

# **Covered Calls LEAPS Protective Puts**

Bring more profit to your  
investments with simple  
Stock Option Strategies

# Covered Calls

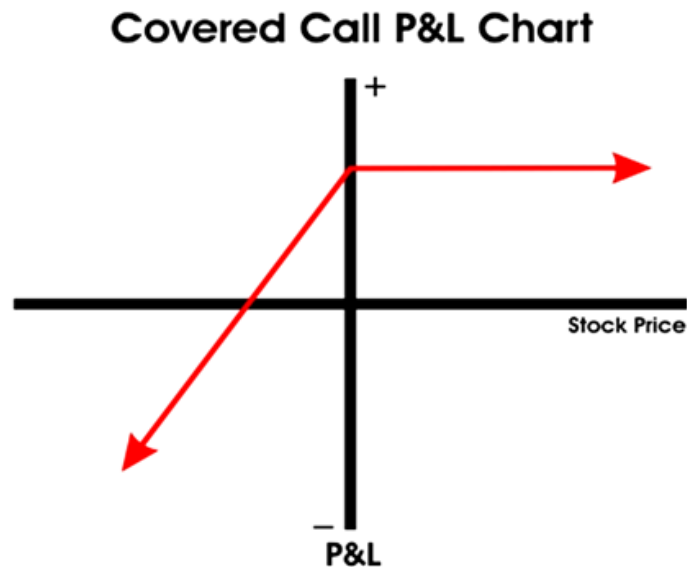
- One of the most commonly employed option strategies.
- Even the Legendary Investor Warren Buffett use's covered calls to bring additional returns to his investments.
- Commonly referred to as Buy Writes by floor traders which are widely employed as a strategy to hedge long positions.
- Normally used by retail investors with the intent of holding longer term positions.
- From time to time can be useful in mid to short term hold trades as a method of defining a targeted exit of a stock position.

# Why Covered Calls

- Market studies on stock price movements show that stocks tend to not move up or down with significance over 85% of the time.
- If that is true then longer term investors have their money sitting stagnant most of the time.
- The Covered Call Strategy is designed to exploit the slow moving nature of up trending stocks and extended consolidations.
- This strategy is well suited for small, or stocks prone to high volatility.
- Mid and large cap, well established companies make the best covered call positions. Often these are dividend paying companies.
- Premium collection from the sell of calls can be done month after month lowering your overall cost of the trade and bringing income into your account.

# Covered Call P&L Graph

- A Two Part Position
  - Long Stock
  - Short Call Options



# Benefits and Risks

- Long stock holders acquire 1 long Delta for every share owned.
- A 100 share stock position would have 100 Delta's of risk.
- When selling a Call options against the stock position the holder acquires negative Delta's
- The Call seller also acquires negative Theta putting the passage of time on your side.
- The call seller acquires an **Obligation (Liability)** to provide the underlying to the call buyer, if and only if, the stock closes above the agreed upon Strike price at expiration.
- The call buyer also has the right to exercise the call option prior to expiration as long as the stock is trading above the agreed upon strike price. This is called Early Exercise. Early exercise is relatively rare but does occur on occasion and the call seller must be aware that it can happen.

# Covered Call Example

You hold 100 shares of XYZ currently valued at \$107 a share. You sell an OTM NOV 111 call with -.36 Deltas collecting \$1.12 per share in premium with only 44 days to expiration.

- $100 \text{ Deltas (long stock)} - .36 \text{ Deltas (short call)} = 64 \text{ Delta (overall Position)}$
- This position has reduced the Delta risk but has also capped the profit potential of stock at \$111.
- Because the short call has only Extrinsic at this point (\$3 OTM) it is subject to daily decay that will speed up as expiration draws near.

## If statements

- If XYZ closes at any price below \$111 at expiration, the call buyer rights are terminated and the call seller keeps the stock and the premium collected for selling the call.
- If the stock closes at or any price above \$111 per share, the stock will be called away and the holder will receive \$111 per share for the stock and will also keep the premium collected for the sell of the call.

# Friendly side of Theta

- What we know about Theta
  - Theta decays the extrinsic value of an option
  - OTM options prices are totally made up of extrinsic value
  - Option contracts begin to decay quickly in the last 30 days of to expiration
- Covered Call rules
  - Sell only Out-the-Money calls to maximize the decay of the extrinsic value.
  - Give option buyers the least amount of time possible while still collecting adequate premium for selling a covered call. 45 to 30 days left to expiration is the sweet spot for finding and selling covered calls.
  - The Delta's of 45 to 30 tend to be the "Sweet spot" for covered calls
  - Only in special situations will I sell calls with less than 20 days to expiration.
  - To use this strategy in the most conservative way only sell call options on stocks that you currently have a profit built in. This is called legging-in.

# The Risks

- The stock upside gains are capped at the strike price of the short call
- The maximum profit on the short call is limited to the premium collected at the time of sell
- The stock can be “Called” away from you if the stock is above the strike at expiration or if the call buyer exercises early while the price is above the strike.
- The major risk in a covered call is that there is No downside protection on the stock thus trade management is very important when employing this strategy.



# Legging in to Covered Call

- It is commonly taught to sell the short call position at the same time the stock trade is made.
- I have found this to be very ineffective especially for those with technical analysis skills
- When I trade stocks suitable for covered calls I normally find them on weekly charts breaking out of a resistance or reacting to a technical support. This generally creates a short term move with momentum and I want to ride this move before ever thinking about selling a call.
- When the stock begins to show signs of slowing down for a pullback or consolidation I leg into the covered call position by selling an OTM Call. Doing this will provide you higher premiums and in most cases improve your trade success.

# Risk Management & Trade Adjustments

- Stock is falling in a covered call position and will violate up trend or fail a major support, what can you do.
  - Buy back the call first, (it will often be at a profit) then sell the stock to avoid additional risk. I always use price alerts to warn me when a stock position is a risk. Many brokers offer conditional orders that would allow you buy back the call and sell the stock at the same time with one order.
  - Purchase a Long Put (protective put) to define minimize downside risk.
  - Morph the covered call into a credit spread trade by purchasing a call further out of the money than the one originally sold. (This covers the short call and does not create a naked position.) Then sell the stock position.

Pfizer Inc 28.75 29.04 28.35 28.52 -0.45 -1.55% 2.40

Price History



PFE Add Indicator Daily 0.16 0.56% 23515800

3.30 Real-Time 0.16 0.56%

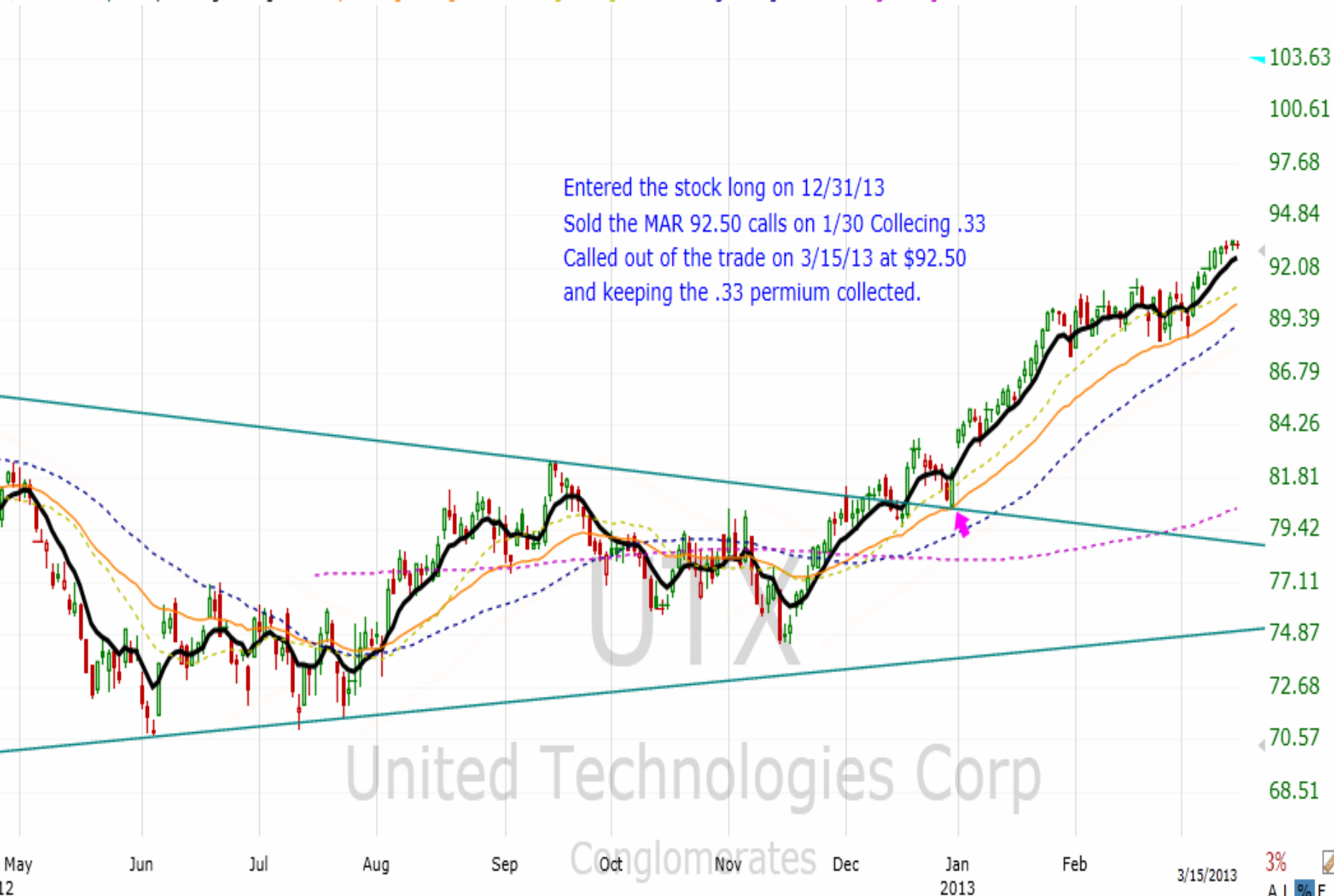
Pfizer Inc 28.58 28.95 28.52 28.89 +0.16 +0.56% 2.40

Price EAvg 8 EAvg 34 Avg 20 Avg 50 Avg 200 PSAR 0.02 0.03



United Technologies Corp 93.30 93.50 93.00 93.28 -0.17 -0.18% 2.32

Price History Exp Moving Average 8 Exp Moving Average 34 Moving Average 20 Moving Average 50 Moving Average 200 Parabolic SAR 0.02 0.03



[Price History](#) ▾
 [Exp Moving Average 8](#) ▾
 [Exp Moving Average 34](#) ▾
 [Moving Average 20](#) ▾
 [Moving Average 50](#) ▾
 [Moving Average 200](#) ▾
 [Parabolic SAR 0.02 0.03](#) ▾



# Exit Stock Trade by Selling covered Calls

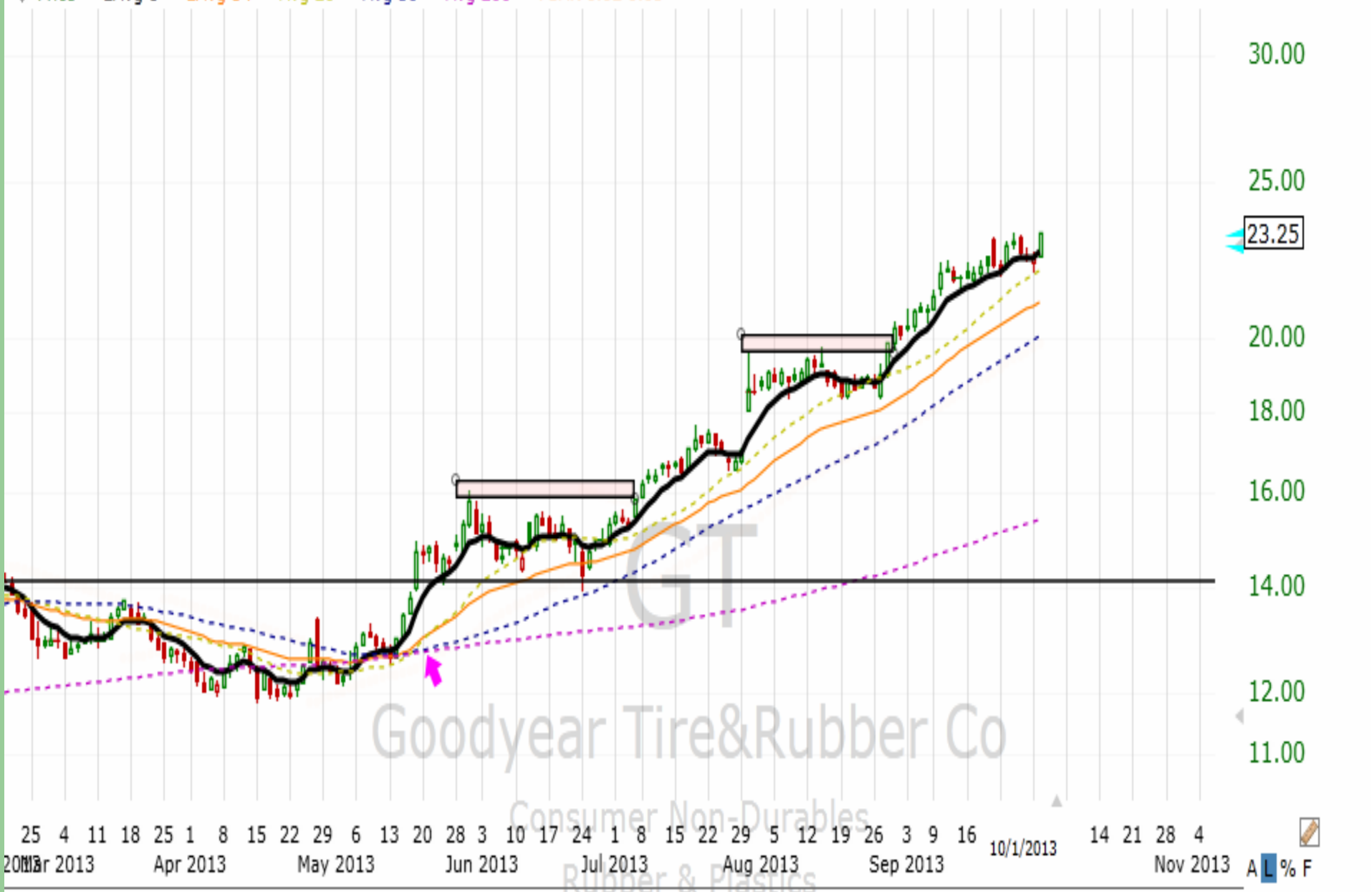
- To employ this strategy to shorter term trades the overall market and the stock being traded should be strongly bullish.
- Define a point of exit on the stock position with the goal of being called out of the stock.
- Best used on stocks exhibiting strong upside volatility. (implied volatility)
- This strategy requires good technical analysis skills to be effective. Timing is very important.
- Selling calls At or very near the money are the most effective.
- Days to expiration can be very short (less than 5 days even) if the implied volatility keeps the premium levels viable.

GT Add Indicator Daily 3.56% 4898200

0.90 Real-Time 0.80 3.56%

Goodyear Tire&Rubber Co 22.50 23.26 22.42 23.25 +0.80 +3.56% 3.68

Price EAvg 8 EAvg 34 Avg 20 Avg 50 Avg 200 PSAR 0.02 0.03





Price ▾ EAvg 8 ▾ EAvg 34 ▾ Avg 20 ▾ Avg 50 ▾ Avg 200 ▾ PSAR 0.02 0.03 ▾

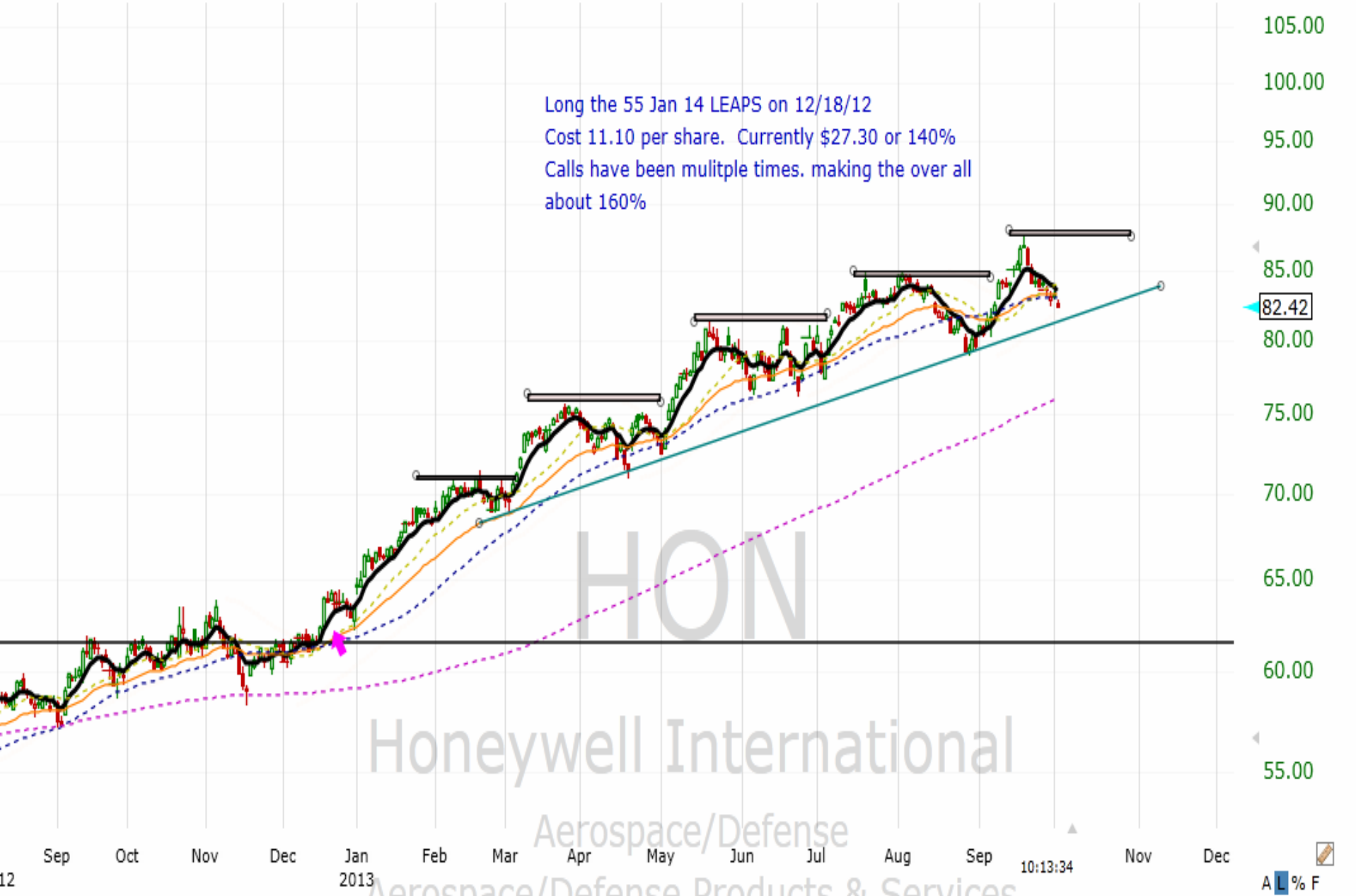


# Covered LEAPS

- Covered LEAPS are a perfectly viable strategy for longer term traders looking for more efficient use of capital or those with smaller trading accounts.
- Before attempting a covered LEAP make sure it is allowed by your broker and it does not create large margin requirement.
- A covered LEAP will create a margined position.
- The same basic rule apply to the covered LEAP as used in a standard covered call.
  - Leg in to a covered position after the LEAP has a profit in it to be most conservative.
  - Sell out of the money calls with 45 to 30 days left to expiration.
  - Deltas in the 45 to 30 range
  - Use the same risk management rules

Honeywell International 82.65 82.88 82.22 82.42 -0.80 -0.96% 2.84

Price History Exp Moving Average 8 Exp Moving Average 34 Moving Average 20 Moving Average 50 Moving Average 200 Parabolic SAR 0.02 0.03





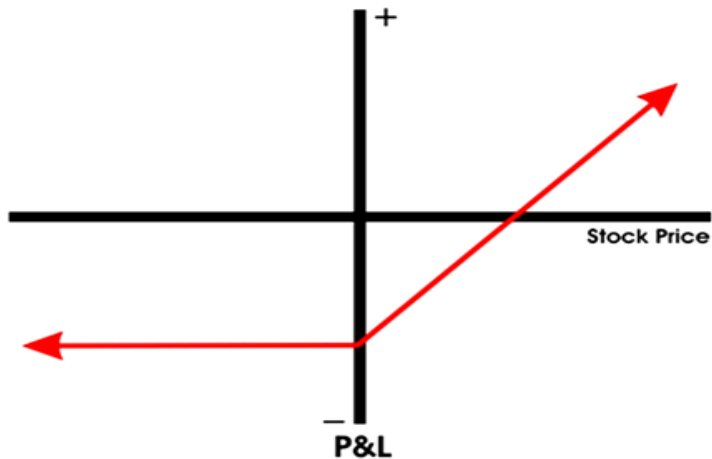
# Protective Puts

- Provide better protection than a standard stop loss but there is a cost associated.
  - Provide absolute protection if the stock suddenly gaps lower.
- Protective Puts are often thought of as insurance on long stock positions because you pay a premium to get the protection and it is absolute as long as the contract is in force.
- The Protective Put is a long position with negative delta that can be used to hedge a single position or an entire portfolio.
  - Long Puts have negative Theta so are subject to decay. OTM puts higher risk of decay
  - Put buyer gains the right to sell a stock at a specific price within a specific time.
- Particularly handy in short term situations if volatility is expected to increase due to a market driven event such as news or a stock specific event like earnings.
- Can be used to protect a stock position, LEAP position or even a directional long call position.

# P&L Graph

- Unlimited potential gain in the stock
- Limited (capped) potential loss

Protective Put Strategy P&L Chart



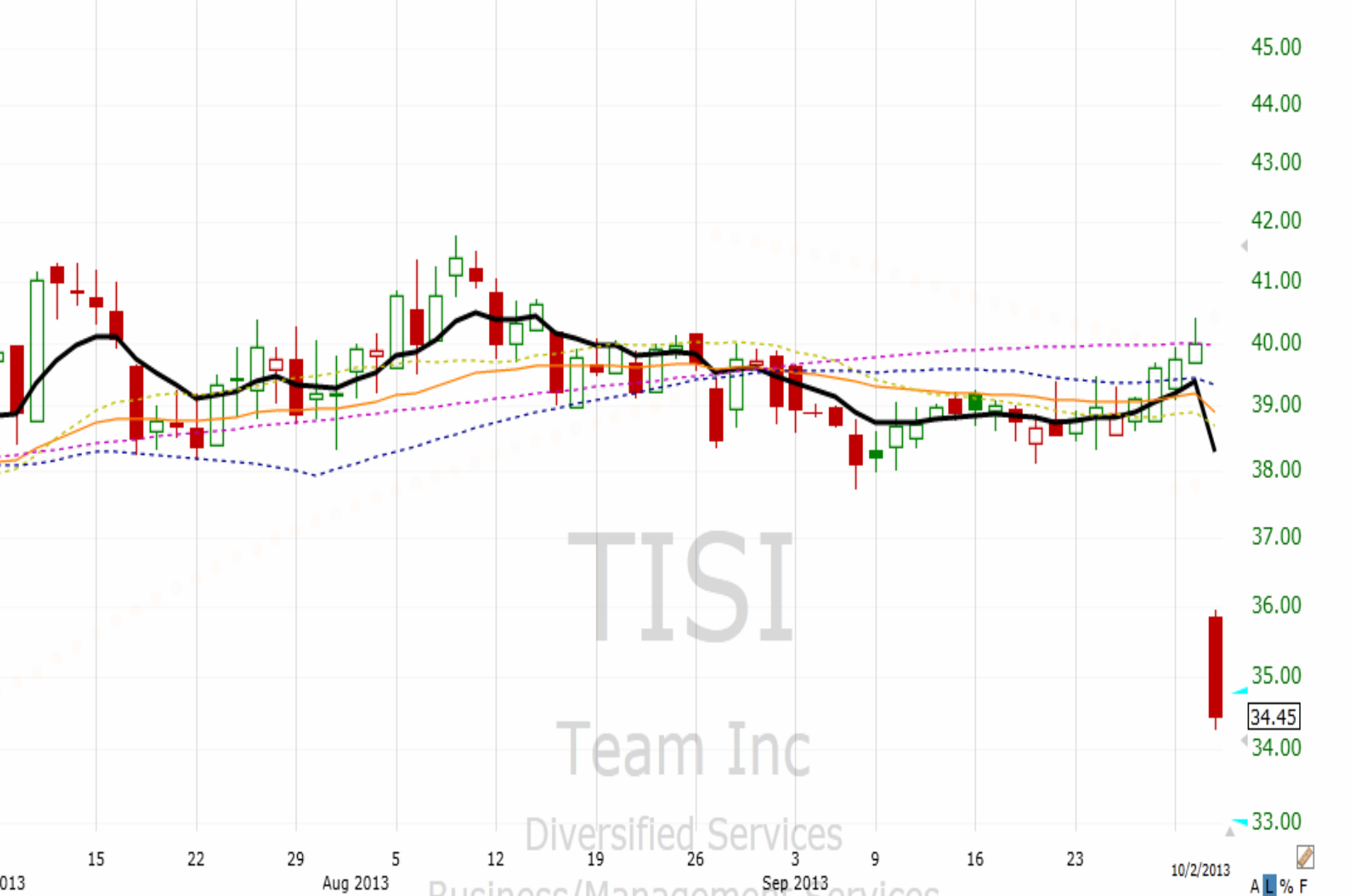
Team Inc 38.76 39.68 38.76 39.61 +0.50 +1.28% 9.03

Price History Exp Moving Average 8 Exp Moving Average 34 Moving Average 20 Moving Average 50 Moving Average 200 Parabolic SAR 0.02 0.03



Team Inc 35.85 35.94 34.25 34.45 -5.55 -13.88% 9.03

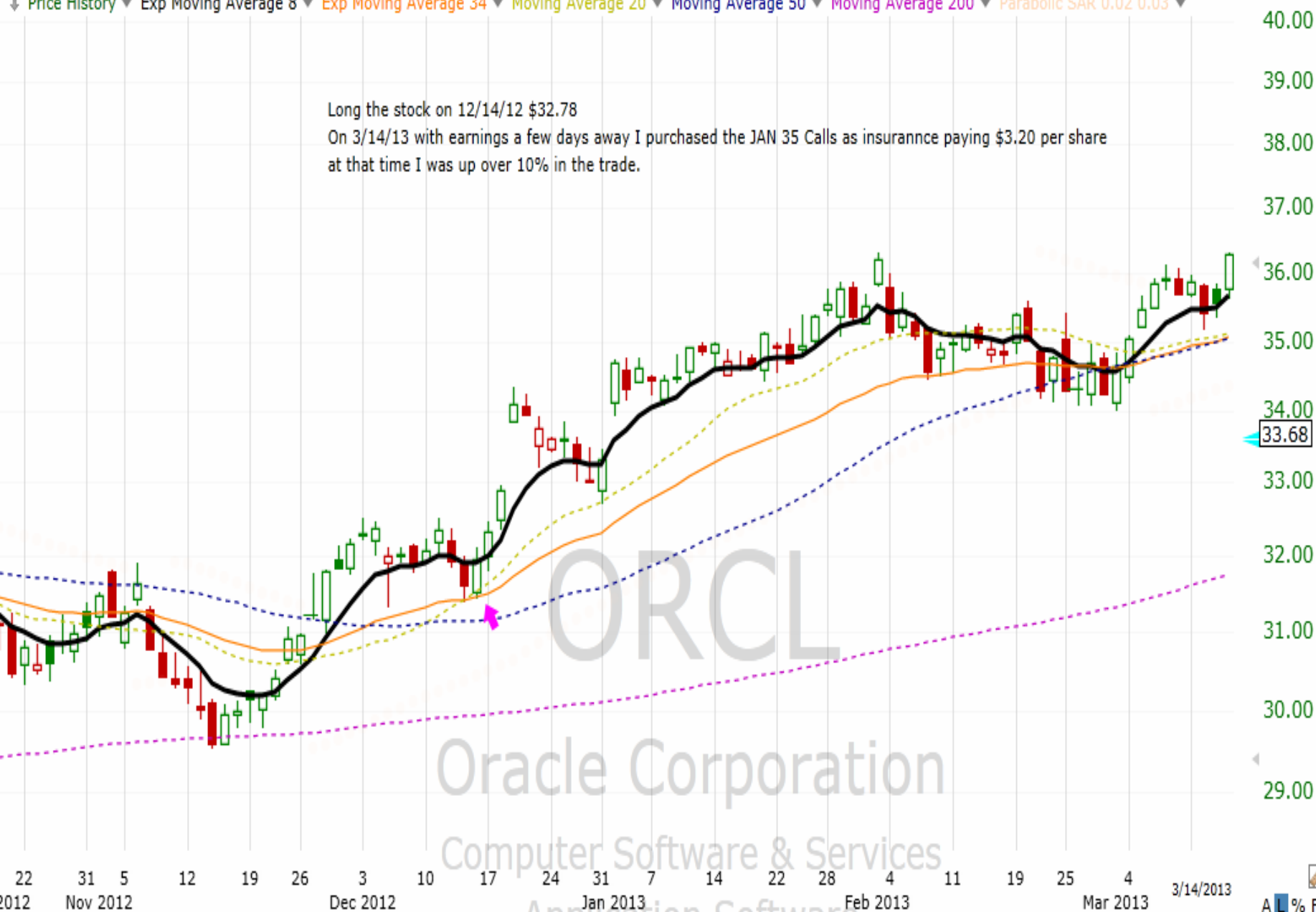
Price History Exp Moving Average 8 Exp Moving Average 34 Moving Average 20 Moving Average 50 Moving Average 200 Parabolic SAR 0.02 0.03





Oracle Corporation 35.78 36.33 35.62 36.30 +0.72 +2.02% 3.00

Price History Exp Moving Average 8 Exp Moving Average 34 Moving Average 20 Moving Average 50 Moving Average 200 Parabolic SAR 0.02 0.03



Oracle Corporation 32.79 32.94 32.18 32.30 -3.46 -9.68% 3.00

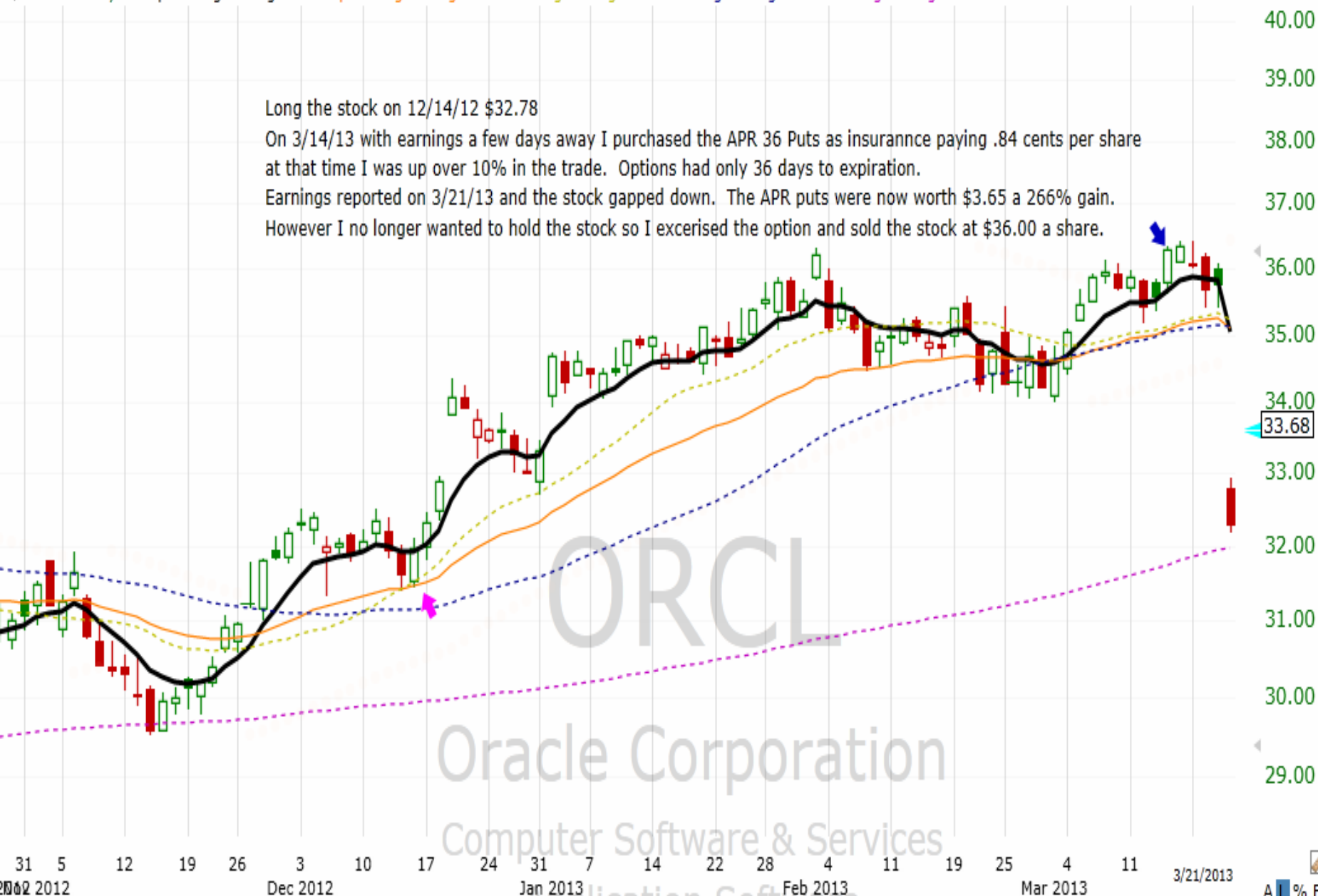
Price History Exp Moving Average 8 Exp Moving Average 34 Moving Average 20 Moving Average 50 Moving Average 200 Parabolic SAR 0.02 0.03

Long the stock on 12/14/12 \$32.78

On 3/14/13 with earnings a few days away I purchased the APR 36 Puts as insurance paying .84 cents per share at that time I was up over 10% in the trade. Options had only 36 days to expiration.

Earnings reported on 3/21/13 and the stock gapped down. The APR puts were now worth \$3.65 a 266% gain.

However I no longer wanted to hold the stock so I exercised the option and sold the stock at \$36.00 a share.



# Thursday – Premium Collection

- Vertical Spreads - Credit
  - Putting time on your side
  - Putting odds in your favor
  - The construction of the trade
  - Trade Rules
    - Making monthly income
  - Risk Management

# Class email address

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