TRANSCRIPT

Cboe: Finding an option strategy to match your outlook

Jermal Chandler: I am Jermal Chandler and I'm with Cboe Global Markets. Colin and I, we want to talk more about today about doing a LEAPS options purchase with a call. We are going to introduce this concept today. So, as we move forward, please look at our disclosure slide and understand that the information provided is for general education purposes. So, we're going to, as we go forward with the agenda for today in this particular session, we're going to begin with an introduction to LEAP options. We're then going to talk about some of the benefits and limitations with these securities. What is stock replacement? We're going to try and answer that question for you today, right? Then, we're going to give a stock replacement example and compare that and contrast that to what it would be like if you just still kept your stock holding. Finally, we're going to break down the differences with a little chart that looks at return on investment between the two there, and hopefully that'll kind of bring home this interesting concept.

Options were originally created with expiration cycles of three, six, and nine months with no option lasting longer than a year. Options of this form for such terms still constitute the vast majority of options today. On October 5th, 1990,

due to popular demand, leap options were created for investors who like to focus on a longer-term horizon. So an interesting acronym, I know, but LEAPs basically stands for Long-term Equity AnticiPation Securities; don't ask me why they didn't include the T. They're available in over 2500 equities and 20 indexes. LEAPs basically operate the same way as regular options, but a few caveats here, but they're available in two forms, calls and puts, those are the only kinds we got so far as far as options. The number of shares covered by one contract is 100. They permit the buyer the right, but not the obligation to buy stock if you have a call, or sell stock if you have a put at expiration, and they cause the seller to have the obligation to buy shares if you're short a put, or sell stock if you're short a call at expiration. So with that regard, they're similar to regular options.

So, what's different? Well, LEAP options have expiration dates greater than a year, and sometimes upwards of two to three years. That longer timeframe allows for more prolonged exposure to price movements, so if you're forecasting for a particular movement, you have a longer timeframe for your situation to play out. Once an option is less than nine months, it typically ceases to be considered a LEAP call. So for example, if you pull up Microsoft option chain, and you look at the January 2021 Microsoft options, you'll those exist, and pay attention to the amount of days until expiration on that. And

then you pull up the January 2022 options. The latter is a LEAP; January 2022 is well over 500 days until expiration, so there's your differences, right?

Colin Songer: So Jermal, I think this is a great opportunity; you gave a great example. Let's take a look at this, right? So let me bring that back to Trader Pro. So if anyone has Active Trader Pro at home, look fire it up, follow along with us, this is a great way to utilize the tools that we have. So as I bring it back to Trader Pro here, you mentioned Microsoft. So let me put that in the top left-hand corner. Yeah, that's right, I already fired up the option chain which is right in this menu here, you'll see the option chain available, and then here, we can see exactly what we're talking about, when we're talking about those longer-date options, so Jermal brought it up, January 2021. Okay, well we got it here. Now notice that we already have the days to expiration right in there, right? Well I'm not going to have to do the math; I'm pretty sure that's less than nine months, so let's take a look at that January 2022, which if I hit this right key, I can go right over and get that longer-date option. Now look, 520 days to expiration. True, that's longer than a year. So this is a way that you can find those LEAPs out there and view the different expiration dates that are available. So I just thought that was a great opportunity to be able to dive in there and see that.

Jermal Chandler: Yeah, no, and that's great, Colin, because like you pointed out, there's something to that. Always pay attention to the expiration, pay attention to the days. We know there's a lot being thrown at you when you pull up that option chain. You'll get more comfortable as you look at it. Take a look every day, but pay attention to those little details, right?

Okay, cool. Now that we talked about what LEAPs are, let's talk about some of the things that you need to know about LEAPs. With them, like everything, there's pluses and minuses and LEAP options are no different. First of all, when you purchase LEAP options, they are less capital-intensive than purchasing the underlying stock. So this basically dovetails in this concept of leverage when you're talking about an option. Remember, for every one option, you control 100 shares of the stock. In relation to that use of capital and leverage, LEAPs have a potentially higher return on investment, which basically kind of gets into this idea of arguably a better use of capital. What I mean by that is, consider this, making $100 on $1,000 is better than making $100 on a $10,000 investment, right, when you think about the percentages there.

One important aspect to understand about options is that they all eventually expire, and when you own this longer time-frame option in a LEAP, you have a

longer time until expiration, and as I mentioned earlier, the better chance you have on your option gaining value because of that long time frame. So, since LEAP options don't expire for well over a year, the amount of time until expiration is longer, and LEAPs have lower time decay. That's right, time decay.

We're going to mention Greeks every now and again, option Greeks, maybe you've heard of them, maybe you hadn't, but this is your first introduction to a Greek: theta. This measures the amount of decay of an option. Like I said, they all expire, and we look at it as far as decay, so understand this is signified by the Greek theta, time decay.

LEAPs, as a result of that lengthier time until expiration, you have a longer time for that particular move to play out, so you have that prolonged price movement. LEAPs also behave more closely to underlying stock in this way, and so that is sort of measured, they sort of mirror and move in that way, similar to underlying stock. So when I talk about that, that kind of is measured by the option Greek known as delta. Now while, again, now we've thrown two Greeks at you, theta, and now we're throwing delta. Now while delta might be a discussion for another webinar, it's a concept you should definitely be familiar with regard to options, and stock already, because this helps you

determine how much money you're making or losing based on the movement in the underlying stock. Just know that when you compare equivalent strike deltas from near-term options and leap options, LEAPs will typically have a higher delta. So what do I mean by that? As, you know, we've talked about earlier, Colin showed you the chain there, and you can see, you have the similar strikes, whether it's a $25 and you have a $25 strike in a near-term option, as well as a LEAP, you know? But there's a few caveats to that with regard to expiration options, but it's generally true.

So now, let's move forward with the limitations, right? Because there's always some negatives to the positives, right? And so, with limitations, first off, the bid-ask spread. If you're familiar with this idea of bid-ask spread, not only does it exist in options, it exists in stocks as well. It's what you can buy and sell something at. So, for options, you have a bid-ask spread, and you also have one of course with the LEAP options. It is typically wider with your bid-ask spread in LEAP options. Now how that affects you is that when you purchase an option, you are typically marked a certain amount of money initially, and you'll see the difference -- you're typically, your option is valued based on the mid-market, so that's, it's a lot wider with LEAP options, and when you think about it, it makes perfect sense though, because we're speculating on the value of a stock going out well over a year. There's so many different things

that are going on. There's a fair amount of uncertainty in that time period, when you're looking at the LEAP option, so we have no idea what it'll be trading at expiration, and that's why the bid-ask spread is wider.

Option premiums are higher for LEAPs in comparable near-term options. This again gets to this idea of time value and theta. It's one of the reasons we discuss for this higher premium. Another reason is attributed to the amount of movement that the stock and therefore the option will experience over time. And again, we have a lot of time here before expiration. Each stock, and ultimately option, has its own volatility value along with it. Now we introduce another Greek here: Vega. Vega measures the volatility of an option, and in some regards, the stock. So, there's a lot more volatility when you're looking at a LEAP option, because there's so much going on, and there's so much more time, and there's so many potential things that can happen over that time period, right? So, that's one of the things we see. We all know that that stock could vacillate quite a bit within a year's time period, and there's a lot of unpredictable movements over that time period. So therefore, the volatility value, and the time value, that's essentially what you're buying when you buy a LEAP option.

Dividends, no options collect dividends, and LEAP options are just the same in that regard, so if your sole reason for buying a stock is to capture a dividend, then this strategy wouldn't be feasible for your needs.

LEAPs aren't available on all securities, so that's another thing, just make sure you check and see if you have a LEAP available on the particular stock that you're interested in.

And finally, for those who are used to the fast money-type moves that you'll get with near-term options, fast money if you will, you have to be aware that LEAP options are more akin to a long-term investment, so that longer-term timeframe means you're tying up investment dollars for a longer period of time.

Colin Songer: So, I think, that's a lot of information that we took in, Jermal. Let's take a look at it, right? Let's see this in front of our own eyes here as I jump into Active Trader Pro. So I'm going to go right back in there, and guess what, I'm using the same tool, the option chain. There's so much information that you can customize this in. So let's see, so we said one thing that you mentioned, which I felt was really interesting, now you'll notice that these expiration dates are toggle, so I click it on it shows; I click it off, it goes away. So let's bring up

exactly what you stated about longer-dated versus that front month, and when you hear that term "front month," we're talking about the closest monthly expiration that's available; that's what we're talking about. And if you notice along this horizontal bar, all the expirations, you'll see a D. Guess what that means? Dividends, right? So, as Jermal said, we don't get dividends, but it might be applicable, right? We might want to plan for that. So you can see here as we mouse over, it gives us that information, the ex-dividend date, the amount of the dividend, and even that pay date. Well here's another little lovely feature in that option chain. That lovely E means Earnings. So for an option trader, this might be something that you might want to take into consideration when placing those trades, or choosing that expiration date, and when you mouse over, it does give you that actual day, but the placement of it is between those expiration dates.

Let's tie in some of those other concepts that were discussed. Now I'm comparing the front month to the 2022. Yes, that's a long ways away, 520 days away. If I go with the at-the-money with Microsoft, I'm just going to keep building off of that. We'll see here, let's just go with that 210, all right. So what I've done is I've right-clicked on the column heading, gone, add column, and I've already added this delta as well as the theta columns. Now as you can see here, this is what he was talking about with that delta. In other words,

when we look at delta, if it goes up a dollar, the option price will adjust for this at-the-money, $0.64. This is giving us the idea of that exposure. Now, we've added theta. Well look at the difference here. Look at this longer-date option. I thought this was really interesting, this always gets me. So this is 3 cents per day that the option price is going to decay. Well look at that front month. That's 39 cents per day, so this is showing you, from a dollar value standpoint, the impact that it has on your trades. Well let's talk about that other concept, about the higher option premium. Well the at-the-money for, yes, two days, for Microsoft, is $2.43, right? So that's $243 for one option that I would have to pay. Let's take a look at that LEAP. All right, so 210. Wait a minute, that's $3,400. That's a big difference that we're talking about. So you could see the further out you go, the more that you would have to pay from an option premium standpoint. But as Jermal already pointed out eloquently I might add, is you also have more time for it to move, so you have the ability for that to play out.

Now let's look at the other thing, the bid-ask spread, which is very important for option traders, right? Now when we talk about bid-ask spread, this is what we're talking about. Difference between the bid and the ask. For those who were getting in, you're saying, well it doesn't matter, when I get in, that's what it is. Yeah, I would agree with you to some extent, sure. But guess what, that's

not when option traders are worried about that bid-ask spread. It's when the trade goes against you, and you want to get out, that's where, and myself included, that's where you worry about that. So that is a concern, something to consider, because this one is 4 cents wide. For an option trader, that $4. Okay, I get in, I might lose 4 cents on that. All right, let's look at the leap. That's $1.20. That's $120 difference between that ask and that bid. Is that something you should be -- it's just one of those considerations that you should put out there. Does that mean there's a right or wrong method to this? No, you'll notice that. It's all about weighing those advantages and disadvantages. So I just wanted to share that with everyone before we move forward of how you can see this information right on that option chain.

Jermal Chandler: This is how we work. See, I say things and then Colin makes me look good by actually showing how they actually work. There's nothing better than this. Just trying to make you guys laugh a little bit, we all are at home and we're all hanging out with our kids and our families, which is an interesting, wonderful time, right?

So now, arguably the hard part is out of the way. What is stock replacement? Well, it's just as it sounds, you're essentially changing out your long stock position, selling that, and then still participating by purchasing a leap call

option and being able to participate on the upside type of move, so we're utilizing the leverage of options, with its less intensive capital outlay, while trying to harness the power of lower time decay, as we talked about, and embracing the potential volatility that the market and/or stock provides.

So you could recreate your stock position by purchasing an at-the-money option. Now at-the-money is when you are purchasing, if a stock is trading $250, or let's just go back to what Colin talked about. I believe Microsoft is trading 210, and he looked at the 210 strike, so that's at-the-money. You can purchase an at-the-money option, or you can purchase an in-the-money option, as far as calls, I'm sorry. So in a call option, we're talking about an at-the-money. At-the-money is the same for call input, but since we're talking about call, that 210 would be at the money. For an in-the-money call the option, if the stock is trading 210 and you buy the 205 strike, that's in-the-money because the stock is $5 higher than where the call strike is, okay? So you can either buy an at-the-money or an in-the-money call option and re-place your stock position in that way. Your option position has now taken the place of your stock position, and additionally, you're forecasting an upside move such that you'll be able to participate when the stock continues to move up. And then at expiration, it will give you, say you buy one option, it will give you the right to buy $100 shares at expiration at that exercise price, or strike

price. As we previously discussed, you're using those leverage capabilities of options and anticipating that over the long-term, the movement in the stock will be in a direction that will generate gains for you.

So, let's look at a stock replacement example now, between not only just an option position, but a stock position. So on the left here, we have a stock position. It's stock ABC, trading $100. You're bullish, so you buy 100 shares of that stock at $100. Your cost there is $10,000, 100 times 100, straight up. Your max reward is unlimited because stocks can go unlimited to the upside; they can continue to move up. We've seen that in some stocks, right, particularly this year, and your max loss is limited to the cost, or limited to what you paid for your shares, so as it goes down, you lose money; if it were to go to zero, then you lose all of what you paid; you can't lose more than what you paid. On the right, we have a situation where you have a LEAPs call, so you have still unlimited reward and limited risk with stock ABC trading at 100. In this case, we're bullish, so we're going to get long a call. This is another way of saying, purchasing a call. I know when I started in the industry, you hear all these different things. Purchasing a call, getting long a call, same things. We're buying ABC Jan 2022 100 strike call for $15. We're buying one. So that cost is 1 times 15 times the 100 multiplier we always use for options, which is where we get this $1500 from. Your max reward, again, is unlimited, because stocks

have unlimited movement to the upside, right? Your max loss, now here's the interesting part, when you pay for an option, you only lose what you pay, so your cost is limited to what you pay.

Colin Songer: So I just want to really summarize, because this is a great comparison, right? This is that advantage/disadvantage thought process that traders would be doing, right? We look at, if I went with the LEAPs, yeah, lower max loss, but I also have a higher breakeven. For those out there who are probably saying, I'm not sure what breakeven is, for option traders, the breakeven is, at expiration, this is the point that we are hoping that it's above or below, or where I start making money if it moves further. In other words with calls, it's above the breakeven if I bought it, and with puts, if I bought that put, it's lower than that breakeven where I start making money. So hopefully that clears that up for you, but I think this really does give you a breakdown of, with shares, right when I buy it, if it goes up, I start making money. With calls, you'll notice that all right, well I needed to move more before I start making money, but there's less money that I can lose. So there is no right or wrong, it's just weighing those advantages and disadvantages and see which one is best-suited to what you're trying to accomplish.

Jermal Chandler: Yup, so let's push this forward. Let's say you're bullish on stock ABC which is currently trading $100 a share. You think the company has great fundamentals, and it's currently in the process of bringing several new products to market. You think the stock price of ABC could eventually go to $150 per share, or even higher if the company's successful with these products. Your understanding is that the products may take anywhere from 9-15 months to bring to market. You could simply buy shares of ABC, like we said, 100 shares, $100, and put your $10,000 out there, and appreciate, in hopes that the stock continues to climb in the months ahead. But you decide you don't want to tie up $10,000 in capital for a significant amount of time. I mean, we're talking about 500-plus days, right? So instead, you decide to purchase a LEAP call that expires in January 2022 with a strike price of 100, and you're paying $15 in premium, just like we talked about, right? So your risk is now limited to the $15 in premium that you paid for the call option, and your potential upside is limited. So, now we're looking at the P&L graph, right? What we just said is that you're going to buy one option at $15. Remember $100 multiple, so it's $1500, right? And again, first we need to understand breakeven, as Colin said. When you purchase a call, whether it's LEAP call or any call, your breakeven is the strike that you have, that you own, in this case the 100 strike, plus the premium you pay, which is $15. That's how we get the $115 breakeven, so as you see on the chart here, that's why we

have $0 at 115, because that's our breakeven at expiration. Now this is all at expiration. Anytime you're looking at P&L graphs, take it to expiration. As you can see, we have days to expiration here at zero. Take it to expiration; that's the scenario you need to look at. So we have these orange arrows at your breakeven; that's $115. Anywhere below $115 at expiration, you're losing money; you're not making money at all, and anywhere below the strike, so at $100 and below, you're completely losing all of your premium, so you're losing 100 percent of your premium, but again, you're losing less premium than you would have if you purchased the stock. Above the breakeven, you start to make money. Potentially, you can make an unlimited amount of money if the stock goes up; it's possible, right? We don't know how often the stock's going to go up. The whole reason you're choosing this LEAPs call is so that you have a lot longer time period, because stocks don't just go straight up, despite some of what we've seen. They sometimes go up, down, all around, right? And so the reason why you're choosing this LEAP option is so that you have a longer time period for your potential forecasted move to play out here.

So, that's your graph, right? Now, let's look at this return on investment idea that we talked about earlier, because I think this really kind of hammers home what we're talking about today, and everything that we've said. So we have on the left, you have buying 100 shares at 100. You have in the middle buying

a 90-strike LEAPs call that you paid $20 for, and then you have on the far right our example that we just showed in the P&L graph and we've been talking about, where you bought ABC -- the hundred strike call for $15.

So on our left, you buy 100 shares at 100, you should all be familiar with this. If not, it's okay. But again, let's start with our breakeven, because if you buy 100 shares at $100, at $100, you're not making any money yet, right? Now if it drops to $75, well you lose $2500. That's -25% return on investment. If it drops to 50, you've lost half of your investment, or -50% return, -$5,000. At $125, well you've got a $2500 gain, right? And that's a 25% return on investment, and then at $150, you've made $5,000, or 50% return on investment.

Now, let's look at our ABC LEAPs call on the 90 strike. Now you paid $20 for this call, so those of you who have listened, shout out the answer if you know it -- I'm just kidding. Your breakeven in this case, like we just said, you have the 90 strike that you own and you pay $20 for it, so 90 plus 20 is a breakeven of $110, okay? Anywhere below strike at expiration, you're going to lose money. So in this case, our strike is 90. Now while we don't have it up here, at expiration, anywhere below 90, you lose all of what you paid for the call, so that's why at $75 and at $50, we lose 100% return on investment, or we lost

the $2,000 we paid. The $2,000 comes from one option times 20 times the 100 multiplier for options; it's always 100 multiplier of options. That's where we got to $2,000 from. At 100, so our call is in-the-money, as we talked about, in that the stock price is above the strike price of 90, so it's $10 above, right? So we paid $20 for that expiration. That call will be worth $10, which is $1,000, so we lost $1,000. So we have lost 50% return on our investment.

Now above the breakeven of $110, things get interesting. At $110, it is $15 in-the-money, if you will, and at that point, we're making our $1500, or 75% return on investment. At $125, the option is $35 in the money. We paid $20 for it, and that's why we're making $1500, so that's a 75% return on investment. Remember, you always have to remove what you paid for the call. So in this case of, at $150, our option is $60 in-the-money, but we paid $20 for that option, and therefore we're actually making $4,000 on investment.

Now, this may confuse you when you actually are first starting to trade and you look at the ATP and you're pulling it up, in this scenario, you will see you have $6,000 worth of an option, but you're actually making $4,000. Remember, you paid $20, always keep that in mind.

On the far right, we have this situation we just showed you on the P&L graph. Remember, our breakeven in this scenario is $115. So, below our breakeven, we're not making money. As a matter of fact, below strike at expiration, we're losing 100% of our investment, so at 100, at 75, at 50, we're down $1500, down 100% of our investment. At 125, at that point, the option is $25 in-the-money, we paid $15, so our gain is $1,000, or 67% return on investment. And then at 150, the option is $50 in the money. We paid $15 for it, and our gain is $3500. So as you can see, there is an interesting thing that happens below the strike, because you lose all of what you paid, but again, you're paying a fraction of the amount of what you would have paid in stock, and when it goes to the upside, you do have a higher return on investment, because you're making a decent amount more money on a smaller investment. So there it is, plain and simple, everything we laid out, we introduced the whole thing to you, and now we've shown you how and the way this works, so it's something to consider and look at.

So, our key takeaways here. LEAP options are call and put options that have expirations greater than one year. They allow you to gain exposure to stocks and ETFs that you want to own with minimal capital outlet. We discussed all the benefits and limitations which include less capital outlay and favorable return on investment on the benefit side, and on the limitation side, we noted

the bid and ask spreads being wider, and option premiums are higher, compared to equivalent near-term option strikes.

The stock replacement strategy can be done in a couple of different ways. You can use a call at expirations. In this case, we talked about using it for LEAP call options, so you can have that longer time period for your predicted stock move to come about. This allows for less capital use with the options, and they behave more similar to stock.

Now real quick, before we move forward, I want to explain how there's been two scenarios probably for this year along where you could look at this and try it. There's a lot of stocks, I mean we had an incredible bounce back to where we are as far as the market has gone. And some stocks you may feel have, you wanted to participate on, but it's kind of gotten away from you; it might be a little too expensive now, that you, instead of buying stock, you could look to buy a leap call option in this situation. You're using less capital, maybe you're worried that, but you know what, you're using less capital as opposed to using a large amount of stock.

Or, what about this, you have some stocks that have been really beaten down this year: cruise lines, hotels, restaurants, and from what a lot of analysts are

saying, their earnings are not going to be good for well over a year, right? And so they might just sit there at those prices for some time. But every now and again, we've seen them jump around. Those are situations where maybe you could look to use a call option as well, because maybe, a year-and-a-half from now, you'll be looking back at certain stocks and be like, man, this stock is back to $70; this stock was $15 in August of 2020. So, those are a couple of scenarios where you could use LEAP call options.

Colin Songer: Excellent, and that's really a wonderful way to lay it out for us here today, Jermal, thank you so much. But, you know what, I'm going to shift gears on you. So what I'm looking to do is we went, where we think that that thing's going to fly through the roof, what if it's not going to fly through the roof? What if I think it's going to kind of, just kind of sit there, maybe slowly ground on the way up? A topic of conversation that seems to come up very often is the idea of creating income. So, what alternatives could someone possibly consider?

Jermal Chandler: You know, that can happen too. I mean, that happens from time to time, Colin. So there's strategies for that too at the outset. There's so many different strategies that you can use options for, and we got one for you here, too. We got something called a "covered call." Now, you can generate

income with a covered call. And so first, we're going to explain a covered call and strategy. We're going to explain that strategy in detail. We're going to use a trade example to illustrate the risks and rewards associated with a covered call, and then we're going to juxtapose that to a stock sell limit order, and you'll understand why. Then we're going to touch on when and why it makes sense to use a covered call. After that, we're probably going to show you a little bit about choosing strikes and expirations within a covered call using ATP, and then finally, we're going to discuss the exit strategy on a covered call, because this one is not as vanilla as some of the other options strategies. You know, there's some thinking that goes into it ahead of time, and as long as you're prepared ahead of time on the different scenarios that can happen, you'll be just fine.

So, what is a covered call? Well, to create a covered call position, first we need 100 shares of underlying. Now this can be something that you previously owned, or it could be something that you recently purchased; up to you. This is the P&L of that, right? So you buy stock, stock goes up, you make money. Stock goes down, you lose money. We're familiar with stock. Then you need a short call option. Now the seller of an equity call options assumes the obligation to sell shares of the underlying at expiration, so you don't control whether or not you sell shares; actually the call buyer does. But that's

something to understand about selling a call option. So once you combine this 100 shares of long stock position with one short call option, then you're considered to be covered, and you can fully meet the obligation with the shares that you already own. There's no margin required for selling calls; i.e. you don't have to put up any extra cash, because you own the stock where you have, are selling one call.

Now keep in mind, remember, we talked about for every one option, you control 100 shares, so you have to do this one-for-one and so that you wouldn't have to put up any extra additional money, so if you own 100 shares, then you're able to sell one call and be considered covered. A call seller who's written that call, or sold -- we're going to use those interchangeably; we're going to put you onto some of the option jargon today. Writing a call, selling a call, same thing; they're used interchangeably. So, when you sell that call, you're considered to have a short position in those options, is also another thing, short positions, selling written. So to be clear that you're buying stock and selling a call option one-for-one or on a share-for-share basis, and this position is held until the call expires worthless, or the call expires in-the-money; remember we talked about in-the-money before where the stock is higher than the current strike for a call. Or, unless assignment, early

assignment happens, and we'll get into that discussion later too because that's something you should understand.

Remember, the seller of the call could potentially have that obligation to sell the underlying stock, so that's why you own the stock in that scenario for it to happen, so we're going to cover all these different scenarios for you guys.

Colin Songer: And Jermal, I think this is a great opportunity; let's put some numbers to this. Let's see if we can show everyone how Active Trader Pro can help visualize this scenario that we're discussing. So I'm going to jump right back into Active Trader Pro. Under options, we're going to select that profit/loss calculator, so yes, I already fired this up online, so what I'm going to do is I'm going to bring it up here, and I'm going to put in that example that I've been working off of, which is Microsoft. Now you'll see in this profit/loss calculator, there's a lot of information in here, but let's just model up what we were talking about. The bottom-right hand corner here, you'll see, "add simulated position." So when I click on that, that will bring up a pop-up. I can go in here and we could talk, when we talk about covered call, talk about lingo, right? Covered call, buy-right is the same thing, buy-right just means I'm buying shares at the same time, selling a call. And look, if you struggle with the lingo,

don't worry. It's like a whole 'nother language. The more that you're around it, the easier it is to pick up.

So let's go in here, let's just model that up real briefly, and let's just say, all right, let's go out to next month, and let's just use the at-the-money just because it's easier that way. This is showing you how much the stock price is; it's pulling in that ask price, and what the bid price currently is for that call, and I'm going to click "apply," and look what the calculator does, it adds it in there. Boy, I know that we've seen this profit/loss diagram before. Yes, it is the same idea, right? And if I expand over on the bottom-left here, you could see that I can see the individualized, legs, yes, the individual stock, yup, seen that before, and then selling that call, right? Where I went out, I received premium to sell this call. We can see that individual legs, and then together, that's where the strategy, that's where the magic happens, right? Jermal, let's break this down here. So we got a lot of information here, so why don't you break down the max gain, the max loss, the personality of this trade.

Jermal Chandler: So yeah, as you can see, once you've sold that call, and so above 215, that's where your max gain starts to come in, above that breakeven level. You can see below there, at a certain point, you're just losing money on the stock. You're not losing on the call, because the call has lost a certain amount

of value, and so after a while, a large portion of your loss will just be pertaining to the stock that you own, and that's something that you really have to remember, and so this is what we're going to get into when we're talking about the pluses and minuses of this strategy, because it's interesting. I mean, there's a lot of moving parts here, you're long stock, you're short a call. And so you have to be aware of a couple of different things with this strategy as we go forward.

Colin Songer: So, let's do this. So as you could see here, as Jermal stated, above that strike here, that's where we're seeing our max gain. And you can see that right here on the profit/loss calculator. In this scenario, it's saying if it's above the 210 strike that we have down below here, you'd be net now $609. Now obviously, this is not including commissions, or the per-contract fee that would go along with it, and as Jermal stated, the further down it goes, the more that we're losing money, which why are we risking money?

To make money, we want to make money. So it also gives us that breakeven, which is, you'll hear that over and over again, which is how we as option traders evaluate at expiration where we don't make money, but we don't lose money, right? And that's where it shows it right here, so we know how much we're risking with that stock, which would be the $20,391. If I was saying,

where did you come up with that number? Well, I just multiplied by 100, because that's how many shares that we purchased here, so I take that breakeven on a cover call, and I just multiply it by 100, and that's going to be my max loss. That's substantial loss that we're talking about. We actually, I think it's a great opportunity to dive right back into our presentation here, because I think this gives us a great breakdown of that.

Jermal Chandler: Yeah. I mean after, Colin just beautifully laid that out for you, now you see your upside profit potential is limited, because of the call that you sold. At some point, that call will be in the money, and it will obligate you to sell stock. So the upside profit potential is the strike price, plus the call premium received, minus what you paid for the stock. If you're assigned, then the stock is sold at the strike price. Your breakeven point, well that's the stock price paid minus the call premium received, and we're going to show you another example of it too to give you more because numbers really help with this. Your downside loss potential is substantial. Why? Because the risk is with stock, which is something you should call be pretty familiar with that regard anyway, stock goes down, you lose money, and we've all kind of dealt with that before, so the short call option only offers limited protection. The entire stock cost minus the call of your premium is received is your risk overall.

So let's take a look at this trade example here. You have a situation where we compare a covered call to a sell limit order, right? So, if you see the situation where you have a covered call versus a situation where maybe you want to sell stock at 125, right? So you own 100 shares at $110, and you're targeting $125 as your sell. Well in this case, you decide to sell XYZ 125 strike call at $4. So your risk is the stock price paid minus that premium you received. What that means is at that point, you've lowered your breakeven to $106, and anywhere below $106, you're going to lose money on your stock. Only your stock. At that point the call premium is much lower than $4, and you're starting to lose money on your stock as the stock goes down, as Colin showed you in ATP beautifully. Your reward at $125 is $19 per share. So that is a situation where at expiration, at $125, your stock is what you call "called away," meaning it will be sold because you have the obligation to that short call. So your reward is your 125 strike, or stock, minus the $110 you paid for stock, plus the $4 of premium that you took in, so you would receive $19 per share in that scenario at expiration where your stock is called away from the short call that is in-the-money.

Where it's profitable? Well that's your breakeven again. That's above $106, that's where you're profitable; that's your breakeven, so $110, which is what price you paid for stock, minus the $4 you took in for premium, is your

breakeven, and above that, this strategy is profitable. And the timeframe on this, it's, your exposed until September expiration.

Now, with the sell limit order, for those of you who are familiar, this is where you're saying I want to sell this 100 shares at $125. Your risk is what you paid for the stock, which is $110. Anywhere below that, you're losing money; anywhere above that, you're making money. Your reward in this case is $15 per share if you sell stock at $125, right? You're profitably anywhere 110, like we said, anywhere above 110, you're profitable on your stock. And in this scenario, you're exposed until XYZ hits 125. So you're basically sitting there, waiting until your sell limit order gets hit, so that's something that happens pretty regularly, right? So that's the differences between those two, it's an interesting thing to look at.

Now, why are you selling a call against long stock? Do you want to sell the stock? Do you expect the call to expire worthless? That's good thinking, but what if you're wrong? What if the stock declines, instead of rises? What if you don't want to sell stock? What if your plan is, if the stock rises too much, what do you do then? When will you buy back the call? So these are all the things; I'm telling you, there's a couple of moving parts here, and so what we want to do is try to help you decide a couple of things ahead of time; you have to think

it out a little bit. Income-oriented investors, they used covered call strategies with their goal of collecting, or enhancing their cash returns. In exchange for that call premium, the investor accepts a limit on their upside profit, as you can see, right, from the graph here. Your limit on your upside profit starts at, in this scenario, 106. They believe that the stock will trade in this neutral to bullish range. Now this is income-collecting people, and during that lifetime of that option, and they're comfortable with that.

Now, investors who are targeting that preset sale of price, that we talked about a second ago, they can sell a covered call hoping that the stock will be called away, meaning it will converge at some point the short call that you have, versus your long stock, and it will net out, and you have no position, so you're hoping to sell stock in that regard if you're that type of person that's looking for a preset sale price. So your effective selling price is the equivalent of the strike price of the call plus the premium received. So an example that we just showed you, this would be the 125, plus that $4, your 125 strike that you were sold, plus the $4 in premium, which is 129; remember we said that $19 in premium, that's your effective selling price. Now some investors trade covered calls to get a limited amount of downside protection when they expect shares to decline. Selling that call only offers limited amount of downside protection, so keep that in mind.

Finally, something that you need to be aware of is early assignment. Now this can happen in short equity and ETF option holders at any time prior to expiration. Sellers of covered calls therefore must consider the risk of early assignment and should be familiar with when it's greatest. Early assignment, typically what happens to stock dividends. Now this is literally something we can make a whole 'nother webinar about, this idea of early assignment. One thing that you need to know, as Colin showed you earlier, looking on ATP and see when you have a dividend, need to be aware of when your stock has a dividend; that's the take-home message.

Colin Songer: And Jermal, that's a great point, and a lot of times when people use covered calls, sometimes they have those securities because it brings in dividends into their account. So you want to make sure that, you've got to be comfortable with the idea of selling that security in your portfolio. If you find yourself where you're worried about assignment, you don't want it to happen, this might not be the approach, and let me tell you why. Where's max gain? It's if you get assigned, right? That's what we want to happen. We want that max gain, so be comfortable with that idea if you find yourself where you really don't want assignment to happen, this might not be the strategy for you.

Jermal Chandler: Okay, so exit strategy. Always know your exit strategy, in any scenario, right? So if the stock rises above the strike price of the call, then your decision has to be made whether you're going to hold it until expiration and allow the stock to be called away, whether you want to buy it back at 70-90% of its value, or if you want to roll it to the next expiration, option traders will say roll, and that's when you, in this case, say we're short that September call, right, and you decide to buy it back, and then sell another one in September; that's called rolling. You have in essence bought your September call and sold an October call, so that's a roll position. If the stock barely moves and the call is still out of the money in their expiration, then you can decide to hold it until expiration, and allow that call option to expire worthless, you could continue holding a stock without selling it, or you could sell another call option, again, like roll again and reinitiate after expiration.

Now, if the stock price falls, then the decision has to be made whether to close that option at a lower value, so if the stock price falls, say for in our example, we sold a $4, and now all of a sudden it's 50 cents and the stock has gone down below 106, you can decide to buy it back for say 40 cents or something like that, your decision, and risk further stock declines, like the stock could continue to fall, right? I mean that's just the life of owning stock. Or you could decide to close the covered call position, and possibly at a loss.

Colin Songer: Yeah, and I was just going to add to that, Jermal, what you just mentioned is so important. So I want to emphasize that point. I know we're coming up to time here, but really just want to point out that look, if it's going against you, remember, this is a neutral to bullish strategy, so anytime you're rolling or doing any adjustments, you should always be reanalyzing the security, because you want to make sure you're still neutral to bullish. If you think the price is going to fall, that's not really what this strategy is utilized for, right? Because where do we make money? Remember, we're risking it to make money, right? That's at the end what we're looking to do, so if it's going against us, why would you stick with it?

So let's recap this, and I mean, that's a lot of information, Jermal. Let's just recap what we covered here today.

Jermal Chandler: So, in closing, we talked about what a covered call is. It's a position with limited upside profit potential and substantial potential downside loss. Using our trade example and using ATP, we showed you the covered call strategy and how it can be considered an alternative to sell limit order. We discussed the ways in which the covered call might work for you. We showed you strikes; we showed you that scenario where you could see

your max loss and your potential max gain in that situation, and finally, we talked about exit strategies, which is really important, understand those ahead of time. Now it's up to you guys to put a covered call on.

Colin Songer: Thank you so much and thank you everyone for attending here today.

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.

A covered call writer forgoes participation in any increase in the stock price above the call exercise price and continues to bear the downside risk of stock ownership if the stock price decreases more than the premium received.

Greeks are mathematical calculations used to determine the effect of various factors on options.

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