The income "circle of life" using options

August 9, 2019

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Presentation Outline

- Circle of Life
- Selling Puts – Motivations and Objectives
- Cash Secured Put Example
- Selling Calls Against Long Stock
- Managing Covered Calls

Circle of Life

Options can offer investors an “alternative” to buying or selling stock:

- Alternative method to enter/exit stock positions
- Potential for improved returns on stock (selling options)
- Unique risks vs. stock needs to be understood
- Position management likely required

Motivations & Objectives

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Why Cash-Secured Puts?

- Do you **forecast** a temporary downturn in the market?
- Are you **bullish** on the stock or ETF?
- Do you want to own the stock below its current market level?

- ***Do you want to buy the potential dip?***

Characteristics of Cash Secured Puts

- Typically involves selling ATM or OTM options
- **Assignment** is potentially welcome and desirable
- May be possible to buy shares below current market price with funds set aside
- Can potentially earn additional interest income on funds set aside
- If assigned, investor now has risk of owning the stock or ETF

Cash-Secured Put Example

Writing OTM Puts
Primary Objective: Buying Stock

Date: March 20

XYZ Options			
		Calls	Puts
May	75	$8.20	$1.30
	80	$5.00	$3.10
	85	$2.70	$5.80
Jun	75	$9.00	$1.95
	80	$5.90	$3.90
	85	$3.60	$6.60

Data on XYZ:
Currently trading at $81.50
- Forecasted high = $86.50
- Forecasted low = $78.50

Your objective:
You'd like to buy XYZ stock
at $80 or less in about 3 months

Action:
Sell 1 XYZ Jun 80 put at $3.90

Not including commissions

OTM Cash-Secured Put at Expiration

XYZ at or above $80 → put worthless

Keep $3.90 premium as income

Return if put expires and no assignment

$$\frac{\text{Income}}{\text{Investment}} \quad \text{X} \quad \text{Time Factor}$$

$$\frac{\text{Put Premium + Interest}}{\text{Cash Deposit}} \quad \text{X} \quad \frac{\text{Days/Year}}{\text{Days to Expiration}}$$

$$\frac{\$390 + \$0}{\$7{,}610} \quad \text{X} \quad \frac{365}{90} \quad = \quad 20.8\% \text{ annualized}$$

Not including commissions

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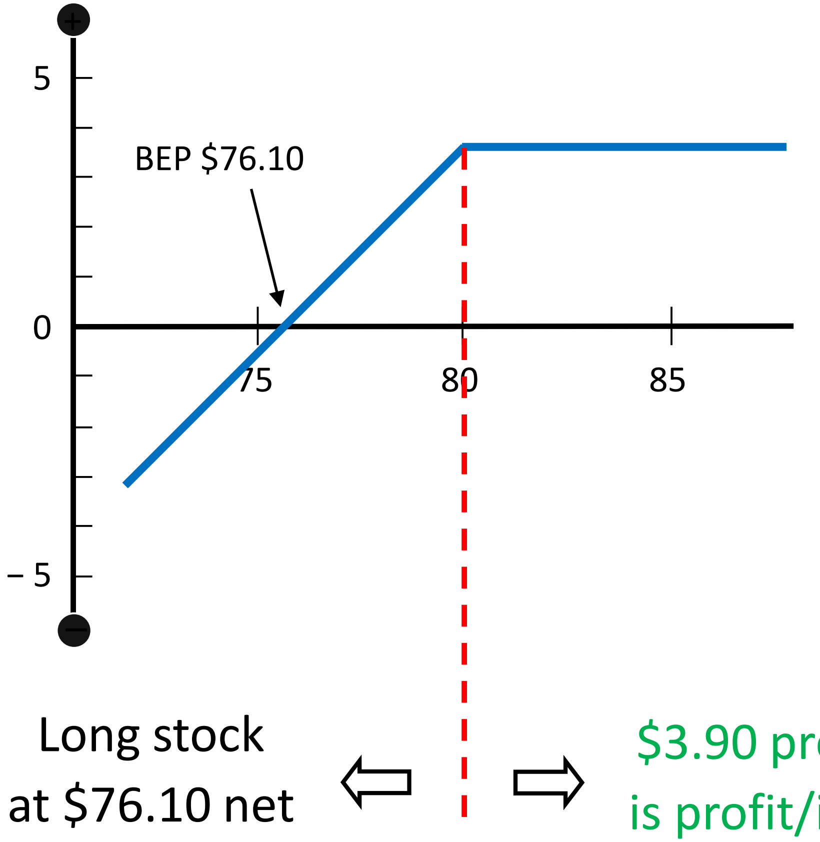
OTM Cash-Secured Put at Expiration



Long stock
at $76.10 net

$3.90 premium
is profit/income

Break-even at Expiration:

$80 – $3.90 = $76.10

Maximum Profit:

$3.90 premium received

$390 total

Not including commissions

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OTM Cash-Secured Put at Expiration

XYZ below $80 (let's assume $79) → primary objective met

Assigned → buy stock at $76.10 net

- If XYZ between $80 and $76.10 (BEP)
  - Stock bought for <u>less</u> than current market price
  - Unrealized profit as long as shares retained
- XYZ below $76.10
  - Stock bought for <u>more</u> than current market price
  - Unrealized loss as long as shares retained

Not including commissions

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Selling Calls Against Long Stock

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Why Write Covered Calls?

- Primary goal – increase returns
  - Call premium received and kept (assigned or not)
  - Generate <u>additional</u> income (over any dividends)
- Investor’s forecast
  - Neutral to bullish on the underlying stock
  - Within a small price range over strategy’s lifetime
- Call premium’s limited downside benefits
  - Lowers stock’s break-even point (BEP) by call premium amount

Covered Call Example (OTM)

You now own 100 XYZ shares currently trading at $79.00

- Effectively own shares from $76.10
- Looking to exit those shares & add on to our profit
- You have target sale price for stock of $82

Sell 1 30-day XYZ 82 call at $1.60

Total premium received = $160.00

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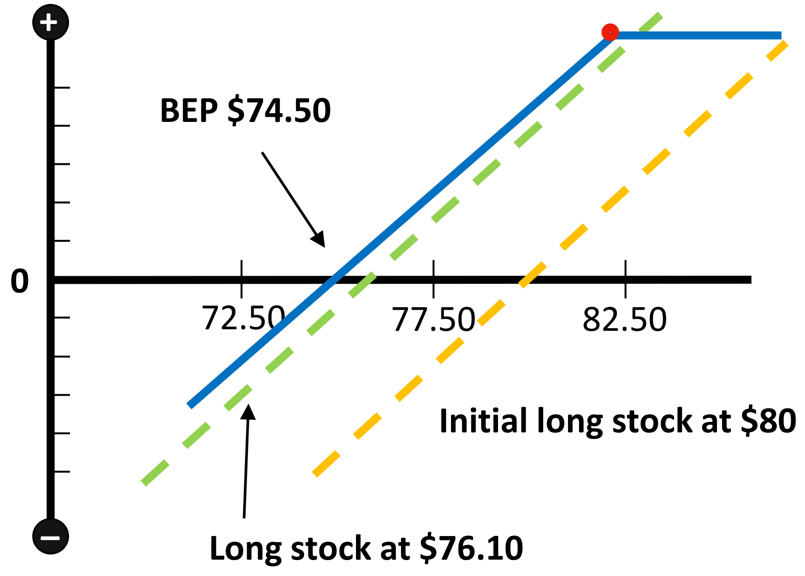
Covered Call Example (OTM)

Own 100 shares XYZ at $76.10

Sell 1 XYZ 82 call at $1.60



Maximum Profit if Assigned:
Effective Stock Sale Price –
Stock Price Paid
($82 + $1.60) – $76.10 = $7.50
$750.00 Total

Break-even at Expiration:
Stock Price Paid –
Call Premium Received
$76.10 – $1.60 = $74.50

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Comparison of Stock vs. Options Strategy

Shares were originally trading $81.50, fell to $79 and rallied to $82

Scenario:

A. Buy 100 shares for $80 and sold at $82
B. Sold 1 80 put at $3.90 (cash-secured put) and assignment resulted in owning 100 shares from $76.10. Next, sold 1 82 call at $1.60 (covered call) and upon assignment, effectively sold stock at $83.60

	A	B
Initial Investment	$8,000	$7,610
Gross Profit	$200	$750
ROI	2.50%	9.86%

Managing Covered Calls

Scenario 1

What should you do if XYZ rises above strike price prior to expiration?

A. Do nothing and wait for assignment.

B. Buy back the call and keep the stock.

C. Close the entire position by buying the call and selling the stock.

When should you choose between A, B, or C?

Market conditions can change, but…you should have a plan when you initiate the position.

Scenario 2

What should you do if XYZ is unchanged
at at expiration?

A. Write another call.

B. Sell the stock.

C. Employ another strategy

There is no “objective answer” to this question. Every investor must make an individual decision.

Scenario 3

What should you do if the price of XYZ begins to decline sharply?

A. Write another call (at a lower strike?).

B. Hold the stock.

C. Buy back the short call and sell the stock.

A prudent investor might use stop loss orders to protect against sharp declines in the underlying.

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