

TRANSCRIPT

Options 101: Selling options

Nicholas Delisse: Good afternoon, everyone. My name is Nicholas Delisse. I'm with Fidelity's Trading Strategy Desk. And, of course, joining me is Cale Bearden. Both of us are with the Strategy Desk. And this afternoon, we're going to be talking about selling options, the different strategies, some of the basic strategies, of course, with selling options. We're going to be addressing and talking about, first and primarily, selling cover calls and the different aspects that to into that and different considerations you need to keep in mind. We're going to segue the conversation to address cash-backed puts, cash-secured puts and we're going to wrap the session up and take everybody through how you might place a couple of these trades, execute these trades on fidelity.com. With that being said, Cale, why don't you introduce for everybody the strategy of selling a covered call?

Cale Bearden: Yeah. Appreciate that, Nick. Appreciate everyone spending some time here. Again, Cale Bearden. I'm on our Trading Strategy Desk. A lot of information that Nick and myself want to discuss here today. And as mentioned, we are going to be kicking it off with selling covered calls and different considerations and things to think about. And we're going to kick the

conversation off with, first, what does it mean to sell a covered call? So with a covered call, we're going to have two components. And both of these components are going to be working together. We're going to have a long stock component. So we're going to have ownership of shares of stock or an ETF. And we're also going to have a short call. And both of these are going to be working together, to create our covered call strategy overall. Important to remember, with a covered call and with options in general, that a standard options contract is going to represent 100 shares of the underlying. That means we need to have at least 100 shares of the underlying stock or ETF, for us to be able to sell our call and for it to be considered covered. So when we're talking about a covered call, the covered portion of it means, in the event that our short call is ever assigned, that we already have the shares available in our account, available to deliver to the long-call holder, who may decide to exercise. Now that being said, with it being in 100-share increments, if we have greater than 100 share, if we were to have, say, 500 shares in our account, we would be able to sell up to 5 calls against our shares. If we were to have 1,000 shares in our account, we could do up to 10 contracts. Do want to mention, if you do have a larger quantity than 100, by no means do you have to sell the same number of calls as the number of shares that you have. But typically, that's what traders would look to do, is to sell calls against all portion of their shares. But certainly, that's personal preference and up to you.

So when we sell a call, what we're doing is we're taking on an obligation. And the obligation that we're taking on is to sell our shares at the strike price, all the way up until the expiration day. Now with both the strike price, as well as the expiration, those are up to our choosing. We get to decide what strike price we would like to sell. And also we get to decide what expiration date that we would like to pick. So like many things in finance, whenever we're taking on an obligation, we expect to have some type of compensation. And the compensation that we receive for selling a call is that we get to receive the premium. When we sell that call contract, we are bringing in money into our account. And it's in the form of a credit. So the seller of our covered call has that obligation, to sell that stock, if we're assigned. And again, that's going to be at that strike price, that you agree upon too, whenever you decide to sell that call against your position. So we're receiving compensation for taking on that obligation and we're having a risk-reward dynamic that's taking place. We're going to be touching more on that risk-reward dynamic whenever we get to some of our risk diagram.

Want to start out with talking about why we would look to sell a covered call. Certainly an important question that we want to be able to answer and know, what are we getting and why would I look to do it? So covered calls allow

traders to take advantage of a lack of movement in the underlying price of course, lack of movement is not something we can necessarily profit off of, if we just own the stock outright. If we own stock, we need share price to go in our favor. We need the share price to go up. We don't really have that ability to make any money, if the stock just decides to move sideways. What's important with a covered call is going to be what your outlook is, what you expect to happen on the security that you're trading. And with a covered call, the ideal outlook that we're going to have is taking on a neutral to slightly bullish view on the security. So neutral meaning that we expect some type of sideways type of price movement. And the slightly bullish aspect is we may expect the stock to go up a little bit but certainly we don't expect it to be a situation where the stock is runaway to the upside. Now that being said, if we expect a neutral to bullish type of viewpoint, if your expectation is that the security is going to either rise substantially or fall substantially, then likely a covered call is just not going to be the appropriate strategy.

Let's talk about a couple of the goals here with covered calls. And really, the primary goal of a covered call is to create income. And that income is being created because we're receiving that premium, bringing in a credit to our account for taking on that obligation. And we're trying to allow time decay to erode away the value of that options contract. Time decay is what allows us to

sell that option and, hopefully, as time passes on, we're able to purchase that contract back at a cheaper price and we're able to make the difference of what we originally sold that call for versus what we have to pay to buy that call back, possibly, in the future. Additionally, the premium that we receive is also going to help offset some of that downside risk of owning the stock outright. So it's a way of having time work in our favor. It's a way for us to generate income for sideways type of price movement in our security. And also, lastly, it's going to help us reduce that cost basis of owning a stock. So now that we have a general understanding of what a covered call is and the purpose behind the strategy, Nick, do you mind walking us through an example, so we can put a few of these concepts into action and see what it means to us as traders?

Nicholas Delisse: Absolutely, Cale. One thing I want to underline was something you actually just mentioned. And that's what we have in the middle of the slide, is that outlook. Outlook is so important. It is extremely important, of course, that you have a neutral to moderately bullish outlook. If you're wildly bullish or you're wildly bearish, this particular strategy doesn't make sense. And we're going to step through a couple of those reasons. And so you definitely want to, of course, start with the outlook -- and based on your outlook, will a covered call make sense? -- as opposed to looking for securities to, necessarily, trade that covered call on. Could be beneficial to look at a

couple different securities and then develop an outlook on that. And then potentially that outlook matches that.

The way that you actually put together this trade is... Let's say you have 100 shares of stock. And in this example, we're using stock QRS. Let's say, of course, you've purchased those shares of stock at \$92 a share. It's fairly reasonable. Of course, in order to make this particular purchase, you'd have to put up \$9,200. One hundred shares times \$92 gives you that total amount there. And this particular ratio and relationship is important. Because as Cale mentioned, one contract is covered by 100 shares of stock. And this is a mistake I've seen some traders make before, where they're looking at 100 contracts for 100 shares. One hundred contracts actually require 10,000 shares of stock and would be a wildly different position. So it's important to remember one contract represents 100 shares. So if you start with 100 shares of stock, long, at the 92 strike price, you have a moderately bullish outlook, you're neutral to moderately bullish, well, what you could then do here is you could then sell a call against those shares. And in the example we're going to look at, we're going to assume we're going to sell a call with a strike of \$95. And, of course, you're going to receive \$1 premium for this. So at this particular time, this option is \$3 above where the stock is at and you're receiving a \$1 premium for that. Now keep in mind, with the 100 multiple,

you're then receiving \$100, not just \$1. And if you're doing this over 500 contracts, where you're putting up 500 contracts, well, you'd be receiving \$500. And so this scales, from that particular perspective.

Now, with these assumptions in place, we've put together a table -- take a look at, well, what your gain or loss would be at these different price thresholds. So let's say the stock rallies, almost 10 percent, goes up to \$100 a share. Well, with this you've made \$8 on the stock. Bought at 92. You could then sell at 100. And this particular table is looking at the what if you've been closed out of the position separately. So you made \$8 on the stock. It's then showing you'd lose \$4 on the option. Because at expiration, the option is in the money by \$5. So you'd have to pay the \$5 to close it. Well, you received \$1. You take a \$4 loss. This would all net out to a \$4 gain. Now another way to think about this is... Let's say the stock did go up to \$100. And this would be true whether it went to 100, 105, 120, or even just 95. All it takes, of course, is the assumption that the option is in the money by one penny or more and that you are assigned, you are called on to fulfill your obligation to deliver 100 shares of stock at the particular strike. Well, what's going to happen with that? Well, if you bought the shares of stock at \$92, you're then fulfilling your obligation to sell it at 95. You're going to make the \$3 on the stock. And this is going to be true regardless of whether the stock is at 95 or, as I mentioned, 120. Now

since you've been called on to fulfill your obligation and deliver the shares, you get to keep the premium. You get to keep that \$1 premium, so you've made \$3 on the stock. You keep the \$1 premium. You've net made \$4 on this particular trade. And you can see, on that total profit/loss, this is showing you make the \$4, whether it was at 95 or 100. Or really, any higher and it would be the same. Now, you do have a downside breakeven, that we're addressing here. And the reason for this, of course, is, if you bought the shares at 92 and you receive a dollar premium, well, if that particular option expires worthless, you get to keep the dollar premium. That's yours. You don't have to give that back. And so that \$1 premium is going to offset the drop in the stock. And this is why a covered call is frequently referred to as a partial hedge on the security. Because if the security drops a little bit, well, this is going to offset that loss. But in reality, this is still a stock going sideways. Now, it can go sideways and still go up a little bit or go down a little bit. But if it only drops a dollar, you're at your breakeven, still kind of going sideways. Where, of course, the larger risk comes into play. And this is where there could be the potential for a substantial loss in the trade, as it drops, 85, 80, 50, or even, in the worst-case scenario, declares bankruptcy and goes to zero. What happens with this? You have the obligation there to sell shares, if they go over the 95, but you still have the shares of stock. And so, if the stock drops, that could

hurt a lot. Because you can take that full loss on those particular shares of stock, as it drops.

Now, a lot of traders actually like to look at the profit-and-loss diagram, because it can help analyze, from a different, visual perspective, what that looks like. And you can see here we have two lines, a lighter-green line and a darker-green line, that's been plateaued at or above that \$95 price. And what this is showing is, at any prices below 95, you're a dollar ahead. You'd make a dollar more or you'd be a dollar ahead -- than simply owning shares of stock. But as it goes beyond 95, well, you don't make any more money. And so many traders that Cale and I have worked with, you know, they've talked with us and they've been disappointed. "My stock is at \$100," "It's 110. I've lost money on the call." Well, really, you're at your maximum gain potential. You should be happy with this. Being assigned is a good thing, when it comes to selling covered calls. As such, if you had the expectation that it would do that... Well, this goes back to what Cale was mentioning on. Well, you're really bullish and potentially this trade doesn't really make sense. Now, with this chart, we can see a crossover, where we see, in essence, what we termed as a point of indifference. And that's right at that \$96 mark. The reason why this has been termed that point of indifference is you can see, if it's above that price, if it's a 97, 100, or even higher, you'd rather own shares of stock. If it's below that

price, we'd be ahead, trading the covered call. Naturally, of course, if it's below the \$91 breakeven for the covered call, you'd rather if we had just closed out of the stock position and not had any trade. We'd be ahead, in that particular scenario. But with this point of indifference, if you're expecting a stock to be higher than that, well, you'd rather just own the shares of stock or potentially set a higher strike on the option. There's a lot to think about with this. But let's take a look at different ways traders might actually manage a position, once they've put it on. Cale, can you talk just a little about that?

Cale Bearden: Yeah, of course. And, Nick, it's very important, in planning the trade, to understand what is that opportunity cost level. I know it sounds a little bit funny to say sometimes, but Nick and myself, as well as my eight other colleagues, we'll talk to clients that, opportunity cost may hurt more than having a loss overall. So that's definitely a consideration and something we need to think about is, "How am I going to feel, if I miss out on some of that opportunity cost to the upside?"

Let's go ahead -- we're going to talk about the strategy management. And once we place the trade, we have this covered call on in our account, what are some different choices that we have as far as managing the trade, going forward? So we have three different ones here. We have buy to close, roll,

and let it expire. We'll start out here with buy to close. So our first choice of buy to close is if we wanted to purchase back the contract. We originally sold that contract. We brought in a premium. We're taking on that obligation. But if we would like to close out that obligation, then we have that ability to purchase that call contract back. And we're going to pay whatever the current market price is for that underlying premium. So that premium that we're going to have to use to buy back that call is going to be a debit transaction. So as Nick was saying, if we sell the call for a dollar and later on down the road we decide we don't want that obligation on anymore and now that option's trading for 50 cents, we have to spend \$50 to buy that option back. We originally brought in \$100. We're going to make the difference of that. We're going to make \$50 on that trade. So the difference between what we originally sold that option for and what it costs to buy it back is going to be our gain and loss only on the option. As Nick mentioned, we have two components that are in play here. We have a stock component, that's going to have its own individualized gain or loss, and we have the option component, that's going to have its own individualized gain and loss so we have to take the net effect of both of those to determine what was our gain or loss overall. We have a lot of clients that like to only focus on "Did I make or lose money on the option?" and they tend to forget about the stock or the ETF that they own. It's important to remember that this is a holistic strategy, that we have both of

these components, that are working together. Now, the reason that we would look to buy to close is maybe we have a shift of opinion or a shift of outlook and we no longer want to carry on that obligation. Maybe our original outlook of being neutral to slightly bullish is no longer our deal. Maybe we believe the stock is going to start to move to the upside and we don't want to cap that upside potential. Additionally, maybe our contract is in the money. So we have some of that opportunity cost that may be coming into play, like Nick had told us, that we got it wrong. We decided to sell a call -- capital gain potential - - and the stock decided to rise rather rapidly. And now we have an in-the-money contract. Well, we may have an in-the-money contract, where we have a loss on the option, but we could possibly still want to keep the share of the underlying stock. So we decide to buy back that option, take our loss on the option, and let our stock run.

Second choice here would be rolling the option. And rolling is the process of closing out what you currently have on, your current short call that's open in your account, so buying back that call, and opening up a new trade, with a brand-new idea. And with a roll, we're able to accomplish this is one trade ticket, instead of breaking it up into two separate orders. So two separate orders would be buying to close the option and then deciding to sell another one, at a later point in time. Rolling is combining both of those. We're buying

to close what we currently have and we're selling to open a new option, accomplishing it all in one trade ticket. Makes your life a little bit easier. One of the reasons we'd look to roll is, again, we may have a shift of opinion or a shift of outlook. And we want our new outlook to be a representation of what we have in our account. Maybe we have an idea that the stock is going to start to move to the upside but still, once again, only moderately so. We may want to adjust that option strike price in order to take advantage of that. Another reason, very popular reason, that Nick and I talk with traders all the time about is, well, maybe our option is about to expire and we want to prolong that trade and have that trade continue on into the future. So we can buy back our option that's about to expire and we can sell a new option, that's further out in time and collects more premium, and still have that covered call on in the future.

A last one here is going to be letting it expire. So letting it expire, there's kind of two ways that we can do this. One is if our option contract, our call that we sold, is going to finish out of the money. So the share price is going to be below our strike price. We can just let it expire worthless. We can let it go through expiration. And that way, we don't have to pay anything to buy that option back. So that full amount of premium that we originally brought in, we don't have to pay a single penny to buy it back. We can just let it expire. And

we will be back to our stock position. Another way would be, what if our contract is about to expire in the money? So we got it wrong. Once again, our share price went well up above where our strike price is. One, we can just let that expire. And what would happen is we would likely be assigned on that position. So we would have to fulfill that obligation, like we talked about. We're obligated to sell those shares. Well, if we just let it expire in the money, well, those shares are going to be going to the long-call holder, who decides to exercise. So three choices here. We can buy to close that option, we can roll that option, move it to a different strike price or expiration, or, lastly, we could let it expire, whether it's worthless or if we're okay getting rid of those shares that are covered by that short call. So, Nick, that takes us through the covered-call portion. I know another one that's very similar, certainly another popular selling strategy that we talk with clients about quite a bit, is going to be selling cash-secured puts. Do you want to go ahead and give us an idea of what we're working with here with selling puts and some considerations to take into account?

Nicholas Delisse: Absolutely, Cale. And one thing I want to highlight, before we really jump into cash-secured puts, is that cash-secured puts are the other side of the coin, when it comes to covered calls. And a more complex topic will actually be that they're considered to be synthetically identical to each other.

Many traders will, of course, go back and forth between covered calls, cash-secured puts, depending on where they are in their account. Because it's effectively the same thing. With that being said, what I want to highlight, of course, is what a cash-secured put is, if you're not already familiar with it, and how it mirrors that covered-call selling strategy. So when you are selling a put, you're, of course, taking on the obligation to buy shares of stock at a specific price, similar to, when you sold the covered call, again, you're taking on the obligation, but then, again, with the covered call, have the obligation to sell shares at the price. Both scenarios, of course, that obligation is involved. You don't have control over whether the other side of the agreement chooses to exercise their right. So with this, of course, you can be asked to fulfill your obligation any time. These shares can, in essence, be put on to you. Now, the way this, of course, would be set up is you have that agreed upon strike price that you're agreeing to buy those shares of stock, through the potential expiration of the put. Now in exchange for this risk, in exchange for this obligation, you're paid a premium. With this, of course, your maximum profit potential with selling a cash-backed put is limited to the premium you received when you sold the put. So if you only brought in \$100, that's the most you can make from the trade. You bring in \$500, that's the most you can make from the trade. And there's no way to make more than that, with just this particular trade. Now, there is substantial downside risk with this trade, just like the

substantial downside risk from selling a covered call. Because you have the obligation to buy shares. As such, as the security drops significant, as it drops from the proverbial 100 dollars to 90, to 80, to 50, zero, well, you have the obligation to buy shares at that higher price. That obligation could become quite substantial. What makes this covered by cash is at the start of the trade you're actually putting up the amount of cash that you'd need to cover the obligation. So if you're selling a put with a strike price the proverbial 100 dollars a share, you'd have to put up \$10,000, which would be what it would take to buy 100 shares of stock at that \$100 per share. As such, of course, since your maximum loss then is if you are put those shares and the stock dropped to zero, that is then covered. And you can't lose any more than that, which is what allows this particular strategy to be done in types of accounts that might require that the maximum loss is assigned.

Continuing on, there's a lot of different reasons why traders might look to sell puts. And some of these, of course, apply more specifically to put selling versus selling covered calls. To an extent, many traders might gravitate to selling covered calls if you already own shares of stock. Well, if they don't own shares of stock, while they could buy the shares and then immediately sell the puts -- or I should say immediately sell the calls, many traders might simply just sell a put as a way to buy shares. If the stock is at \$100, they might look at

selling a 95-strike put. They might look at the price as being attractive compared to the \$100. And this is that look on, instead of placing a limit order, you can get paid, in essence, to have that limit order out there. Now, there are some pros and cons, like we've discussed. There is no return with options trading, without risk. And part of that trade-off between this and simply placing a limit order is, if you had placed a short put sale at that strike price, stock could go down to \$90 and then back up to \$100. And if it's above your strike at expiration, you'll never buy the shares of stock. So to an extent, having the limit order, you would actually buy the shares of stock and you'd be able to enjoy that upside. The flipside, of course, is that, if the stock comes down to your strike and it's at 94.75, with that 95 strike, and the stock stays there and you're assigned, well, you'll get to keep that premium in addition. That can make it a little bit more attractive, with adjusting your cost basis even lower on the particular position. Keep in mind, though... We've worked with a lot of traders that have looked at a security when the stock is at \$100. It might be very attractive at 95. But if that stock drops to 70, it might not be attractive at 95 anymore, to buy that, but you'll still have that obligation there. So you'll definitely want to be sure to manage the trade.

All this kind of builds into the second and third circle that we have here, that, traders, they might sell cash-backed puts as a way to generate income. So if

they feel the stock is going to go sideways, maybe bounce off of that particular strike price but you'd be okay buying it at that price, you could earn a little bit of income. That \$100 or \$200 or five hundred the trade will bring in is extra, that you wouldn't already have. And that kind of builds into this third point, of earning interest on the cash you have in your account. Keep in mind, again, there is no return without risk. And as such, you might be able to put up the \$10,000 to back the put, for that dollar premium or \$2 of premium you might bring in, and that might be greater than what you might receive in a money market account over that same timeframe but the risk potential is also greater. Because as we've talked about, you have the obligation to buy shares, which might not be attractive as the security drops. Definitely something that you want to keep in mind. With that, why don't we actually go through an example of what it would look like to buy a put and what that profit and loss would break down to. Cale, could you step us through the example?

Cale Bearden: Yeah, of course, Nick. And certainly, it's a tough penny market right now, in terms of yield. So want to make sure that everyone is comfortable with going through an example, making sure that you understand what the trade-off there are. Nick, that's something that we talk about all the time. With options, it's all about trade-off. And being prepared before you place the trade, that way there's no surprises whenever we're trying to manage the

trade. So the example we had laid out here is that we have \$9,000 of cash sitting in our account. And once again, we're looking at QRS stock. And it's trading at \$92 a share. So as we analyze QRS stock, we may look at it and say, "I like the company but I don't think that it's going to have a large rise, at least for the time being. But I wouldn't mind owning it at \$90 share, if given the opportunity," all while being able to possibly make some money while we wait, if we just trade sideways. So again, we have to have that neutral to slightly bullish outlook on the stock. We don't want to expect it to make a large rise in price. And, of course, we don't want to expect it to have a dramatic fall from grace in price, as well. So the example we had laid out here, on the right-hand side, is we could look at selling, to open, the 90 put. And we're going to receive that one dollar's worth of premium, again. Or \$100 would be our maximum gain potential. Now that cash that we had set aside, of \$9,000, with it being a cash-backed put, we are going to have to set aside that \$9,000, in the event that we have to fulfill that obligation that Nick was talking to us about of possibly buying 100 shares at that \$90 price at some point in the future.

We have that similar table, that's here on our next slide, as well. On our far left-hand column, we're looking at the stock price at expiration. So we have all the way up to \$100 per share. And then we list, down at the very bottom, \$80

a share, with, of course, numbers in between there as well. Second column is going to be that premium received. So the premium received is going to be a constant amongst all of them. We're still receiving that one dollar's worth of income. Column three is going to be the value of our put at expiration. So, important to remember, and selling strategy, we're hoping that those options contract get closer and closer to zero, so we don't have to spend any money to buy it back or we can spend less than what we originally paid -- or, excuse me -- brought in when we sold the option. Far right-hand side is going to be the profit and loss of the strategy as a whole. So let's start with looking at what if share price is at \$100, whenever we're said to expire. So as Nick had told us, we're going to have that slightly bullish to neutral outlook. So if QRS was trading at 92, whenever we originally sold that put, and we had almost that 10 percent rise in price... Let's remember, we're obligated to buy shares at \$90. But if the price is all the way up at 100, our put is going to decrease in value. And at expiration, if we close right at \$100, our put is going to expire worthless and it's not going to have any value. So we get to keep that full \$1 that we originally brought in. And we'd have a \$100 gain on this trade. Now, of course, Nick had mentioned that point of indifference, that we'll look at here in a moment. But if we just imagine in our head, if we would have just bought the shares of stock at 92 and it's trading at 100, well, of course, we would have made more money just by buying the stock outright. We're going to skip

down one level. We're going to go to 90. And 90's going to be the same story here. So if we're at \$90 at expiration, then our put, once again, is going to expire worthless. We are not going to have to pay any money to buy that option back. And we're going to make that full \$1 that we originally brought in. Things start to change, though, once we get to \$89 a share. Of course, we're obligated to buy at \$90 a share. So if price has gone down to 89 and we let it go through expiration, well, our put is still going to have a value of \$1. We brought in a dollar originally. It's now trading at \$1. So if we decided to buy it back, we're not going to make any money. We're going to be even-stein. We're going to bring in a dollar but we had to pay a buck to buy it back. That's going to be our break-even point. Breakeven is a very important point to understand in cash-secured puts. That is the point where we neither make money nor lose money. I like to call that our line of defense. That's the price that we really want our security to be trading up above, come expiration. As we get a little bit further down the list, we'll look at \$80 a share. If we're down at \$80 a share and we have to buy our security at \$90 a share, well, of course, we're going to be \$10 in the hole. We bought it at 90. Currently trading at 80. We're going to have a \$10 loss on the put. But remember, we also brought in that \$1 originally, as well. So we brought in \$1 up front. Now that put is trading at \$10. So if we decided to buy it back and we pay that full 10, we're only going to have a \$900 loss -- still a loss that, of course, none of us

would like to take but it is going to be a little bit less than if we were just to buy the stock at 90. And that goes back to remembering that it is a way to have a slightly lower cost basis in the trade.

Next example here is very similar to that risk diagram that Nick took us through a bit earlier. And you may notice that that dark-green line, which represents our short put, looks virtually identical to that covered-call example that Nick had took us through. And Nick had used that fancy word of *synthetics*. And that's really all synthetics mean to us, is our risk diagrams are virtually going to be identical for a covered call and a cash-secured put, if we're talking about the same strike price. Couple things I'll point out here. We're going to look at that dark-green line first. You'll notice, at \$90 a share and anything up above, we have that flat line, where we're putting that ceiling on top of our head. Or in other words, we're going to have some opportunity-cost possibilities that come into play. Also, keep in mind where that breakeven is. We talked about that breakeven earlier being at \$89 a share. Because we're obligated to buy at 90. We brought in a dollar originally. So 89 is going to be kind of that point of our line in the sand, our point of defense. Now that point of indifference, as Nick had talked about, as we kind of shift over, looking at that lighter-green line... That lighter-green is going to represent if we were just to purchase the shares of stock. So our point of indifference, in this example, is going to be

right around \$93 a share. And again, that point of indifference marks that area where we start to have opportunity come up above that level. Of course, if we thought the security was going to go to 95 or 100, then we would be left with a couple of different choices. For one, we could have just bought the stock, and enjoyed some of those gains if it did go in our favor. Or we could look at possibly utilizing some different strike prices. This is a great way to start to conceptualize and learn options, especially for folks out there that are a little bit more visual in nature. This is a great type of diagram to get comfortable with and familiar with. Because not only does it show us where do we make money in the trade but it also starts to show us where does our risk to start to creep up, as well. So now that we have a little bit better understanding of some of the pros and the cons that go with these cash-secured puts, Nick, let's have you discuss some of those different considerations for managing the position, once we have it on.

Nicholas Delisse: Absolutely, Cale. And a lot of these choices for management are going to be very, very similar to when you have a covered call on a particular position. A little bit of the difference, though, of course, is, with the first point, buying to close, if you're just buying to close the put compared to buying to close the call... You sold that obligation. Well, in this scenario, you wind up not having shares of stock. With the covered call, you have those shares of

stock. And so that definitely has to be considered with the covered call as compared to this, is are you also closing out the shares of stock? With a roll, it's very, very important to do what Cale was mentioning, on splitting it up into its components. With a roll, that involves a buy-to-close side of the trade but also a potential sell to open. And both of these aspects have to make sense, with the trade. If they don't both make sense, then potentially the roll doesn't make sense. And Cale and I've worked with numerous traders where they looked at a roll and potentially it makes sense to close out of the trade they have but it doesn't make sense to open a new trade. Or even, potentially, it might make not make sense to close out of the trade they have, while it also makes sense to open a new trade. And then you have to weigh, well, which one makes more sense? Potentially, if it makes sense to leave what you have open and a new trade makes sense, you might simply place the new trade and leave the old trade open. If, however, maybe you're limited by capital considerations, where you don't have the capital to have both trades in effect at the same time, well, then you might weigh that and look at it and go, "Well, the new trade makes more sense, so I might simply close out of the old trade, then place the new trade." With all of this, one of the big things to consider when it comes to buying to close is taking a look at and asking yourself the question, "Would I place this trade today?" If the answer is no, potentially just closing out of the trade makes the most sense. And this becomes an

important consideration, when you're comparing buying to close versus simply letting the trade expire. Many traders might sell a put for a dollar, going, let's say, a month out, and, that last week, they could close out for 10 cents. As such, they're looking at it and go, "Well, is this one last week, is it worth 10 cents? Is the risk worth only 10 cents, when I've already received 90 percent of my profit potential?" In that particular scenario, they might choose to go ahead and buy to close, to remove that risk off the table. They might then even look at it and go, "Well, what other option could I sell, to generate additional income?" And they might then combine that into the roll. If, however... Let's say they've looked at it and gone, "Well, I sold this for a dollar. It'd cost me 50 cents to close it out. There's still 50 cent of premium left, for just one more week. I'd still place that trade today." Maybe they would then leave the trade intact and let it expire. It does, of course, continue to have the risk that, while you have the trade open, there's the risk that you could be asked to fulfill your obligation on the trade, if the security drops. If it doesn't, you could then keep that last of the premium. And this is a question that many traders have to ask, of course, is is that last bit of premium worth it, to let it expire, for the risk of potentially having to fulfill their obligation.

Now, let's take that scenario I mentioned earlier on in the presentation, about you're looking to sell a put, because you want to buy shares of stock. You've

sold the put at that 90 strike, in the example, and the stock has dropped to 89. Well, you did this, to begin, because you wanted to own the shares. And so you would let this trade stay. You'd let it expire and go through that assignment process. And you, of course, would be assigned at your strike price, be obligated to buy at your strike price, with your cost basis adjusted by that premium you receive. And you then have that long share position that you wanted to begin with. From there, of course, you could place additional trades. You could sell covered calls against it or simply own that particular long position. It is up to you. With that being said, why don't we go ahead and take a quick review, to look at some of the differences between covered calls and cash-backed puts?

Cale Bearden: Yeah, Nick. And, you know, we see at this point, hopefully, that options allow us some different choices. We talked about, early on, if we're going to be a stock trader, we're just going to need price to go in our favor. It's going to be a directional idea. And our sole profit and loss is going to be determined by if the stock moves in our favor or if moves against us. But with options, we have some of those different choices, where we can take advantage of different market forecasts, we can take advantage of, one, directionality... So if we have a moderate directional view, we can take advantage of that by selling an option. We can also take advantage of time

passage, as well. And certainly, a lot of folks who trade options like to have time on their side. In reviewing covered calls, it's important to remember that there's going to be two components in play. We're going to have a stock component, where we need to own at least 100 shares of our underlying. And, of course, we're also going to be selling one call, against those shares that we already own. And that's what makes it a covered call, in the event that we do get assigned on our short call, that we have the shares available to deliver. Important to remember the pros and cons, some of those trade-offs that we had talked about. For one, we're still taking on downside risk in the trade, where, if the security moves against us and makes a meaningful move to the downside, we're still likely going to have quite a significant loss possible on our hands, because that option that we sold is only going to help offset some of that downside move to a minimal effect. Now, what we receive in return is, of course, we get that income generation, where we bring in money in the trade and, if our stock does move sideways, then we have that ability to profit off of.

Nicholas Delisse: With puts, of course, you have that obligation to buy shares at that price, through the expiration. And so it functions at a very similar level. And, of course, if your short strikes are the same, if you bought shares of stock and then sold a call at one strike and you sold a cash-backed put at that particular

strike, the net will wind up being the same. The amount of cash you'll have to put up into the position and your upside potential will be about the same.

There are some small mechanical differences, of course, with... If the stock goes up, well, your maximum profit potential with put is a little bit simpler, because it's just a premium received. You're not having to factor in the gain or loss on the stock, in addition to the premium. But that downside substantial risk remains the same, where, if the stock drops significantly, you wind up owning shares of stock, just like a covered call. And that could be very, very difficult to swallow, as that stock is just dropping. Again, with the cash-backed put, it's cash backed because you're putting up the cash to cover that particular obligation. If you're not putting up the cash to cover that obligation, it could be considered to be uncovered. And when we step everyone through placing the particular trade on fidelity.com, we'll show where you might have some issues, where some traders have had issues with selecting the drop-down on that to be sure it is covered by the cash in their account versus uncovered. Of course, in both scenarios traders are typically using these types of trades to generate income, to generate a return on a security that they feel is going to go sideways. And this goes back to what Cale was mentioning at the very beginning, that, if you feel the stock is going to go up, you buy shares of stock, which will be profitable. If it goes down, you lose money. If it doesn't move, you're not going to make anything but you're not going to lose

anything. Selling covered calls, selling cash-backed puts is a way that you could still generate that return as the stock goes sideways.

Now when it comes to actually executing the trade... This kind of builds on what I was talking about earlier, that you don't want to make the mistake of forgetting that 1 option represents 100 shares of stock. And worked with a lot of traders, in the past -- and this is more prevalent with long options -- where they've purchased 100 long options, trying to get that exposure of 100 shares, not realizing that multiple there. Little bit less frequently, we see traders, of course, that have sold 100 contracts short against 100 shares. That takes that ability to be able to have uncovered, because the other 99, in that particular situation, were uncovered. With this, of course, when you're placing this trade, if you're selling a covered call, have to have 100 shares of stock to sell that 1 call against it or roughly that capital that would be required to purchase 100 shares of stock, when you're selling that particular put against that. Keep in mind, of course, those particular ratios. And it's always important to remember and think of how much risk you're comfortable with. It kind of builds on the other example Cale was talking about, the... If you have 1,000 shares of stock, you don't have to sell a covered call against all 1,000 shares. Maybe you only want to sell a covered call against 500 of those shares, because that's all you're willing to cap the upside potential on. Or, you know,

if you have cash and you're trying to generate income on the potential with that, you might be not wanting to push the boundary, so to speak, where you're only willing to contribute the amount that'll be required for 1, 2, or 3 puts, even though you might have the ability to trade much more than that. So position size and managing your position size can be an important thing to consider when you're managing your risk. With that, let's go ahead and segue and take a look at fidelity.com, on the way you might sell covered calls or cash-backed puts in your account.

Cale Bearden: Yeah, perfect. And, Nick, everyone should be able to see my fidelity.com page right now. We're on the main landing page. So as soon as you log in to fidelity.com, this should be the page that you see. And we're going to be starting with the options chain, so a tool that's very important, certainly something that you want to be comfortable with. The easiest way to get there is we're going to go up to News & Research, at the very top, in the green, and we're going to go down to Options, about halfway down the list, click it on here. Takes just a moment to load. And we're going to have our options chain that pulls up. We will have to type in a particular ticker symbol that we want to analyze. And for our example here, in our test account, we're going to assume that we already own 100 shares of SPY, which is an ETF that tracks the S&P 500, and we're looking to possibly sell a call against those 100

shares that we currently own, to take advantage of maybe a viewpoint of that we're going to go sideways for a period of time. So we'll type "SPY" here, in our Symbol field. And then you can either press Enter on your keyboard or click on this magnifying glass here just to the right of the Symbol field. Once you do such, you're going to have the options chain that starts to populate down below. You're going to have different expirations, that run horizontally across the screen. Keep in mind that you are able to scroll left and right, if you don't see the expiration that you're looking for. And then we're also going to have all of these different expirations list the different strike prices available.

Currently, we're going to have the 343 strike be our lowest one, the 352 be the highest. If you don't see the particular strike you're looking for, keep in mind that you can come up here to the very top and click on Strike. By default, it's going to list 10. You can show all of them, if you'd like. Certainly, for SPY, you're going to have a number of different strike prices that pop up. But you also have the choice for 5 and 20. And my personal favorite is going to be this customizable range, where I can specify the exact strike prices that we're looking for.

So we're going to use the September monthly contract as part of our example here today. And it's going to be this very first option that's listed here -- or very

first expiration, I should say. And down below, as mentioned, we're going to have these different strike prices that are available. So on our covered-call example, as we all remember, we're expecting some type of sideways to slight up move in our security. So, important to see where we're currently trading, at \$347 and some change. So if we look down in our options chain, we're going to be looking for some strike prices just slightly up above that. For example, we'll look at these \$348 strike price. And our calls are going to be listed here on the left-hand side. Our puts'll be on the right-hand side. So to sell a covered call, we're going to look over here to our Bid and Ask column. The bid'll be the furthest left. The ask will be the next one over. And all we're going to do is we're just going click right on the bid price so as a seller, we're going to click on the bid.

I'm going to open this up in a new tab here. And once I do, it's going to pull you up to a trade ticket that looks exactly like such. Now looking at our trade ticket here, you're going to notice that many of the fields are going to be prepopulated. We have our Sell to Open. We have our expiration, our strike. And, of course, we clicked on a call. We do have two responsibilities, though. We need to click into the quantity field, type in the number of contracts we're looking to trade. And then also, a little bit further down, we're going to need to select the Order Type. So we're going to use a limit, in our example. When

you click on Limit Price, it's going to have a pop-up field where you can specify the price that you're looking for. You can refer just above here and see where the current prices are. You can also click on Refresh Quotes as well, to get updated pricing. We'll type in \$6, which is currently the bid price. And then we want to make sure we look at our other fields. If we only want it good for the day, we can leave this as is. And then, as Nick had mentioned earlier, we do have that margin-or-cash feature that we could choose from. Once you've decided on the price that you're looking to put this order in at and as well making sure the details are all filled out correctly, you click on Preview the Order. It'll give you a brief read-back. And then, if everything looks as it should, you can go ahead and place that order.

Quickly here, going to go back to our options chain. For puts, it'll be the same thing. We're going to look on the right-hand side. And we'll click on the Bid price for one of these options. We'll use that 344 here, open it in that new tab for a moment. It's going to pull back up the trade ticket for us. Again, we're going to need to fill in the quantity that we're looking for, if we want to use a limit price or a market price. We'll put it in at the current bid. And then, very important, for it to be a cash-backed put, you're going to need to make sure that Trade Type is listed as Cash. So if you do not have margin on your account, you're good to go. You're not going to have those choices. But if

you do trade in margin, just keep in mind that you will have to specify in that drop-down. So, folks, we are right at time here. So do want to thank everyone for the time.

END OF AUDIO FILE

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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.

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