TRANSCRIPT

Strategy Basics: All about Calls

Presenters: Allen Helm; Edward Modla

Allen Helm: Thank you, everyone for attending today's session. We know your time's valuable and we appreciate you taking the time to join us today. My name is Allen Helm, I'm the regional brokerage consultant for Austin, north Texas, and Oklahoma. Our role as a group, there's quite a few of us nationwide, we cover the country as far as regional brokerage consultants. Our goal is to provide education and help our clients with their self-directed investment decisions. I'm happy today to bring our April event with Ed Modla from the OCC. Our first session today will All About Calls. We'll do a second session that will be All About Puts. And then our final session for the day, I'll host a panel with two special guests to go over evaluating underlying stock choices and options trades and we'll walk through how you would take a look at analyzing some ideas and some tools that we have as far making selections. I hope also you can stay with us for all three sessions. Keep in mind that you would need to enroll for all three sessions, so if you haven't done that, you can go back in after this session's over, enroll for those sessions. Just a few housekeeping items before we get started. There is a question link at the bottom of the page. You can type in and ask your questions there; we'll take some time today to go through some of your questions. There is also a survey. Please fill out that survey after the presentation. There's also some additional education materials that we send out and the survey is completely anonymous so if you would please take the time to do that. You can also download today's session. At the very bottom there will be a download link where you can download the sessions that we go through on those presentations that Ed's going to bring to us from the OCC. So, without further ado, I will introduce Ed Modla at the Options Clearing Corp. And Ed, if you could just tell us a little bit about your overall background and we'll kick today's presentation off.

ED MODLA: Sure, Allen. Thanks for the introduction and thank you to you and the Fidelity team for having me here today. This is what I love to do, talk options. I got started in this business 25 years ago -- hard to believe that 1997 after graduating from the University of Illinois with my degree in finance. Went right to the trading floor in the open outcry pits in Chicago. Also spent some time in New York as a professional options market mater. And I've been in the business ever since from different capacities as a broker and now as an educator working for OCC, but specifically the division of OCC that is investor education, also known as the Options Industry Council. So, happy to be here. As Allen said, this first session is going to focus entirely on call options. Not going to be every single thing you need to know about calls, but we're going to touch calls from different directions and hopefully provide something for everybody. If you're new to options or whether you have some familiarity and use them in your account today, hopefully there's something here no matter what your skill level. First, our disclaimers: options are a complex tool that need to be well understood before being used in a live account. And keep in mind as we go through the presentation today, the examples we use are for educational purposes only and should not be construed as advice or guidance. Here's the outline for today: we're going to start with definition and motivations for call options. What are they and why do investors use them? Then we'll take a look at transitioning those motivations into some basic strategies focused on the bullish market outlook. We're talking call options, and that is where the market bias is going to be mostly focused when you're using calls. So, covered call, long call, and then we'll look at a two-sided spread. And then a little bit about exercise and assignment, whether you're long a call option with the opportunity to exercise or short a call option subject to potential assignment. Which reminds me of the word short; I often like to outline this upfront. Many of you who might be familiar with the term short might equate that to mean short stock or short the market, which is bearish. That is a common definition for the term short. In the options space, there's another definition. It means something different, and it means you have sold an option that you had not previously purchased and are short the options contract. It has nothing to do with market direction, bullish or bearish, it just means you're short the contract. So, keep that in mind, that dual definition of short as it might come up through the presentation today. We're going to start with a definition of calls and before me and Allen get into that, I'm going to spend a minute right here and provide an analogy. For those of you who are new to options, this might be helpful to go through an analogy to identify and translate what call options are in a different way. So, here's the analogy: Let's say you are an investor who's interested in buying real estate and you find a piece of real estate that costs 300,000 dollars. You're considering buying this as an investment. And after some scrutiny, you decide that's just a lot of money; I don't want to spend 300,000 dollars, it's a lot of risk, and I'm not too sure where this price is going to go in value over the next year. So, you decide you're not going to do it, you're not going to buy this property. Subsequently, the seller comes to you and says, "Okay, how about this deal: if you give me 1,000 dollars right now today, that's mine to keep. I will allow you to buy this piece of property from me for 300,000 anytime you want over the course of the next year and then after a year, this deal goes away." So, now you have something else to consider. You think about it and decide, okay, I think that sounds good. I can pay 1,000 dollars out of pocket today. That money's gone, I can watch the value of the property. If it goes down, I just walk away and I lose 1,000. If the value goes higher, I have the opportunity to pay 300,000 dollars and capitalize on the appreciate of value. That symbolizes the functionality of call options which we're about to get into and define. I'll take this a step further. What if this landowner offered that same deal to a few other investors, not just you, but a few others? And someone else said, "Well I'll pay 1500 for that" and someone said, "I'll pay 2,000 for that." And you say, "I'll pay 3,000 for that." And the seller takes your 3,000 because that's the best offer. That's the functionality of price discovery -- market participants bidding up the value that they perceive in this deal and discovering a fair price. Further than that, since you have other investors involved now, if you purchase this deal and the value goes up, instead of actually buying the land, you could sell this deal back to those other investors for a price they're willing to pay after the price goes higher. That part speaks to the fundability of options -- the fact that you can buy them from someone on one exchange and then later sell them to someone else on another exchange. So, the function of call options, price discovery, and fundability all translate from that analogy. So, let's take that and move it into the definition of call options. And we're going to specifically be talking about equity call options today as opposed to index calls or index puts later in the second session. Equity call options are contracts -- well, they're not actually physical contracts. If you're wondering, can you send me the contract, can I read it, the answer is no. The verification of this contract is really accomplished in the industry through the execution of transactions at the exchange level through the brokerage statements that you get from

Fidelity and through the clearing process at OCC. There isn't a physical contract that can be read and scrutinized. But they are called contracts, where the buyer has paid the cost of the option upfront, that's a sunk cost paid immediately in order to have the right to buy shares of stock at a given price. And traditionally for standard option contracts, it is 100 shares of stock that underly the contract. The seller is paid the premium, receives cash into their account and in exchange for that payment is willing to take on the obligation to sell shares of stock at a transaction price, which is otherwise called the strike price. And this right and obligation of the buyer and seller exists up to and including the expiration date. Both of these pieces are chosen by the buyer and the seller of the contract and both of these pieces go a long way towards determining what is this going to cost. What is the price or premium of the option contract going to be? Now, there's a few motivations that we'll get to as we walk through our examples. Buying calls is more or less speculating to the upside; selling calls that you don't already own or shorting calls is a strategy used to generate income and reduce risk tied to a long stock position. So, two pieces there. And as we get into walking through these examples, Allen, when you talk to clients about call options, using options in this capacity, long versus short, where do you say investors tend to gravitate to towards two different objectives?

ALLEN: Yeah, I would say over the last several years with interest rates being so low, selling covered calls or if you own the stock and you're willing to deliver that stock maybe at higher prices somewhere down the road -- and keep in mind, to Ed's point, the contracts can be both shorter term and longer term. I mean, you can look at contracts out just weeks, you can look at contracts that go out months and even out years. But it's a way to generate income, and the vast majority of folks that I have talked to over the years will take a look at covered calls as a way to generate income off of positions that maybe they're willing to sell somewhere down the road in time, whether that's shorter term or longer term, and maybe think of it as possibly a limit order that we've put in on a stock. So, maybe the stock's at 100 bucks, we're willing to sell it at 120 a few months down the road and maybe we'd get a premium of five dollars for that to take on that obligation. And so, that's a way to generate that income into the account, particularly like in retirement accounts. So, it's an offset. Now, to Ed's point, I do talk to clients that use long calls that are maybe looking to speculate, and you can absolutely do that. So, you think XYZ's going to go from 100 to 200 dollars in the next six months, that's a way to possibly play that speculation or that movement in the stock. But primarily, Ed, the majority of the clients I talk to are using options to generate income or try to generate income. That's the primary source.

ED: Yeah, I see the same exact thing, the short call against the long stock as you've identified of the covered call. So, let's start there and then we'll look at long calls after that. But this covered call position, the potential to increase the returns in your account while you're reducing risk at the same time. Usually those things contradict each other. Can I increase my return and reduce the risk? Well, with covered calls, depending on how the stock plays out, you can actually accomplish that. Now, let's see what this strategy is all about. It consists of two pieces: selling one call option for each 100 shares owned. A few things to say about this: if you don't have 100 shares, then you really cannot sell a call option. Because remember what this means as we defined it upfront: selling this call option obligates the investor to deliver or sell 100 shares. If you didn't have 100, if you had 75 or 50 or 25 shares, then you would not be covered in the sense that your obligation is not covered by the shares owned. Of course, if you have 500 or 1,000 shares and you're looking at selling calls, you can choose how many you would like to sell. If you have 1,000 shares, you can sell up to 10. But you don't have to sell 10, you can sell eight, five, three, two, bring in some premium, bring in some capital cash into your account and still have shares that could capitalize on that upside. The other thing to say about this is just definition in terms of your covered calls. You may hear the term "buy-write" used as a substitute for covered calls. They mean the same thing as far as what the position consists of, long 100 shares, short one call, but the buy-write is generally understood to mean you execute both of these pieces at the same time, simultaneously, at one singular price. Buy 100 shares, sell a call, and pay a net debit and execute both pieces at the same time.

ALLEN: Yeah, and Ed, that's a great concept just to make sure -- especially people that are fairly new to options. So, if you have those stocks in the account already, then to Ed's point you would sell a covered call. So, let's say we had Apple or Google or Facebook or whatever in those account, Microsoft, and we had 100 shares that we could sell. You can sell a covered call or write a covered call, but you can also if you wanted to buy 100 shares and then at the same time sell a covered call against that, that's a buy right and that's a feature that you can do on Fidelity's tools to do that as one seamless trade. So, sorry to interrupt, Ed. Go ahead.

ED: Yeah, no, investors often confuse that because often they'll say covered calls and they'll actually you're referring to that simultaneous transaction. Which is fair and there's nothing wrong with it, but in a more traditional classic and specific sense, buy-write means simultaneous, covered calls more or less refers to having owned the shares, maybe they've consolidated, maybe they've started to rally a bit, and when you're ready to sell them, you start selling or what we say overlaying options by selling calls against shares that you had previously purchased. It's a little distinction between those two terms. Either way, you have this construction of long stock, short call with the motivation of capitalizing on some level of bullish outlook. It's important to remember this, that if you are bearish the covered call has risk to the downside. If you are neutral on the market, the covered call won't suffer but it's not completely consistent with a neutral outlook. The driving force of profitability as we'll see when we look at the example on the next slide is the long stock. So, a bullish outlook to a certain extent, more specifically up to the chosen strike price. If you believe the stock will rally up to a certain level and you're not so sure it's going to get beyond that level, that becomes a starting point on choosing your call option strike price. The level you think the stock will get to but not break through within your chosen timeframe. You will see that the risk reduction element here lowers the breakeven point. And all the time when you're selling options of any kind, you have to make sure you're evaluating the premium that you're receiving and make a decision: is this premium, is this cash that I'm taking in worth the obligations that I am going to also have to take on with respect to being short the contract? You have to think about both of those things when you're selling an option to make sure it's the right strategy for you. So, Allen, let's just go right to it and see what this looks like on a P&L graph. We have the two pieces, we own shares at 75 and let's just say we bought them there, we thought the stock was going to rally. It hasn't happened, we're still at 75, we're still bullish, but starting to get concerned about that downside so we overlay the 80 strike call. What does this do? Since we're receiving a dollar 80, our total cost is the net difference, or 73.20. Lowering the cost, lowering the breakeven point, that's risk reduction. You still have risk on the downside, but it's risk reduction and then this element here of obligating ourselves to sell these shares at 80 dollars, which means that far upside we cannot capitalize on. If this intersection is breached, for those of you looking at the numbers, this would intersect here at 81 dollars and 80 cents. Above that level the long stock would outperform the covered call position. Now, Allen, options are not set-it-and-forget-it tools, so as we look at say the covered call position here when it comes to monitoring overtime as the stock might be moving around, what thoughts do you communicate with clients about monitoring positions and position managements with this strategy?

ALLEN: So, you know, clients, when we're looking at these types of strategies, you probably don't want to do covered calls on stocks that you've held for 20 years that maybe you have a cost basis of two or three dollars and then all of a sudden you're selling shares at 80. Maybe you do, but you have some pretty big tax gains, so that's something to think about when you're looking at covered calls. The other thing to consider is, to Ed's point in the diagram, do you believe that the stock will cap out maybe at that breakeven point? So, if we take in that dollar 80, and are we going to cap out, and is that stock going to go from 75 maybe to 85 or 90, we would eventually be locked in and miss out on that upside gain. So, real life story, Ed, I've got a stock that I bought at 65 bucks, I wrote covered calls on it for the last six months, I actually wrote a 75 call on this example, the stock's at 92. Well, I'm capped out. I've made money on the position, but I didn't make as much if I would've just left it alone and not sold the covered call. So, you've got to think about that, but on the flipside of that, I took in a lot of premium over that six, seven months, which also then reduces some of the downside risk as you take in a dollar 80, let's say three or four times in a timeframe. So, that adds up too. So, you really need to evaluate those individual stocks and whether you could potentially lose those and whether you're okay with doing that. And maybe you have 1,000 shares. Well, you don't have to do all 1,000 shares; you could maybe do half the position or a third of the position and leave the other. Or you could stagger even; you could write the covered calls at 75, 80, and 85 and maybe stairstep those up. So, those are the kind of conversations we have with clients, Ed. And having done it myself, it can sometimes be painful when they get away like that. So, anyways. My wife always tells me, "Shut up, you made money, so I don't want to hear it."

ED: Making money, you can't complain whenever you're putting money in your putting money in your pocket.

ALLEN: But it hurts, Ed, it hurts. (laughs)

ED: Yeah, but those are excellent points and you're right. The strategy is very popular, widely used, but there are some things to consider, tax implications that you touched on. And there's this fact that you are obligated to sell shares at that price. Many investors, they might think, well, I don't want to sell these shares, I want to keep the stock but I also want to sell the calls. You've got to be careful there. You are taking on that obligation, if you go too far up in your strike price selections, you say, well I'm not going to sell 80 because I actually might lose the stock, I'm going to choose 85, 90, I'm going to go way up. All of a sudden that premium starts to shrink and back to that motivation and considerations that we showed earlier, the premium has to be worth taking on that obligation. If the stock rips higher and goes through 90 and you're giving away your shares and you only brought in a dime or a quarter for that option, was it worth it? So, you have to consider a few things but certainly (inaudible).

ALLEN: Well, the other thing, Ed, that clients, especially if you're fairly new to it, you could always do one contract to start out and kind of test the waters. So, you don't have to do all of the positions. And the other confusing thing that happens is I think clients think, well, I sold a contract at a dollar 80, I'm kind of locked in to not being able to do anything, and that's just simply not true. If you sold that contract at a dollar 80 and now it's only worth maybe 80 cents, you could buy those contracts back and close that obligation out. So, a lot of clients that are new to that just don't understand.

ED: Exactly. Yeah, that risk of losing the shares that you don't want to lose really is most prominent when the shares rally sharply higher very quickly well above the strike. And you're right, Allen, when the shares rise gradually, if time is passing and they approach that 80 level, there is the potential to take some action and remove your obligation by closing up the position. So certainly, a great, popular strategy, but certainly more to consider as you implement it into your live account. Let's shift gears now, Allen, and look at this long side of buying calls in a few different ways. First with the long-call position. It's very simple, you're just buying a call option, no other piece to it. Certainly, if you have the right to buy shares at a particular strike price, then as the share price rallies -- and that would have a positive influence on the value of your call option, I chose those words carefully, positive influence, because when you buy calls or when you buy options, the element of time is working against you and potentially the perception of future stock price movements could also be working against you. For those of you so inclined, I'm referring to the implied volatility of options, which we're not going to get into today, but there's multiple factors that are involved in the changes in option premium. Stock price is one of them and for the long call, a bullish outlook or bullish move is what you're looking for instead of buying shares. If you buy shares, (inaudible) 100 shares, it's going to cost some money. That long call is a much lower cost, but as we'll see you give up something in order to get that lower cost of entry. And long calls, I don't mind saying it's not easy to buy options and be profitable. It's difficult to have a high batting average because it requires the direction that you're expecting the stock to move to be correct, but also that element of time. The timing of the share price movement must also be correct. The P&L graph here is very simple; there's not much to it. With a long stock position potentially at 90, you have your 90 strike call option at 2.05 to compare a buying the right to purchase shares at 90. The breakeven point, I'll say at expiration, your breakeven point is 92.05. All these P&L graphs you're going to see today are drawn with the expectation that we are at expiration. Very quickly, the reason why that is is because prior to expiration, given a certain stock price, we cannot precisely calculate what the option will be worth. We don't know what implied volatility might be in the option. We don't know what the perception market participants might have and how volatile this stock might be for the remaining time in the contract. So, it's an inexact science. At expiration, it's an exact science. We know exactly what the option is worth given a stock price, so this P&L graph drawn at expiration. Allen, what comes to your mind when you're looking at this risk profile, any thoughts on the long call?

ALLEN: Well, so a couple of things to think about on this. As a client when you're looking through this, we can buy 100 shares at 90 bucks or whatever the price of the stock is so what the outlay's 9,000 dollars. Or we can buy maybe 10 contracts which gives us 10 times the exposure, Ed, right? And if that stock actually moves in the direction that we're looking at, the leverage is tremendous, right? So, maybe that stock goes from 90 bucks whatever to 120, the compounding leverage piece of that is huge. Now, the sad reality is this piece of it, we have a wasting asset. The time component of that option is going against you. Every day that goes by, that option loses a little value and time value. And to your point, if we don't get the timing right, it can be an expensive loss because in reality all we have is a contract that says we have the right to buy shares at a certain price. If that stock isn't above that price, that contract has no value at expiration. So, tremendous leverage. If you get it right, man, maybe you're driving Ferraris by the end of the time. But if you get it wrong, you can lose money. And so, you just want to be careful as you're looking at ideas and evaluate what you're risk/reward ratio looks like and how much capital you want to allocate to speculating on that direction. But it is a valid strategy that people can look at and use.

ED: Yeah, I'm glad you mentioned leverage. Having spent my entire career in options and futures, the term leverage comes up an awful lot. And we always have said it truly is a double-edged sword. If you get it right, the percent of returns can be healthy, but if you get it wrong, in this case you could lose 100 percent. You have to keep that in mind as well. But certainly, there's a place for long options, a place for long call. Perhaps it's in your most confident positions or when you are 10 out of 10 on your confidence on where the stock might be headed within a timeframe or you want to speculate with a little bit of premium, there could be a place for long options in your portfolio. At least understanding long calls because you might be looking at other strategies that involve the long call or say the bull call spread. So, starting with the same outlook, bullish on the underlying, cost of entry lower, requires direction and time. And instead of just buying the long call, Allen, let's overlay another option on top of it. Two pieces now into the bull call spread, same motivation as above but we're going to lower the cost in exchange for maximizing our profit potential on the position. How do we do that? We add a short call.

Buying a call option at the 90 strike provides us with the right to purchase shares at 90. Selling a call option at a higher strike price is going to bring in premium, but in exchange for that premium, obligate us to sell those shares at 95. The best that can happen is the stock rallies above 95 up into this area up here. We have the right to buy shares at 90, obligation to sell them at 95. That would bring in five total dollars. We pay to this smaller amount of a dollar 35 as compared to the long call only. Our maximum profit then is that five dollars we can get minus the debit up front, maximum loss reduced to a dollar 35. A lot of investors like this because it's calculated, it is lower cost, it does capitalize on a bullish outlook. And if you also have the opinion that the stock is going to have the potential to rally but you don't think it's going above 95 or you don't think it's going above 98 or 100, you can look to sell an option at that strike to lower your cost and still be exactly consistent with your market outlook. Allen, we've got a few different positions here now, so when we look at where the stock might be, what do we need to consider as we approach expiration now that we've got long and short options in the mix?

ALLEN: Yeah, so we'd want to manage this for sure. The thought process, though, here we are at baseball season or the start of baseball season. The long call, we're trying to hit a home run, right Ed? I mean, we go long call and we got it at 90, we're hoping that thing goes to 200 bucks, right? I mean, we really want that. This is a more conservative way to do the direction. Once again, to the graph that Ed's showing, we're buying a call, we're paying the two dollars and five cents out, we're selling the 95s and collecting the 70 cents in. The risk then out of our pocket's a dollar 35. The thing about this though, it's less capital, it's more of a reduced risk type of trade in the sense that you're not paying the 2.05 out but you are capping the upside potential. So, if that stock does really run and you get the thesis right, it goes to 1.20 in the example we're looking at here, our maximum profit on that's going to be capped at 3.65. But you're absolutely right, Ed, a lot of clients take this route because from a directional standpoint, it's a cheaper way to play the direction and you're risking a dollar 35 instead of 2.05 for the chance to potentially make 365 based on your thought process. But it's something you definitely would want to manage, particularly if the strikes got close to like 92, 93, you know, those are some things that you'd want to manage and maybe roll those positions out and take profits or take a look at it. So, you can always call us; we'll help you through that process.

ED: Yeah, the multiple options aspect may add to the likelihood of needing to manage the position. And as we close up our discussion on strategies, we're not focused on the bearish strategies, but just for those of you who might be more interested in selling options, you could flip this around and be selling the higher priced, lower strike call, buying the higher strike, getting a credit and this is kind of the reverse looking graph up here to try and capitalize on the decay of options but also have it be calculated. Now when you do that, undoubtedly, you're also going to flip this ratio or relationship between how much you can make and how much you can lose. The credit spread, generally speaking, at a lower potential profit and a greater maximum loss because they're associated with a higher likelihood of being profitable, getting that breakeven point as you say here. If the stock was at 90, your breakeven point requires you in this debit spread to have the stock move in a certain direction to breakeven. The credit spreads have the opposite effect; you're breakeven point will be at a better position and will allow you the opportunity to profit given some slack or some movement in the market against you to still be profitable.

ALLEN: And you're taking the cash in, too.

ED: And bringing in capital, right, which works in your favor again in that income generation idea. Also, as we look at sort of the call options in the final piece of this presentation before we look at some live action on the demo, the exercise and assignment activity or your considerations, call holders, call buyers can do various things of course with their option. One of them is to sell to close prior to expiration. In fact -- now I'm not just speaking about calls but options in general -- most options that are opened are closed before ever reaching expiration. Every year consistently it has shown about 70 percent of all options opened are closed. They do not reach expiration. This dispels the myth you may have heard that's very widely spread that most options expire worthless. That isn't true. Most are closed before expiration, the profitability of which we cannot determine because the industry is not tracking the entry price and the closing price of every investor. But the bottom line is that they're closed prior to expiration. One other thing to say about this, the term rolling is often used and beginner investors may have some confusion about that. Rolling is simply closing the current position you have and establishing that same position again maybe at a different strike or maybe at a different expiration. So, closing what you've got and then reestablishing that position with a different detail.

ALLEN: And Ed, we make that very easy on our tools for customers. We have a role in the way that works. So, let's say I've sold a covered call for Microsoft or Apple, whatever the stock is, and let's say we're a few weeks from expiration, you just drop down a menu on the roll, it'll load up that position and then you can sell the next -- so let's say we're in April right now -- you can sell the Mays or the Junes out. And then what it does is it'll close the position and it'll give you a net credit and then sell the opening position. So, maybe we're closing it at a dollar and selling it for five out so the net credit would be four into the account. So, it's a very easy process to do here at Fidelity.

ED: Yeah, that functionality is very helpful. And yeah, rolling is as simple as that, closing and reestablishing. Of course as a call holder, you have the right to exercise either at expiration, which is when most exercises take place, or prior to expiration, at your discretion. About 10 percent of all open positions, options positions, are exercised at some point. Or hold the option and abandon it at expiration if it has no value. If you do the math there, the other 20 percent or so of all options (inaudible).

ALLEN: And that could be, Ed, the example of the long call that we bought at two dollars, right, the stock didn't move in our direction. Now, it's worthless, worth a nickel or whatever that is. And so, there's no value so that contract just expires worthless and you lost that two dollars.

ED: Yeah, the option holder there in that case, you said Allen, they're going to be watching that price so if the stock isn't moving, now it's worth a dollar 80, now it's worth a dollar 50 and now it's worth a dollar, do you cut your losses and get out or do you hold to see if it turns in your favor? Of course, if the stock runs lower, you might not even have that opportunity to get out and sell for some value. But yeah, about 20 percent of options here held through expiration expiring without value. From the call writer's perspective, this is the call seller, the investor who's short the call option, really just thinking about the opposite perspective here assignment can occur at any trading day. You always have to be prepared and willing to accept assignment and manage your position appropriately. A very key element here, option does not have to be in the money, meaning the strike price below where the stock is trading, to be assigned. An option holder has paid for the right to buy shares. They can do so even if it's not in their financial best interest. They can communicate with Fidelity and say I'd like to exercise my contract. They have the right to do that. A call seller is subject to assignment even if they're not expecting it. It doesn't happen often. In all of my years in the industry I could probably count on my fingers how many times it's happened to me, but it can happen, and if you trade options enough, it may happen to you where you get an assignment that you didn't expect. All in all, if you cannot tolerate assignment, if you do not want to be assigned, the only way to completely avoid any assignment risk is closing the position by executing a buy to close, which eliminates the open short position which is also called an open short assignable position. You get rid of it by closing it, then you don't have that assignment risk. So, a little bit there about strategies, exercise and assignment. Allen, I think maybe it's a good time to take a look at some of these things on the Fidelity platform.

ALLEN: Yeah, we'll do that but just real quick on the assignment piece, the majority of those, wouldn't you say happens around probably a dividend if it's early assignment, Ed? I don't know if the industry has any stats on that, but I would think. So, something important for folks to think about or consider. So, if you have a dividend paying stock and you write a covered call on it, there is a possibility if that stock is probably around the money or in that area, if the time value or the value of that contract is less than maybe the dividend value, the holder on that contract might actually take the stock early to capture the dividend relative to the value of the options. So, Ed, do you have anything else to add on that?

ED: You're absolutely right. We have gotten that question before and unfortunately there are not statistics that at least we have at OCC regarding how often that is. But certainly, undoubtedly when it comes to early exercise of calls, the circumstance of an upcoming ex-dividend date is the overwhelming reason why investors exercise early. Call holders are not subject to a dividend payment, they don't have a right to it. Shareholders are. We all know the share price is going to drop by the dividend amount on the ex-dividend date. So, that becomes that rationale. And real quick there, Allen, before we take a look at what you've got up there, the exercise activity –

ALLEN: Oh, I'm sorry, I'll stop sharing?. You go ahead.

ED: No, go ahead. You can go ahead and share. I was just going to say if you're wondering when do I exercise or when might I be assigned, the day prior to ex-dividend is when most of that activity takes place. If you exercise your call the business day prior to the ex-dividend date, then you will be a shareholder of record entitled to the dividend payment. Just wanted to clarify that.

ALLEN: So, Ed, does my screen look okay? Can you see --?

ED: Yep, it looks good.

ALLEN: Okay, good. Good deal. So, let's go into some basic things that you can take a look at on Fidelity.com initially and then we'll also take a look at Active Trader Pro. But real quick, so one question that always comes up, Ed, is well, how do I update my accounts to add options? And by the way, guys, you do have to fill out an options account on each and every account that you have with us. So, maybe you have options on an individual account, but you would like to add that on a retirement account. You do have to go in each individual account and fill out an options application. So, the way you do that, if you just go to Fidelity.com and go investments, investment products, if you just choose options here, this will actually take you to a page and notice it says apply for options here. Ed, I've got you right in the center of my screen, so I'm moving you over. Apply for options to trade options here. If you click on that, it'll take you then to apply for options. And then from there, you can actually go in and you can update any of your accounts. So, for example, if I go in just say apply options, it'll show me if I had more than -- this is a demo account -- but if I had more than one account and it'll show the different accounts and then it shows actually what that options level is. And you can always update your options information here. So, that's something that folks -- that's where you would go in to update it. And it's actually a fairly fast process. So, I think the turnaround time on reviewing that's been less than a week. So, that's something that you can do to add. The other thing is people always ask, well, where can we get ideas or things to look at maybe covered calls or call ideas? Actually, inside Fidelity.com right here, there is an area where you can go into news and research. And if you go to stocks -- so hang in there with me, I know we're talking about options but trust me -- if we just go into the stocks area, there's actually a research area, a research report area that you can go into. And it shows all of the research firms that Fidelity, all the third-party research firms that Fidelity offers. And then inside this research firm report, this will take you to the different research providers. And actually Argus writes a weekly options research report. And they look at both covered calls and long call ideas. So, Ed, they'll give you some ideas on long calls, maybe on earnings plays, those types of things. They'll also give you ideas on covered calls. So, the way you find that, if you go into just the Argus analyst, it's going to show you all of the various research reports that Argus writes. And they have model portfolios, they've got sector analysis and things that you can look at here. But if you go to the very bottom of the page and you just go to the weekly options watch, every Monday I'm here in Texas, so every Monday at around noon, that comes out. You can go in and read the report. If you click on the report, they're going to go through some of their ideas. They'll a lot of times feature a particular stock that they're looking at or they like. And then if you go down, they'll show you some covered call strategies on individual stocks so you can see they're writing some covered call reports on Alphabet, Google, Apple, Caterpillar, Chipotle, Exxon. But they have different strategies and they'll even go as far as telling you, Ed, what expirations they're looking at, what the strike premiums are, and then taking a look at kind of the risk status based on their research reports. They also incorporate ideas for long calls. So, if you want to do a little bit of speculation and take a look at those different ideas, once again, they'll show you things that they're looking at. You know, in the example here they've got Raytheon, Coca Cola, Ameriprise Financial, and then they'll go in and tell you what strikes that they're looking at and give you that dated information. And then finally at the bottom, they do covered call strategies on exchange traded funds. And so, they look at the two indexes, SPY and QQQ, so the S&P 500 and the NASDAQ. But then they also take a look at sector-specific ETFs. So, based on some of their analysis, they're looking at sectors they think might perform based on probably business cycle modeling. And so, they're looking at those type of ideas to write. And once again, they put the valuation from a risk level here into this report. So (inaudible).

ED: Yeah, Allen, this is wonderful to see the research. And I focus all my attention on the options piece and the options strategies, but there is that step one. You have to pick your stock, you have to have a market outlook of some kind. And that is where it all begins, and then the options strategy follows that. So, selecting stock certainly, the first piece of the puzzle. I know session three today is going to be all about selecting your stock. I look forward to attending that session and listening in.

ALLEN: Yeah, and we can go into -- the nice thing about the Argus piece that you can take a look at is they're generating the ideas for you so if you're fairly new now, we also have tools, Ed, that you can screen for ideas specifically, let's say the S&P 500, and you're looking for dividend plays and maybe you're looking for ideas where the company has beat their earnings and (inaudible) and they have a price-to-earnings ratio, PTE ratio, that's below a certain amount. So, there's a lot of different variables that you can take a look at. So, this is my active trader. Let me just step back real quick. So, we do have a streaming training platform that's available for download. If you go to Fidelity.com right up here at the top, Ed, on the top right, if you go there you can hit Active Trader Pro. You can download our streaming real-time software. There's a number there that you can call, you can call that number, 800-564-0211, if you need help setting that up. Also, help with options questions that goes into my Active Trading group. So, they're a huge, valuable resource to our customers with different questions that you might have. Once you download this software, it's the same user ID and password that you would use to log into Fidelity.com. There's also set layouts for you to take a look at. So, there's an options trader layout that Fidelity has already created for you to use. So, Ed, you don't have to be a rocket scientist to pull up some of the tools. For today's purpose, we're going to take a look at some of the options tools that are available in the options tab. A few tools that I would like to highlight is we have an options trade builder tool that's right over here on my right. And we also have an options chain that's going right here at the top. And then I've got a live watch list that's running different stocks that you might have along with the different equity scores. So, if we were looking at buying a call or doing a covered call or a different type of strategy, once again, if we just go here to this options trade builder, it's going to populate this window. I can tell the computer kind of what my thought is, Ed. So, you know, I'm bullish, it's going to go in, it's going to say, okay, well if you're bullish, if we buy a call, it's going to explain that strategy for you. So, there it is. We're going to do a covered call. Same thing, it's explaining that strategy. Or I'm sorry, a cash covered put. And then if we do a covered call, it's explaining that strategy there. Isn't it interesting, Ed? We've kind of mentioned this in the past, bullish cash covered put, which we'll talk about in session two, right, and then covered call. So, if we wanted to do a covered call, we just select covered call and hit next from here. And then inside this tool right here, we're taking a look at Apple as the example. Notice here are dates on expiration, here are our strikes. Stock is currently at 168.63. If we wanted to move out in time, we just arrow out. So, let's go out maybe to the June 17 adds. If I wanted to sell the 170s, they're going off at 7 dollars and 30 cents. The 175s are going off at 490. So, I'm willing to maybe deliver my stock here at 175. And for that agreement, I get paid four dollars and 85 cents. You'll notice right here it's telling me kind of my probability of assignment. I've got an assignment chance of 37 percent. So, if I didn't feel comfortable with that, maybe I have Apple at 100 dollars, Ed, and I want to make darn sure that I don't deliver that stock. Well, I can go further down and I can say, well, let's look at the 180s. Now, I don't get as much on the premium, but I do reduce some of the probability of assignment. Now, that's not to say the stock can't run and go up, right? But I've got a 28 percent probability of maybe delivering that stock at 180. So, if I like that, I hit next. I got into the trade tool, it's going to load up a trading window for me. And once again, it'll tell me the benefits and risk. Very similar to what you guys are teaching at the OCC.

ED: Yep, and then from there as we said, you evaluate that premium, is it worth it, am I comfortable, if the stock runs up to 180 I'm selling it there and I'm keeping the 100 dollars. You decide if that's the right trade for you.

ALLEN: Yep, and I get the 305. And once again, if I don't like this and I want to change and I say, well, maybe I want to go to a different strike or a different date, I can just trade it here. From here, I just load up the trading ticket and then I can enter the order. You can put it in -- the current limit price is 305, but if you want to try to sell it, maybe the stock rallies some more during the day, we could put in a limit price of 320 or 325 or whatever that is and try to get a little more if that stock rallies. So, once again, the place that we got that was just in the options tool here. We went to the trade builder, and we went in and just launched the trade builder and we started whatever stock it is we're looking at or exchange traded fund, okay? So, the next tool that we can look at, and this is going to be a diagram of some of the things that Ed showed us on his, if we go to the options tab, we do have a probability calculator and a profit/loss calculator. Let's diagram real quick that bullish debit spread on Apple. I'll just use Apple as the example to keep it consistent. So, we type in AAPL for the symbol. This is going to give us a profit/loss evaluator. If I go to add a simulated position from right here, Ed, I can go in and I can say okay, I want to do a spread. And then on that spread, I'm going to buy to open, and I just plug in what date I'm looking at. So, we'll just keep it consistent, the June 17s, stock's at 168 so I'll do the 165 calls. So, it's going to plug in the value. And then I'm going to sell to open. I'll do a 10-point spread, Ed. And I will do also the June 17s and I'll do the 175s. And so, I'm paying out 10 dollars, I'm taking in four dollars and 80 cents. So, my net debit is 5.80 out of pocket instead of 10 dollars and a dime if I just bought the long call. Now, if I apply that, this is now going to diagram that same diagram that you have, and it will model what my P&L is on this trade. And notice, I'm capped, Ed, I'm capped at 470 on the upside. My breakeven's 170.30 on this example, but I'm capped out and my max loss is 5.30 on the position. Okay? If I like this trade, I can go in then and go from the simulation and I can actually go in here and hit trade strategy. This is going to take me into that strategy area and then from there, I'm going to go in and place the trade. All right, so let's go into a few questions and then we'll close. So, one question that folks are asking is how is premium determined, Ed. So, that's a function really kind of of the volatility of the overall stock and the price movement is there earnings potentially coming up or a dividend. Do you have some color on that?

ED: Just broadly speaking, I always say price and premium is determined by supply and demand of all market participants. Think of that analogy in the beginning with real estate. If there are buyers who are interested in driving the price up, then that's where the price is going to go. The market's always looking for that level of equilibrium where buyers and sellers are comfortable at that level, and that's where price discovery is. And what Allen's referring to those components where the stock is, what's the perceived volatility, all go into that analysis, but ultimately wherever the balance is between buyers and sellers supply and demand, that's where prices settle.

ALLEN: Yeah, and another question is: Can you spend a couple of minutes explaining the impact of implied volatility for us? So, that kind of piggybacks to what we just talked about. So, Ed, what do you think on implied volatility?

ED: I could spend hours on that question.

ALLEN: Yeah, we did a whole session on that once, didn't we?

ED: Yeah, so just very quickly, there's volatility between today and expiration date, which nobody knows for sure what it's going to be. The market's always trying to figure that out, how much might this stock move between today and expiration. They input that into pricing models. That is implied volatility. Higher levels drive prices up, lower levels drive prices down. But it ties back into the previous example. Supply and demand lag implied volatility. It goes back and forth; more buyers in the market drive implied vol up, more sellers drive it down. But it is the most major component to the pricing of an options contract.

ALLEN: So, another question: Where can we apply for options at Fidelity? Once again, guys, if you just go to Fidelity.com and you just go -- you can actually type in the area options applications in the search. I always tell clients I think the easiest way is actually just investment products. You go into options here and then right here you can apply for options inside there. It'll list or show all of your accounts. If you already have an account that has options on it, you can update it. So, apply for options, boom, it takes you in here to that area and then you just apply right there. So, Ed, we're going to have to wrap for the next session. Once again, guys, if you haven't signed up for the second session, it'll be All About Puts. Thanks again for joining us. Ed, thank you for being with us today, and we'll see you here in just a few minutes for the second session.

ED: Yep, thanks. Good to be here.

END OF AUDIO FILE

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There are additional costs associated with option strategies that call for multiple purchases and sales of options, such as spreads, straddles, and collars, as compared with a single option trade.

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