because you will not be writing new contracts as often if the expiration periods are longer. If you were writing only one month options, you would incur three times the brokerage commissions compared with writing options with three month expirations.
- More downside protection in the event of a decline in the price of the underlying shares since the premium is greater on longer-term options.
- Less administrative work, since you only have to research option writing opportunities, handle trades and do record keeping as often as options expire.
- Ability to do some tax planning by selecting options that expire in the next tax year (more on this in Chapter 13).

Given the advantages of each, what should a call writing investor do? Here the subject of diversification again comes into play.

Writing short-term calls with expiration dates from one to three months generally makes sense, although an option writer should usually try to have some diversification in the expiration dates. If an investor's entire portfolio were called away on one option expiration date, the investor might be faced with buying back into the market at significantly higher prices if there had been a

sharp upturn in the market prior to the expiration date. For that reason, if you have a significant position in shares of the QQQ or the DIA, you may wish to consider writing some contracts to expire in a month or two and some that have a lengthier expiration date. Strike prices may also be varied to provide even broader diversification of the option portfolio. From a commission standpoint this is not as efficient as writing the same contract on all shares, as the flat fee component would be applied more than once. However the extra cost may well be worth it from a diversification standpoint.

There is also the problem of a down market. Let's demonstrate this with an exaggerated hypothetical example. Say you are pretty well diversified by owning shares of the QQQ and the DIA. Let's also say that the difference between the price per share of these ETFs and the strike prices when you wrote your call options was both $2 per share out-of-the-money. That would have given you some pretty decent option writing income for the option period, regardless of when the expiration period is. Now, let's say that both the QQQ and the DIA go down by $3 per share between the time you wrote your options and when the options expire. That means if you write a new set of options at the same strike prices you did before, the difference now between the market price of the QQQ and the DIA and the strike prices of your new options will be $5 per share. That is quite a bit greater than the $2 the last time you wrote options. This means that the option premiums and yields you will receive this time will be significantly less than the time before. You would either have to accept much lower returns for the next option writing period, or you would have to reduce the strike prices when you write your next set of contracts by $3 to give you a similar return.

The problem with that is if the market starts to go up again significantly, your lower strike prices would mean that you would give up some of the upside appreciation in your shares. They might be called away from you on the next expiration date at a strike price $3 per share lower than the strike price you used in the first option expiration. Of course, had you written in-the-money calls the first time, you would be in a much better position now. Again, this points out the advantage an investor has who can use short-term technical indicators to assist in predicting trends in the market .

# *FORECASTING MARKET DIRECTIONS WITH TECHNICAL ANALYSIS*

# 9

Double-digit returns from covered call writing on shares of the QQQ and the DIA can likely be achieved on a consistent basis without the use of either fundamental or technical analysis. This would be the simplest possible world for the investor, involving no decision making for the equity portfolio or in the selection of call options. An investor could simply follow these steps: (1) buy shares in the QQQ and the DIA; (2) write calls using a strike price and an expiration date with which he is comfortable and that achieve his investment return objective; (3) following the expiration date, if the shares are called away, start over with step (1); (4) if the shares are not called away, start over with step (2).

For investors who would like to try to increase their investment returns from ownership of QQQ and DIA shares coupled with covered call writing, following the fundamentals of what is going on in the market and the economy can reap some longer-term benefits. In addition, 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 calls, when not to write calls, selling in-the-money calls vs. out-of-the-money calls (and 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 to you 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 then 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 likely 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 your shares
- write deep in-the-money calls for greater downside protection
- write calls with longer expirations for greater downside protection

A significant market upturn

- buy/hold shares and do not write calls
- write deep out-of-the-money calls for greater appreciation potential
- write calls with shorter time to expiration to provide an opportunity to increase the strike prices with future call writing selections

A flat or slightly increasing market

- write calls with the strike price somewhere slightly below or above the current market price, depending on your personal preference
- write calls with expirations that suit your personal preference

## USING SHORT-TERM INDICATORS TO ASSIST WITH STOCK AND CALL OPTION DECISIONS

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.

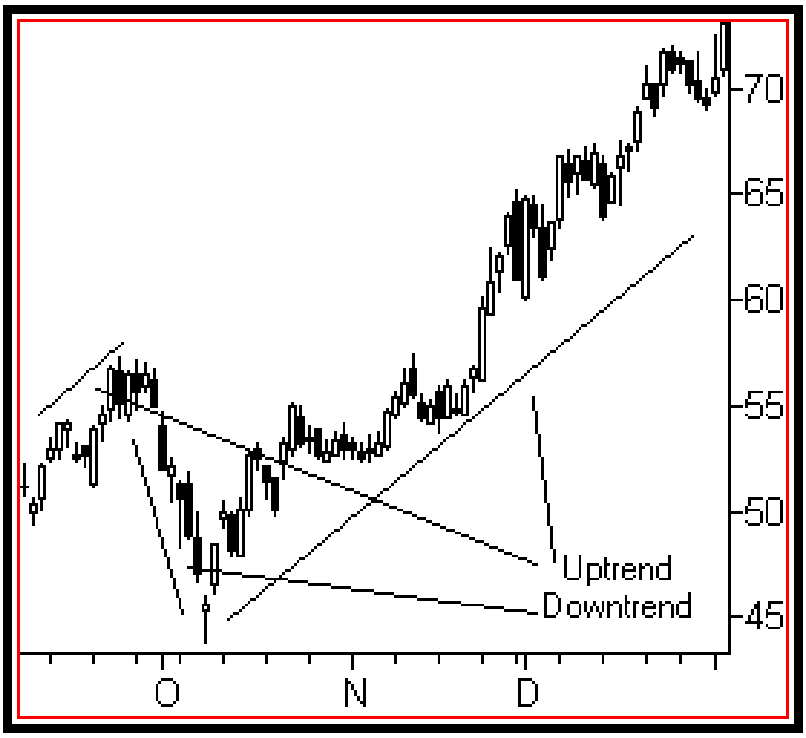
What would it be worth to you if you could reasonably predict such market conditions? Probably a lot. What follows are some of the more widely recognized tools market technicians often use to try to make those predictions. Use them as much or as little as you like depending on your willingness to devote 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 covered call 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.

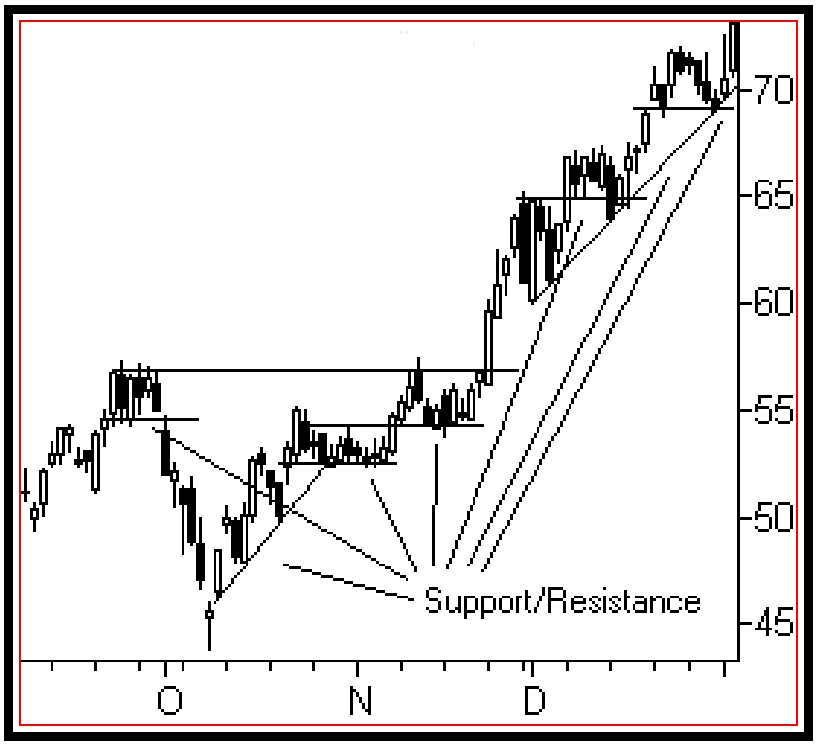
A stock in an uptrend or downtrend will typically continue to rise or fall respectively until some change in conditions occurs. Stock chart readers try to locate the tops and bottoms, which are those points where a price rise or decline ends.

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 calls 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 buying, we might be more attracted to buying shares when they reached a support area. If in the past the price had held several times at this level and then reversed upward significantly, we might be inclined to wait until such a rise had occurred again before writing calls, or if writing calls now, select those that are well out-of-the-money. 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

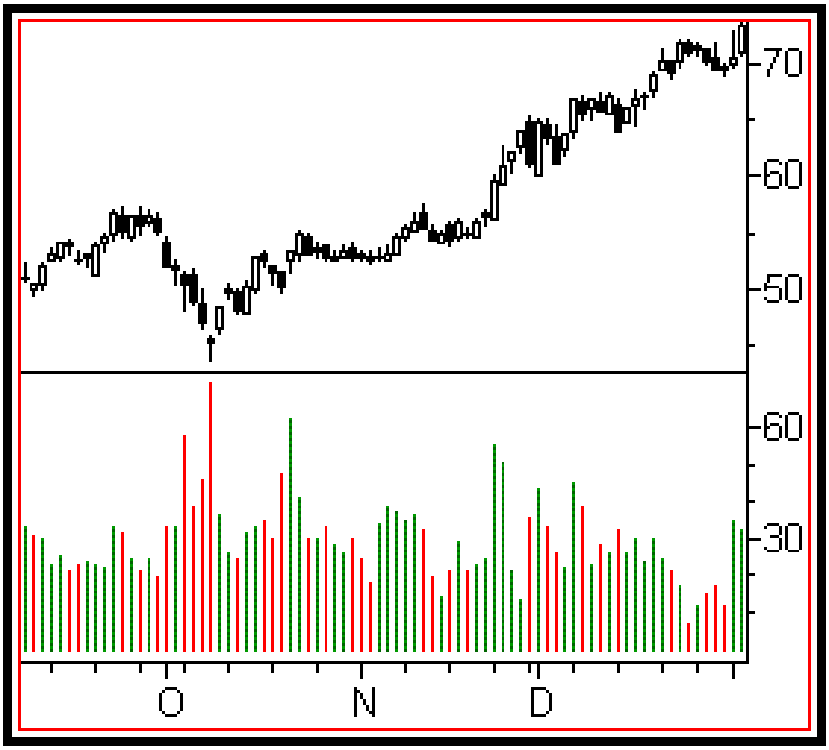
halted and reversed, this would be considered a resistance area for the stock. Here the supply of stock increased in relationship to the demand. If the price has been below this support area and it rose up to it again, we might expect that this resistance area would hold and that the price would either remain at that level for awhile or head down. So, if we were looking at selling, we might be more attracted to selling shares 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 or write covered calls that would give us significant premiums for downside protection (in-the-money calls). 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.

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). In this case, volume is increasing when the price is going 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 and the DIA.



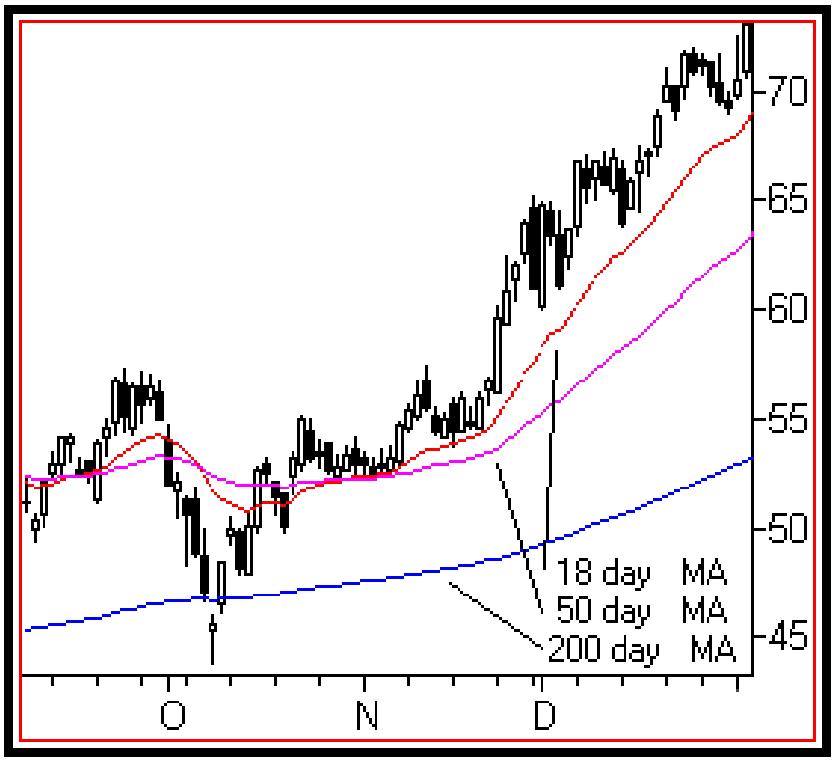

Volume

## 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

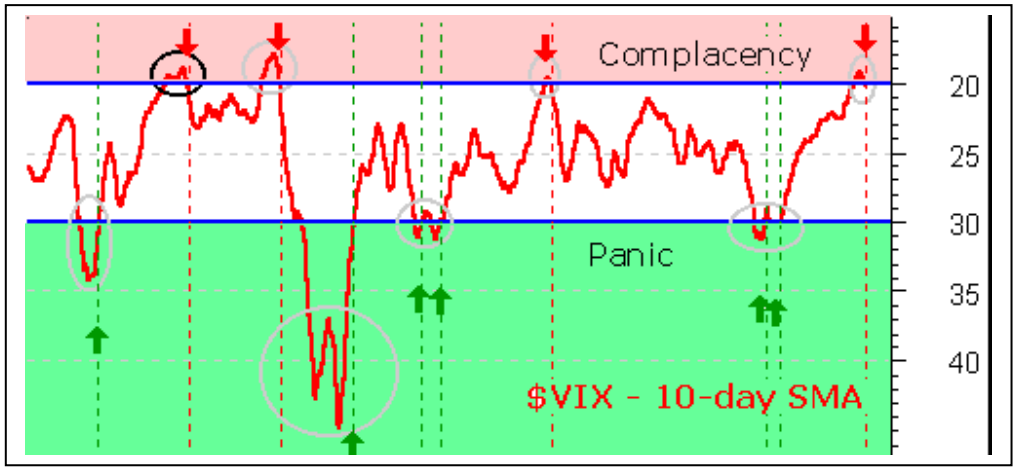
A different twist on this would be a "weighted" moving average. This is calculated in the same way as what we just discussed, except that a higher weight is assigned to the most recent day and a progressively lesser weight to previous days. For example, if you were calculating a 10 day moving average, 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 available on a daily basis by going to www.cboe.com and selecting "Market Data."



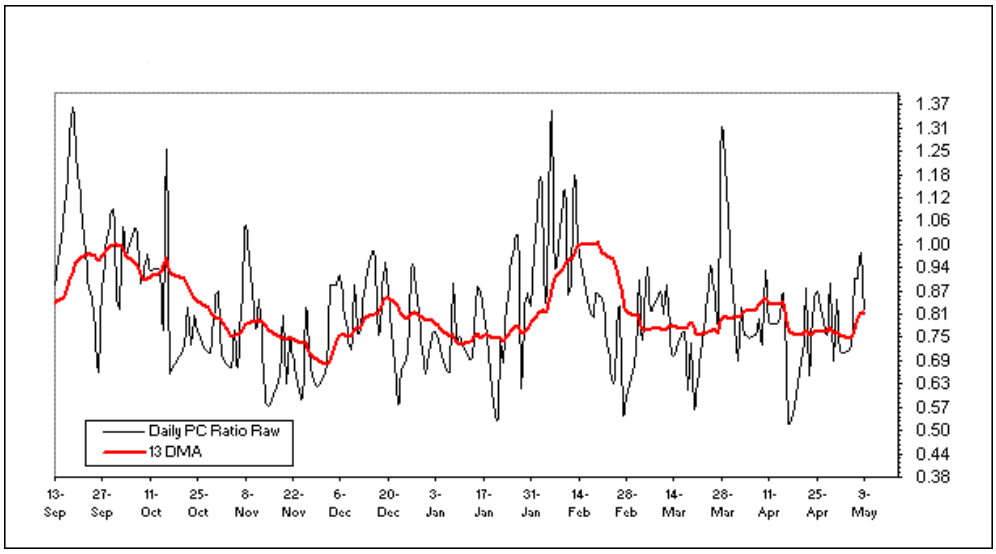

The VIX

## 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. This ratio is also available 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 are 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.

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. According to its founder, John Bollinger, Bollinger Bands can be used for about any financial instrument, including individual stocks and ETFs, including the QQQ and the DIA.


Bollinger Bands

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 brokerage firms allow you to build custom charts of securities, including the QQQ and the DIA, 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 brokerage or through StockCharts.com you can build a chart for the QQQ or the DIA 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 many different technical indicators on 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 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 MARGIN FOR HIGHER RETURNS*

# 10

Some investors are prepared to take more investment risk than others. One of the higher risk strategies for the aggressive investor is buying securities on **"margin**." This is a strategy that would not be suitable unless the investor fully understands how a margin account works and accepts the inherent risks. But for those willing to assume this risk, it is possible that there may be a time when the outlook for option writing is so favorable that an aggressive investor would consider leveraging in order to obtain superior returns.

A margin account is a brokerage account component that has been pre-approved by the brokerage through a margin agreement to permit an investor to purchase securities on credit and to borrow on securities already in the account. Once approved, this borrowing capability is permanently in place unless you have it removed. All the investor needs to do is place an order to purchase additional securities within the approved account. The broker handles everything automatically. Interest is charged at favorable rates on any borrowed funds during the time that the loan is in effect. As of this writing, interest rates on margin loans run from approximately 4% to 8%, depending on the amount borrowed.

When you buy on margin you buy securities partially with your own money and partially with credit your broker provides. Shares of ETFs, including the QQQ and the DIA, are marginable, unlike shares of mutual funds. Buying on margin generally allows you to buy up to twice as much with the amount of money you have than if you just used your funds alone. So, if you have $25,000 in cash or securities in your account, you could purchase up to $25,000 of additional securities with margin borrowings. If all goes well, you would have twice as much gain by using margin than without it, less the interest cost. The other side of the coin is that if the securities go down, you can potentially lose twice as much as you otherwise would have lost. So, as with most investment ideas, there is both reward and risk. For people who are comfortable using debt to leverage investments in the QQQ or the DIA, the relatively low rate of interest you pay on the loan to the broker can be earned many times over if you are regularly collecting option premiums and if the share price is stable to increasing. If the price goes down, however, not only have you lost twice as much, but you are paying interest for the privilege.

The further risk is that if the market goes down considerably, you would at some point receive a **"margin call"** from the broker to add more money or securities to your account, or they would need to sell you out…most likely at a

loss. Obviously you would not want to use margin unless you have a quite constructive option writing outlook going forward.

For investors willing to assume more risk, purchasing additional shares on margin may fit into an option writing strategy. By borrowing on margin to buy the QQQ and the DIA and then writing covered call options on twice as many shares, it is possible in a flat to rising market to earn substantially more on your investment than if you just invested your own funds. In a down market, it would be a disaster. If interested, contact your broker to establish a margin feature on your account and for specific margin requirements applied by your brokerage firm.

The following shows the purchase of 500 shares of DIA in a regular cash (non-margin) account and writing calls:

| DATE--------> | | 9-May | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| X | X | X | | X | X | | X | X | | CAPITAL | | ANNUAL | BREAK- |
| CO. SYM. | # SHS. | SHARE PRICE | MARKET VALUE | OPTION EXPIR. | STRIKE | DAYS | OPTION SYMBOL | PREM. | $ PREM. INC. | APPR. OR (DEPR.) AT STRIKE | ANNUAL YIELD | YIELD W/ CAP. APPR. OR (DEPR.) | EVEN PRICE OF DIA |
| DIA | 500 | $85.81 | $42,905 | 20-Jun | $88.00 | 42 | | $1.40 | $700 | $1,095 | 14.18% | 36.36% | $84.41 |

With the DIA trading at $85.81 the investor wrote five June $88 calls and received $700 in premium income for an annual yield of 14.18%. In addition, there is $1,095 of additional appreciation opportunity ($88.00 - $85.81 x 500). If the shares are called away at expiration, the annual yield with capital appreciation would be 36.36%.

Now let's look at the effect of margin borrowing. An additional 500 shares would be purchased by borrowing. If the same call contract were then written for 1,000 shares (10 contracts), the amount of premium income would double to $1,400 and the capital appreciation opportunity would also double to $2,190.

To compare the annual yield on the combined cash and margin shares, we would need to also subtract the interest expense from the premium income. If the investor were paying interest at a 6% rate, the interest expense during the option contract term would be $296.22 ($42,905 x .06 x 42 days/365 days). Subtracting the $296.22 from $1,400 leaves $1,103.78, which is a 22.36% return ($1,103.78/$42,905 x 365 days/42 days) on the investor's original $42,905 investment.

If the shares were called away at expiration, the investor's return would be 66.72% ($1,103.78 + $2,190/$42,905 x 365 days/42 days).

The effect of this is that for a cost of $296.22 the investor has the opportunity to earn an additional $700 in premium income and perhaps additional capital appreciation of $1,095. At the same time, should the shares head south, the investor faces the risk of double the losses he would have otherwise incurred, plus the interest cost added to it.

If an investor absolutely knew that from this day forward the market would be either flat or increasing (anything other than going down), it would be to his advantage to borrow as much as possible in his margin account, as he could not lose. Few investors either have that knowledge or are willing to suffer that risk. Such is the stuff of which investment fortunes and misfortunes are made.

# 11

## *BROKERAGE ACCOUNTS AND COVERED CALL WRITING*

As stated earlier, purchases and sales of ETFs and covered call 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. 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. Since you will be incurring additional commissions as a call writer, it is 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 and utilize a cash management type of account.

Again, in the event you do not have a computer and/or do not have Internet access, many public libraries today offer free high-speed Internet service, which can be used to obtain quotes, complete the data for the Excel® templates and do your trading through an online broker.

### ONLINE DISCOUNT BROKERAGES

You need to do your option trading with the brokerage where you have your shares on deposit. With just a little experience you will find that trading ETFs and call 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 QQQ and DIA shares you own so that you can make decisions on your call 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.

## COMMISSIONS

The discount brokers generally charge far less than full-service brokerages, 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 brokerages charge for option trades based upon two components. First, there is usually a flat fee per transaction. This is why it is more cost efficient when you trade a larger number of call 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 ETF or 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 calls of the QQQ or the DIA using a limit order the commission would be $22. The larger the number of contracts traded, the smaller the commission as a percentage of the premium collected.

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

Commissions on option trades tend to be higher than the discount brokerage commissions charged for an ETF purchase or sale, which often run between $7 and $30, depending on the broker. But in recent years, fees on options trades have come down significantly and represent only a very small percentage of the call option writing income you will be collecting. As you write more and more call option contracts, your brokerage firm will collect more fee income from you than if you were just the casual ETF or stock trader. It should be a win/win situation for both you and the brokerage. You may be in a position to ask them for a favor or special service now and then. Maybe they will even give you a free trade on occasion.

There are many online brokers such as Charles Schwab & Company, E-Trade, Fidelity Investments, Scottrade, TD Ameritrade, and on and on. An investor should be able to go to the Web site of any of the online brokerages and check out the fees for ETF and option trades very easily. Or, a phone call could be made to get the same information.

The "QQQ_calls" and "DIA_calls" templates we e-mail to you are used to select option alternatives and can be easily customized to include all ETF and option fees charged by your broker in the return calculations. Just add the appropriate charges your broker assesses to the spreadsheet to the right of the calculations.

Both personal and IRA accounts are eligible for covered call writing as long as you are approved for option writing by your brokerage.

There are two things important to focus on in conjunction with writing covered calls through your brokerage account. The first is getting the information you need to complete the Excel® template so you can make your decisions on which calls to write. Second is the process of executing the option transactions. The rest of it takes care of itself. When you write covered calls your broker will credit the cash to your brokerage account the next business day. All of the mechanics occur automatically. Not only will the cash be put into your brokerage account 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. And, if you have a margin loan balance, the money credited to your account from the premium income and any share sales would automatically reduce the loan balance.

## THE OPTION AGREEMENT

There is one critical piece of paperwork that will need to be completed before any option writing can be done. You need to sign an **"Option Agreement"** for each account you have with your broker so that you can trade covered call 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 covered calls 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, are very conservative. This booklet reviews it all. It is also available online at www.cboe.com.

The purpose of the agreement is to help assure the broker 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 covered calls. 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 covered call options. 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, along with

any other investment objectives you may have, which is consistent with writing covered calls.

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 fill in all of the columns that have an "**x**" at the top. After you have entered the ETF name, ticker symbol and the number of shares onto the Excel® template, you are ready to get into the option writing part.

If you look at the bottom left-hand corner of the Excel® template you will see a progressive list of monthly option expiration dates. You should select the dates you want, one at a time, by placing your cursor over the first date, pressing the "Copy" button. Then go back to the "calls" worksheet you are working with by clicking on the "calls" tab at the bottom left-hand corner of the worksheet and then placing the cursor in the appropriate cell under the "Option Expiration" column. Then press the "Paste" button and the date will be there. You should do that on a separate line for each option expiration date you want to consider. You can also type in the date manually. 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 ETF if you have multiple expiration dates and strike prices you want to consider.

Once you have this information in the template, you are ready to begin looking up quotes. This may be done somewhat differently with various online brokerages, but typically what you do is request a quote on the QQQ or the DIA by typing in the ticker symbol. When you have the quote, you can then enter the current price information on the template in the appropriate column so it is up to date. When you are getting a quote, you should find the words **"option chain"** or some other reference to options near the quote. By clicking on this, their system should take you to a listing of all of the expiration dates and strike prices offered. Then scrolling up and down, you should be able to see the option ticker symbol for each option you wish to consider. As you scroll by them, note the ticker symbol for those you want and type in that information in the correct cell on the Excel® template. Again, if it is not obvious after a little searching how to find this, a call to the customer service center should get you the information you need. As an alternative, Yahoo! Finance, BigCharts.com, the Chicago Board Options Exchange Web site (www.cboe.com) and the CNBC Web site (www.cnbc.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 that generally provides real-time quotations.

After you have gotten this information for the QQQ or the DIA and the call option you have selected, your row should be filled up to the premium column on the template. Now get the premium quotes on the option symbols 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. Generally, when you are looking to do a trade on a call option, you can expect to make your trade at about the midpoint between the bid and ask, or perhaps a little bit closer toward the bid side.

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. Gathering all of this data may take awhile initially, but it will go quickly after you have done it a few times.

We will not discuss the decision making process again, as this was discussed in detail earlier. Of course your goal is to achieve your total return objective while obtaining some degree of diversity in your option expiration dates and basing your strike price decisions on how you think the QQQ or the DIA will be performing between now and the time the option that you are considering will expire.

## ONLINE COVERED CALL OPTION TRADING

So, after considering the alternatives, you have made a decision on a call option to write. At this point you are now ready to use the online brokerage 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 call 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" or "sell covered call," however it is termed by your broker. 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. Get this information from your template.

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. 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 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 only 5 cents or less. While you will not be guaranteed that your order will be filled, you will be assured that if it *is* filled the price you will receive will not be less than the limit price you have set…and it may be more, depending on the best price available at the time.

So, you should click on "limit order" and then set a limit price you are willing to accept. Since your transaction will not be completed for less than the limit price, you need to be sure that the amount you set is either at the midpoint between the bid and ask or perhaps even a bit lower to give greater assurance that the transaction will be completed. For example, if the bid on your option transaction is $1.10 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. Normally with option contracts on the QQQ and the DIA there is sufficient liquidity that the spread between bid and ask will not be that wide.

If you were to put in a limit price that is a bit higher than the midpoint between the bid and ask, it would probably take a rise in the price of the underlying shares, and correspondingly the option, before your trade would be executed. Since there would be 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 declined, then the option price will have also declined and your order will not be filled unless the price of the shares and the option rise again. The 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.

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 yields 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 call contracts, it is possible that only part of your order might be filled…say two contracts, with the order for the other eight not filled if the price of the option should quickly back off of your limit price. If you have to go in later and alter your price to fill the rest of your order, or if the balance of your limit order is not filled until a later date, your commission costs would go up. These trades would be treated as separate transactions for commission purposes.

The "all or none order" may be a good idea 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 brokerages will indicate the number of contracts offered at the bid price. 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, 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 brokerages 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 just seem slightly 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. When you have written covered calls, the calls 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 march to the expiration date.

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## *TRACKING PERFORMANCE RESULTS*

Now that you are ready to start your option writing program it is important that you have a mechanism to keep track of how you are doing on an ongoing basis compared with your objective. To accomplish that, when you initiate your e-mail request for the Excel® templates another template will be e-mailed back to you…a file called "results." The following is a sample of how you would use this file template.

### RESULTS TRACKING TEMPLATE

**SORTED BY TRADE**

| X | X | X | X | | X | X | X | | X | X | X | X | TOTAL | ANNUAL |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | SHARE | MARKET | TRADE | | | | OPTION | | PREM. | STOCK | $ | % |
| ACCT. | STOCK | SHS. | PRICE | VALUE | DATE | EXPIR. | STRIKE | DAYS | SYMBOL | PREM. | INC. | GAIN/LOSS | RETURN | RETURN |
| PER | QQQ | 1,000 | $28.28 | $28,300 | 9-May-03 | 18-Jul-03 | $29.00 | 70 | | $1.15 | $1,150 | $0 | $1,150 | 21.20% |
| IRA | DIA | 500 | $85.81 | $42,915 | 9-May-03 | 20-Jun-03 | $88.00 | 42 | | $1.40 | $700 | $1,095 | $1,795 | 36.36% |
| | | | | | | | | | | | $1,850 | $1,095 | | |

The appearance is reminiscent of the "QQQ_calls" and "DIA_calls" templates, but it serves a different purpose. Again, the "**x**" at the top in some of the columns means you need to type in that information. For the rest of the columns the template makes the calculations. There are a few additional columns with an **"x"** in this template. To start you need to enter the account type in the first column. This is particularly handy, as we will see in a minute, if you have more than one account. You may wish to enter "PER" in this column for transactions having to do with your taxable personal account and "IRA" for an IRA account. You can use whatever designation you wish, as long as you are consistent. If you have only one brokerage account, you could leave this column blank. In the column before the expiration date, you enter the date of the trade. If, for example, the trade date was August 15, 2014, you would type 8/15/2014 into the cell. You also need to enter the premium per contract and the net amount of the premium income as shown in your brokerage confirmation. Also, if your shares are called away from you or otherwise sold, you need to determine the gain or loss (the amount of capital appreciation or capital depreciation realized based upon the price of the shares on the date when the calls were written) and enter that information in the "Stock Gain/Loss" column as well. That is all there

is to it. In the unusual circumstance that you bought back your call options prior to expiration, you would need to reduce the amount of premium income you received by the amount you paid to buy back the options.

You can see in the first example that this option writer wrote 10 call contracts of the QQQ July $29 calls in a personal taxable account at $1.15 per contract and received $1,150 in premium income. As the option expired unexercised, there was no sale of the QQQ shares and therefore no gain or loss. The annualized percentage return was 21.20%. In the second example, the option writer wrote 5 call contracts of the DIA June $88 calls in an IRA account at $1.40 per contract and received $700. At expiration the ETF was priced above $88, so the DIA shares were called away. The investor's gain on the shares during the period of this trade was $1,095. In this case, the dollar return column shows the combined premium income and gain on the DIA shares of $1,795 for an annualized percentage return from the premium income and capital appreciation of 36.36%.

You will see that at the top left hand corner of the worksheet it says "Sorted By Trade." Excel® has a sorting capability that can be useful to you advantage with this template. You will see on your computer screen at the bottom left of the worksheet on the template itself that there are four tabs labeled "Trade Sort," "Expiration Sort," "ETF Sort" and "Account Sort." The "Trade Sort" template is the one we have been talking about so far, and it should be used as your primary results template for entering data. The others are available for your use if you decide it is useful for you to be able to look at your results information sorted by expiration date, or by ETF, or by account. Obviously the last one would only apply if you have more than one brokerage account where you are writing options.

The best time to enter the information into the "Trade Sort" template is when you get your broker confirmations in the mail and when options expire. Or, you can get the information online after the trade is executed. Here is what to do if you want to use the other sorting methods. Start by going to the "Trade Sort" template and highlight all of the data by placing the cursor in the upper left-hand cell where your data starts. Click on your mouse button while holding it down and drag the cursor to the right and down until it darkens all of the data cells on your worksheet. Then let go of the mouse button and all of your data will be selected. Now click on the "Copy" icon at the top and then click on the tab at the bottom you wish to use. It will take you to that tab, which has the same appearance as the worksheet you see here. Point and click the cursor into the same cell address in the upper left-hand corner as the cell from which you started copying the data. Then all you have to do is click on the "Paste" icon and all of the data you copied will be pasted into the new worksheet. The tabbed worksheets have been formatted so that they will sort according to what the tab says. All you need to do now is keep the data highlighted and then click on the word "Data" at the top. A drop down menu box will appear. Click on "Sort" and

another drop down menu comes up. Just click on the "OK" box at the bottom and your data is sorted.

It can be useful to look at your data by ETF, for example, so that you can see how many times you have written options on the QQQ and the DIA and how it has worked out for you. That will give you a very good feel for the market over time. You can also enter data into the other tabs and sort by expiration date or by account type.

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## *TAXES AND COVERED CALL WRITING*

When you have success with a call 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.

As we have said earlier, when you write call options you receive the premium income up front into your account the next day to use as you wish. The good news from a tax standpoint is that *even though you have the use of the premium income immediately, it 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 on the options you are writing. That's not the only good news.

### INVESTMENT INTEREST EXPENSE DEDUCTION

Buying shares on margin and writing options on them was discussed earlier. If you do that, and if you itemize deductions on your tax return, you should be able to take the investment interest expense as an itemized deduction up to the combined amount of any interest income and dividend income you report. The premium income from option writing is capital gain, not interest income. If your investment interest expense exceeds your combined interest and dividend income, then the excess interest expense can be carried over as a deduction to the following tax year.

### DEFERRAL OF TAXES TO A LATER TAX YEAR

Let's say that you wrote options on the QQQ with a September expiration date and the options expired without your shares being called away. 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 to select one of the call options with an expiration date in January or later of next year. That way the premium income you receive on those options now will not be taxed to you until the options expire, which would be in the next tax year. You have just deferred the income tax consequence into next year, even though

you have the money 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 calls is **"capital gain"** for tax purposes. The bad news is that the premiums are almost always **"short-term"** capital gain regardless of the length of time the call was outstanding. That means your option writing income is usually taxed at the same rate as if it were **"ordinary income."** You will need to report your option trades on Schedule D of Form 1040. If calls 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 your stock is called away at expiration, add the amount of gain to the proceeds you receive for your stock and report it as one transaction.

If you would decide to close out your option position by buying back the options, any gain or loss would be short-term capital gain or loss in the year that the position was closed out. For example, let's say you wrote options in July that were not due to expire until the following year and you received $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 used the term "capital appreciation" frequently so far, and now we are referring to "capital gain." There is an important difference. When we are talking about capital appreciation, it is an investment term that simply means an increase in value of a security, such as an 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 an ETF or option, is sold. It occurs when the proceeds from the sale of an ETF or an option 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 an ETF you took a **"capital loss"** on, you could use that loss to offset some of the gains you realize on your option writing income. If you had some gains from writing call options, you could also use prior year losses carried forward to offset the gains on the option income. And for any current **"unrealized loss"** in any of your shares, you could sell those shares and use the realized capital losses to offset option writing income.

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

The tax effect may be different, and beneficial to you, if your calls are assigned at expiration on an ETF you have held sufficiently long to qualify it for long-term capital gain treatment. If you sell calls and the calls are assigned, the strike price at which you sell your shares *plus* the premium you received becomes the sale price to determine the amount of gain or loss. Let's say for example that you paid $10 per share several years ago for your QQQ shares. The QQQ was trading at $30, and you had written call options on it for a premium of $2 per share at a strike price of $33. On expiration the shares were called away from you at the strike price. Your gain would be $33 minus $10 plus $2, or $25 per share. Whenever your shares are assigned, the amount of gain or loss and whether it is short-term or long-term depends upon the cost of the underlying shares delivered and the holding period of the shares. What is meant by "holding period" is the length of time you have owned the shares. In this case, because you had held them for a long enough time period to have the sale qualify for **"long-term"** capital gain treatment, the gain on your shares *and the option premium* will be long-term capital gain at a favorable tax rate. So, this is the exception when an option premium is taxed as a long-term capital gain rather than a short-term capital gain.

Here is the rule. Writing an at-the-money or an out-of-the-money covered call does not affect the holding period of the underlying shares for purposes of determining whether any gain is long-term or short-term if the ETF is eventually assigned. If, however, the call writing transaction were an in-the-money transaction, it would not qualify for this special treatment, even if the underlying shares would qualify as a long-term holding for tax purposes. We would therefore not want to write in-the-money calls on shares with a gain that we have owned for more than one year.

## THE WASH SALE RULES

In Chapter 7 we discussed the desirability under some circumstances of writing in-the-money calls. Since writing such calls increases the probability of your shares being sold at a loss (but of course the large premium income received at the time the calls are written more than compensates for the loss), this brings up a potential tax complication when we are using QQQ and DIA shares exclusively, as they will likely be repurchased over and over if you are following the strategy suggested in this book. We need to be careful that we do not violate the **"wash sale rules. "** Part of these tax rules state that if you sell your shares at a loss and buy them back within a 30-day period before or after the loss sale date, the loss cannot immediately be claimed for tax purposes. The loss must be added

to the cost of the newly purchased shares instead pursuant to IRS Publication 550.

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

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

If you do construct your portfolio using only shares in the QQQ and the DIA, you have two choices with respect to either of these securities if they are called away from you and you incur a loss on the shares:

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

or

(2) Sell any shares in the security generating the loss prior to the end of the year and do not repurchase any shares in that security for at least 30 days following the sale (again, a similar but not "substantially identical" ETF could be purchased within 30 days and calls written).

## THE CHALLENGE OF WRITING CALLS ON HIGHLY APPRECIATED SECURITIES

Regarding capital gains taxes, we are used to having the certainty of timing the realization of them so that our best tax interests are served. When we are writing covered calls on securities we own that have grown in value substantially, we never know exactly when that big capital gain might be triggered through an exercise of the option causing a sale of the shares.

Since the strategy in this book employs the use of two ETFs exclusively, and since the investor would be continuously writing covered calls on these ETFs, it is probable that the shares of either or both of them will be called away from time to time. Therefore, you may find that you do not become a holder for a period long enough to qualify them for long-term capital gain treatment upon sale (twelve months under current tax regulations). In the event, however, that you do build up a sizeable capital gain in an ETF, or any security for that matter, you need to be prepared with strategies to avoid realizing the capital gain, if desired, when you have written calls and they are likely to be exercised on expiration.

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

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

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

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

## ROLLING FORWARD

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

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

The QQQ and the DIA have not been in existence long enough to have created significant long-term capital gains, so we will consider a hypothetical security for purposes of example. Let's say you bought shares of AAA ten years ago. You now own 1,000 shares and your cost basis, adjusted for several splits, is only $5 per share. About 2 ½ months ago the market value of the shares was $50 per share, or $50,000. At that time you sold ten call contracts on your AAA shares at a strike price of $55. Since then two months have passed and the options expire about two weeks from now.

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

Not wanting to pay the capital gains taxes at this time, you decide that rolling forward is a strategy that makes sense for you. You get quotes from your broker on calls with the same strike price, but with a longer expiration date. There are several option expiration dates available to you. Which one you select is purely a matter of preference and planning. After review, you decide on the contract at the same strike price and with an expiration date in about 6 ½ months. If your ETF were called away at this new expiration date, it would place the capital gain into the next tax year, which would be more acceptable to you. Of course, it is always possible that the ETF price may decline below the $55 strike price by the new expiration date, in which case you would keep your ETF and the new option premium income. There would be no capital gain realized on the ETF and therefore no taxes to pay in that event…just tax to pay on the short-term capital gain from the premium income.

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

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

This sounds a lot more complicated than it really is. Let's first consider the sale and repurchase of the first option. You sold the initial calls for $2,500 and repurchased them for $3,500 for a loss of $1,000. This loss can be used to offset other capital gains you 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 called away at the new options' expiration you would still have a $50,000 long-term capital gain to pay tax on.

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

If the price of the shares just kept going up, there are a couple of choices you would have. First, you could 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 higher the price rises, however, the more likely it becomes that your ETF will eventually be called away from you at the $55 strike price at some point. So, if your ETF keeps rising, this strategy is simply one of deferral of the capital gain recognition to a time when it may be more acceptable from a tax planning standpoint.

## ROLLING UP

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

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

combination of rolling forward and rolling up. A lot depends on your belief about the direction the market will take. Unfortunately, of course, we cannot always predict the future.

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

You can see why it is always best to write options on shares that you do not mind being called away from you at expiration. You just let them be called away and accept your gains rather than having to chase a rising share price by rolling forward and/or rolling up. Nonetheless, these are workable ways to handle the writing of call options on highly appreciated securities when the price of the shares rises beyond the option strike price. It is best to have a plan at the very start so that if the share price increases significantly you know in advance what action you will want to take.

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

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

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## *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 strategy of all…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.

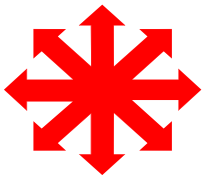
There is evidence that the word is starting to get out to individual investors about covered call writing. Articles are appearing in magazines, guests are invited to speak on CNBC TV (the cable stock market channel) on the subject, and Web sites are being created, sometimes offering outlandish claims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

Clearly past market doldrums have taken their toll on individual investors as they frantically seek out alternatives to "traditional" investing, having lost 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.

Few good new investment ideas are apparent. While writing covered call 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 covered calls on equities may well be one of the few ways to achieve double-digit investment returns for many years to come.

Writing covered calls on two of the most prominent ETFs, the QQQ and the DIA, offer particular advantages to the investor. These two ETFs are highly liquid, trading millions of shares per trading day. Their call options also are highly liquid, particularly when compared with many other stocks and ETFs offering options. The underlying shares representing the QQQ and the DIA are some of the most attractive securities available to investors, namely the stocks comprising the NASDAQ-100 and the Dow Jones Industrial Average.

By using these two securities exclusively for all or a segregated part of a portfolio, investors can eliminate the time consuming process of researching companies for investment ideas and still have the diversification so necessary for an equity portfolio. Time saved can be well spent in doing some technical analysis to assist in timing decisions for writing covered calls. It has the potential to improve upon the double-digit returns that investors can already expect to realize from covered call writing.



# GLOSSARY

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

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

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

**AT-THE-MONEY** – The strike price and the market price of the underlying 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 an ETF or option.

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

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

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

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

**CAPITAL GAIN** – Occurs when the proceeds from an ETF or an option sale is greater than its cost. When writing covered calls, for example, if you receive $3

per share in premium income and the calls expire worthless, your cost is $0 per share and the capital gain is $3 per share.

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

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

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

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

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

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

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

**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 calls are both fungible. All QQQ shares are the same and are interchangeable and all of the QQQ April $30 call contracts are the same and are interchangeable.

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

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

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

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

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

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

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

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

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

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

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

**MARKET CAPITALIZATION –** The total value of the shares of a security. It is calculated by multiplying the market price of one share times the total number of shares outstanding.

**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.

**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) an ETF at a fixed price (strike) until a specific date (expiration).

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

**OPTION CHAIN –** A string of option quotes for a specific ETF which includes every expiration date and strike price available for options on that ETF. This is typically provided by online brokers as a part of their automated quotation service to simplify the identification of ticker symbols for options and to facilitate obtaining quotes and executing trades.

**OPTION CONTRACT –** An agreement by an option writer to sell (call) or buy (put) a given ETF at a predetermined price (strike) until a certain date

(expiration). The holder (buyer) of the option is not obligated to exercise (act on) the option, but the seller (writer) of the option must perform the obligation if the buyer exercises rights under the option contract.

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

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

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

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

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

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

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

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

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

**ROLLING UP –** Buying back a call option position and then writing a new call with the same 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. (Also referred to as "sell covered call.")

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

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

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

**SUPPORT** – Increased demand for 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 an 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.

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

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

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

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

# OPTION, BROKERAGE & ETF WEB SITES ON THE INTERNET

The following Web sites may be useful to those desiring basic information about options, discount brokerages, charts, technical analysis and ETFs, in particular the QQQ and the DIA.

## 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 brokerage 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 *Covered Call Writing with Qs and Diamonds*, Kadavy has also written books including *Boomer's Guide to Double-Digit Investment Income, Covered Call Writing Demystified*, *Covered Call Writing with Exchange Traded Funds (ETFs), Put Option Writing Demystified*, *Writing Uncovered Put and Call Combinations*, *Short Spider Straddles*, *Put and Call Option Writing for the Investment Advisor and Financial Planner, Finding Financial Freedom* and *The Book of World-Class Quotations*: *The Best of the Best Quotations on Earth*.

His books are available on the Internet through Arrow Publications (www.arrowpublications.net) and Amazon.com.

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

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- Use of covered call writing on the Qs and the Diamonds, presenting both out-of-the-money and in-the-money writing opportunities to suit individual investors' needs.

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