

options central



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Understanding Covered Calls and Buy-Write Strategies

By: Bill Ryan

Often in today's financial advice columns, we read about different options strategies designed to help weather these difficult economic times. Many of these strategies are multi-legged, complex combinations often with exotic-sounding names. Ratio spreads, vertical spreads, straddles, strangles, butterflies and iron condors...the list goes on and on. Sometimes, though, it makes sense to revisit less complex strategies such as covered calls and buy-writes.

Covered Calls

One of the first options strategies that investors typically learn is the covered call. Covered calls can generate income with equities or Exchange-Traded Funds (ETFs) that are trading in a tight



range. To establish a covered call position, an investor must sell a call short and be long (or own) the equivalent number of shares of the underlying stock. For example, let's say you purchased 200 shares of XYZ corp. stock some time ago. The stock's relatively flat, trading at \$22 per share. You're not losing money, but you're not making money either. You're collecting a dividend but

would like to generate additional income. You could sell 2 XYZ June 25 call options and collect the premium while maintaining a small cushion on the downside. It sounds good on paper, but with any investment strategy, there is a trade-off. Here, the trade-off is participation on the upside above the short call strike price and the risk of owning the stock.

continued inside



Bill Ryan is a Managing Director in the options marketing department of NYSE Amex Options.

His career in options began with EF Hutton in 1982. Since then Bill has worked at various member firms and has served on numerous options industry advisory committees.

Bill also serves as an instructor for The Options Industry Council, conducting options seminars across the country for all segments of the investing community including registered representatives and public investors.

continued from front

Buy-Writes

Buy-writes are similar to covered calls except that the purchase of the stock and the sale of the call option occur simultaneously. Buy-writes should be done with stocks you are willing to own and willing to sell. This may sound odd, but let's walk through it. At options expiration, one of two things will happen. Either the option will close in-the-money (ITM), forcing you to sell the underlying stock to fulfill your obligation, or the option will expire worthless and you will continue to own the stock. So you see, you must be willing to own

the stock and you must be willing to sell the stock. The buy-write is a neutral to moderately bullish strategy that offers investors the opportunity to buy a stock with slightly less risk than an outright stock purchase. It also establishes a possible exit price somewhere above the current price of the stock. Like the covered call, in return for lowering your risk you sacrifice upside participation and still have the risk of owning stock.

Obligations

A key point to understand about buy-writes and cov-

ered calls is the obligation associated with the short call. An investor with a short call position has the obligation to sell the underlying stock at the strike price any time until the expiration date. Early assignment is possible and you may be forced to sell your stock prior to expiration. While this does not happen often, it does happen and being assigned early could cost you a dividend. This obligation also means that you will not participate in any price appreciation above the short call strike price. For example, if you are short the \$25.00 strike price call and the underlying stock is trading a \$40.00, you still have the obligation to sell the stock at \$25.00. In return for accepting this obligation, you received a premium when you sold the call option. This premium is yours to keep, no matter

“The buy-write is a neutral to moderately bullish strategy that offers investors the opportunity to buy a stock with slightly less risk than an outright stock purchase.”

Welcome to the Summer 2009 issue of *Options Central* – The Options Industry Council's educational newsletter!

In this issue, Bill Ryan, an OIC instructor, discusses two options strategies popular among investors — Covered Calls and Buy-Writes. Then in the Bid and Ask section, OIC's Help Desk provides insight into what happens to an option after a reverse split, and some FAQs regarding covered calls and recent symbol conversions. Don't forget to review our Readers' Quotes section where fellow investors share their thoughts. And finally, check out our fall seminar schedule.

We hope you enjoy reading this issue of *Options Central* and as always, we welcome your feedback!

 NYSE Amex Options.



Table 1*

Buy-Write Net Cost		
Stock Cost	Call Premium Received	Buy-Write Net Cost
(\$40.75)	\$3.10	(\$37.65)

Buy-Write Effective Selling Price		
Strike Price	Call Premium Received	Effective Stock Selling Price
\$45.00	\$3.10	\$48.10

* Commissions not included.

**In order to simplify the calculations, this example assumes commissions of \$0.10 per share for stock transactions and \$1.00 per contract for option transactions. Commissions vary greatly and will impact the profit and loss projections for Buy-Writes. Be aware of your commission rates before entering into any transaction.

Table 2*

Risk/Reward Comparison		
	Buy Stock	Buy-Write
Initial Cost	(\$40.75)	(\$37.65)
Maximum Loss	(\$40.75)	(\$37.65)
Maximum Gain	Unlimited	\$7.35

Table 3**

Static Return			
Income from sale of call	\$310	Days until expiration	130
Initial cost of shares	(\$4,075)	Days in a year	365
Total commission charged	(\$11.00)	130-day time periods/year	2.8
Real return	7.6%	Annualized Rate of Return	21.3%
If-Called Return			
Short call strike price	\$45.00	Total commission charged	(\$21.00)
Initial cost per share	(\$40.75)	Real return	17.9%
Income from 100 shares	\$425	Days until expiration	130
Income from sale of call	\$310	Days in a year	365
Total income	\$735	130-day time periods/year	2.8
Initial cost of 100 shares	(\$4,075)	Annualized Rate of Return	50.4%

what happens to the stock. Why, you might ask yourself, would I give up any upside participation? After all, investors are conditioned to buy low and sell high – the higher the better. Remember, buy-writes and covered calls are neutral to moderately bullish strategies, not to be used if you have a strong bullish or bearish opinion about a stock.

Buy-Write Example

Let's look at a buy-write example. XYZ corp. stock is trading at \$40.75 and does not pay a dividend. The out-of-the-money (OTM) \$45.00 strike price call with 130 days until expiration is trading at \$3.10. You purchase 100 shares of XYZ stock at \$40.75 and

sell 1 XYZ \$45 strike call short at \$3.10, for a net cost of \$37.65 per share (excluding commissions or trading fees) or \$3,765.00 (see Table 1). This is the maximum loss possible for this buy-write, \$310.00 less than the maximum loss if you only purchased the underlying stock. The reduced maximum loss comes with a trade-off, resulting in less upside potential. The short \$45.00 call carries the obligation to sell the underlying stock at \$45.00, no matter how high the stock price rises. Therefore, the effective selling price (once again not including commissions or fees) of the underlying, if assigned, is the strike price of \$45.00 plus the premium of \$3.10 received, or \$48.10. This means that the maximum

profit potential is limited to the effective selling price of \$48.10 minus the original purchase price of \$40.75, or \$7.35 per share (\$735.00 for the buy-write) compared to unlimited profit potential for an outright purchase of the stock (see Table 2). Keep in mind that the premium is only received once. It can either be tacked on to the strike price for a sale, or it can be used to lower the purchase price of the shares, but not both.

Rates of Return

One reason to consider the buy-write strategy is the rate of return. Generally, we look at two types – static and if-called. The static rate of return assumes that at expiration, the underlying stock

is unchanged, below the short call strike price and the short call option expires worthless. Since the option expired worthless, you still own the stock and you keep the premium you received when you sold the call. Going back to our example, we received income of \$310 on an investment of \$4,075. Assuming a total commission charge of \$11.00 for the buy-write we have a return of 7.6 percent. Next, we annualize that rate of return by multiplying the rate by a number of time periods in a year. How many time periods will depend on the time to expiration when the call was sold. In our example, there were 130 days until expiration. We then calculate 365 days in a year divided by 130 days until expiration,

“Annualized rates of return should be used only to compare different time periods and strike prices for various buy-write possibilities.”

which yields 2.8 (130-day) time periods in a year. We then take our return of 7.6 percent and multiply by 2.8 time periods/year, which equals an annualized rate of return of 21.3 percent (see Table 3). Do not annualize options returns with options that have less than 60 days until expiration.

The if-called rate of return implies that the underlying stock is above the short call strike price at expiration and will be called away. Again, we start with the income generated by the buy-write. Here is where the if-called rate differs from the static rate. When calculating the if-called rate of return we need to include any profits from the sale of the stock resulting from the short call assignment. In our example, the income is now the premium of \$310 received for the sale of the short call plus the difference between the strike price of \$45.00 and the purchase price of \$40.75 for the underlying stock. The total income generated by the buy-write would be \$735. \$735

divided by \$4096 (\$4075 + \$21.00 total commission charged for the buy-write), yields a real return of 17.9 percent, which when annualized is 50.4 percent (see Table 3).

Now let’s discuss the annualized rate of return for a moment. Annualized rates of return assume that you can execute the same strategy with the same results more than once in a given year. It is highly unlikely that this will happen. Annualized rates of return should be used only to compare different time periods and strike prices for various buy-write possibilities.

At- or Out-of-the-Money

Which call option should you sell? The \$40.00, \$45.00 or \$50.00? When you compare the at-the-money (ATM) and the out-of-the-money (OTM) calls for the same expiration month, you’ll find that the ATM calls will have a higher static return but a lower if-called return than the OTM calls. This is because the

ATM calls will trade at a higher premium and will have less upside potential than the OTM calls. When comparing the \$40.00, \$45.00 and \$50.00 calls, notice that the \$40.00 ATM call has the highest premium and a static return of 9.9 percent compared to 7.6 percent for the \$45.00 and 3.5 percent for the \$50.00 calls, both OTM (see Table 4). The \$50.00 calls – the farthest OTM – have \$9.25 of upside potential and an if-called return of 17.9 percent while the \$45.00 calls with \$4.25 upside potential have an 11.9 percent if-called return and the ATM \$40.00 calls have no upside potential and a 7.0 percent if-called return.

What to Do When...

You have a covered call position and the stock is above the short call strike

price. Once the option is ITM, the covered call has reached its maximum profit potential. You can wait until expiration, let assignment take place and realize your profit. Or, you can close the entire position by buying back the short call and selling the long stock position. Or, you can buy back only the short call, which will end the obligation to sell the stock and leave you with a long stock position. Which is best? It depends if your outlook for the stock has changed and how much time is left until expiration. You’ll also need to consider commissions, transaction costs and delivery fees. Let’s look at a few scenarios.

Scenario 1: Your view is the same and expiration is near. You believe that there is no upside left in the stock and expiration is



Table 4*

	Static Return				If-Called Return		
	\$40.00	\$45.00	\$50.00		\$40.00	\$45.00	\$50.00
Income from sale of call	\$5.10	\$3.10	\$1.80	Short call strike price	\$40.00	\$45.00	\$50.00
Initial cost of stock	(\$40.75)	(\$40.75)	(\$40.75)	Initial cost of stock	(\$40.75)	(\$40.75)	(\$40.75)
Total commission charged	(\$11.00)	(\$11.00)	(\$11.00)	Income from stock sale	(\$0.75)	\$4.25	\$9.25
Real return	9.9%	6.0%	3.5%	Income from sale of call	\$5.10	\$3.10	\$1.80
Days until expiration	130	130	130	Total income	\$4.35	\$7.35	\$11.05
Days in a year	365	365	365	Initial cost of stock	(\$40.75)	(\$40.75)	(\$40.75)
130-day time periods/year	2.8	2.8	2.8	Total commission charged	(\$21.00)	(\$21.00)	(\$21.00)
Annualized Rate of Return	27.7%	28.2%	9.8%	Real return	7.0%	11.9%	17.9%
				Days until expiration	130	130	130
				Days in a year	365	365	365
				130-day time periods/year	2.8	2.8	2.8
				Annualized Rate of Return	19.8%	33.4%	50.2%

Table 5**

	If-Called at Expiration			
	Purchase	Sale	Commission	Net
Stock	(\$4,075)	\$4,500	(\$20.00)	\$405
\$45.00 Call		\$310	(\$1.00)	\$309
Net Cost	(\$4,075)	\$4,810	(\$21.00)	\$714
Possible if-called return of 17.9%				
	Closed Prior to Expiration			
	Purchase	Sale	Commission	Net
Stock	(\$4,075)	\$5,500	(\$20.00)	\$1,405
\$45.00 Call	(\$1,210)	\$310	(\$2.00)	(\$902)
Net Cost	(\$5,285)	\$5,810	(\$22.00)	\$503
Real return of 10%				

*In order to simplify the calculations this example assumes commissions of \$0.10 per share for stock transactions and \$1.00 per contract for option transactions. Commissions vary greatly and will impact the profit and loss projections for Buy-Writes. Be aware of your commission rates before entering into any transaction.

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only a few days away. You should probably just let assignment take place. In our example, you generated an if-called real return of 11.9 percent and achieved your goal.

Scenario 2: Your view is the same but there is considerable time until expiration. Let's assume that after only 10 days, the stock has risen well above the strike price of the short call bringing your buy-write to its maximum profit potential. However, as the stock price has risen, so has the value of the short call. You now have a profit in the stock and a loss in the option. If the profit in the stock is large enough to offset the loss in the call and leave you with an acceptable net profit, it may be time

to close both positions. Remember, expiration is 120 days away and there is still the possibility that the stock can drop below the initial purchase price prior to expiration – taking your profit with it. If you close both positions now, you may have less profit than if you wait until expiration, but you will free up some capital and can consider other investing opportunities. Let's assume that the price of the stock has risen to \$55.00 with 120 days left until expiration (see Table 5). Using an options pricing model, we calculate that the theoretical value of the \$45.00 call would be \$12.10. If we sold the stock at \$55.00, bought back the call at \$12.10 and paid \$220.00 total commissions, we would have a total net profit for

the buy-write of \$503.00. This yields a 10 percent real return compared with if you wait until expiration to get a possible net maximum profit of \$714.00 resulting in a 17.9 percent real return. Should you take a \$503.00 profit now or wait 120 days for a possible \$714.00 profit? It's up to you.

Scenario 3: Your view has changed. You now believe that the stock still has upside potential. You may want to consider buying back the short call. Of course the call price will be higher than when you sold it, so you will lose money when you cover the short call position. If you choose to do this, hopefully the appreciation in the stock is sufficient to cover the loss from the

short call. If this is not the case, then you must have a strong enough belief that the upward trend in the stock will continue. The risk here is that you have a loss from the short call and you now have an unhedged long stock position.

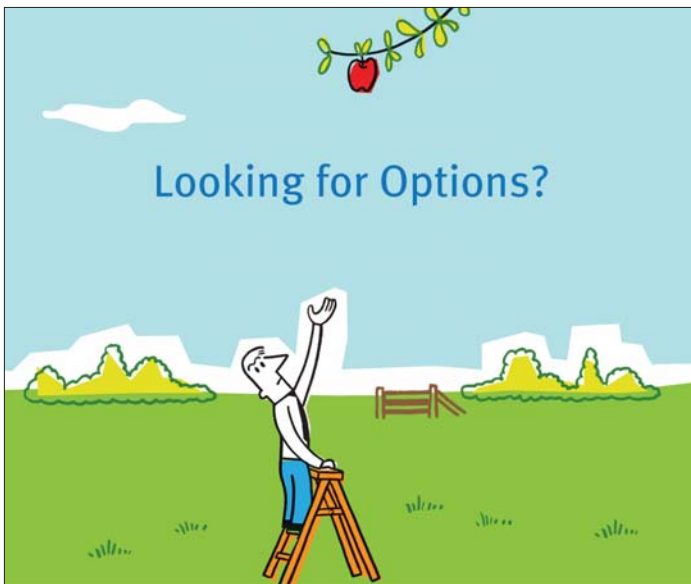
Regardless of the choice you make, be certain to understand your new risk/reward profile.

Are Buy-Writes and Covered Calls for you?

Investors should choose options strategies based on their own goals and risk tolerances. Only you can determine if covered calls and buy-writes are strategies worth considering. Keep in mind these closing points:

- The risk is the stock.
- A short call is the obligation to sell stock at any-time until expiration.
- Do not sell a call if you are unwilling to sell the underlying stock.
- Covered calls can be used to generate income with stocks stuck in a trading range.
- Establish buy-writes only with stocks you are willing to own and willing to sell.
- Buy-writes are a neutral to moderately bullish strategy.
- Compare strike prices and months by using static and if-called annualized rates of return.

The commission rates used in this article do not necessarily reflect your real-world trade scenario and are used to illustrate the impact that commission charges may have on option trades, so please contact your broker for more accurate information prior to trading. Commissions and transaction costs will affect the outcome of all stock and options transactions and must be considered prior to entering into any transaction. Investors considering options should consult their tax advisors as to how taxes may affect the outcome of contemplated options transactions.



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Common Options Terms

At-the-Money

A term that describes an option with a strike price that is equal to the current market price of the underlying stock.

Bull (or bullish) Spread

One of a variety of strategies involving two or more options (or options combined with an underlying stock position) that may potentially profit from a rise in the price of the underlying stock.

Buy-Write

A covered call position in which stock is purchased and an equivalent number of calls written at the same time. This position may be transacted as a combined order, with both sides (buying stock and writing calls) being executed simultaneously. Example: buying 500 shares XYZ stock, and writing 5 XYZ May 60 calls.

Covered Call

An option strategy in which a call option is written against an equivalent amount of long stock. Example: writing 2 XYZ May 60 calls while owning 200 shares or more of XYZ stock.

Exchange-Traded Funds (ETFs)

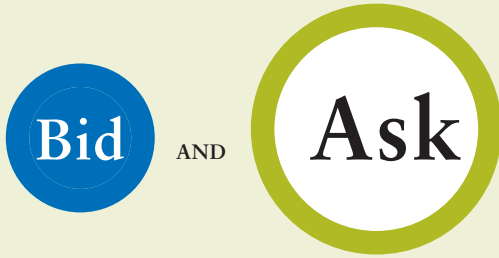
Exchange traded funds (ETFs) are index funds or trusts that are listed on an exchange and can be traded in a similar fashion as a single equity. Investors can buy or sell shares in the collective performance of an entire stock portfolio – or a bond portfolio – as a single security. ETFs allow some of the more favorable features of stock trading, such as liquidity and ease of equity style features to more traditional index investing.

In-the-Money (ITM)

An adjective used to describe an option with intrinsic value. A call option is in the money if the stock price is above the strike price. A put option is in the money if the stock price is below the strike price.

Out-of-the-Money

An adjective used to describe an option that has no intrinsic value, i.e., all of its value consists of time value. A call option is out of the money if the stock price is below its strike price. A put option is out of the money if the stock price is above its strike price.



Q: What impact does a reverse split have on options?

A: When a reverse split becomes effective, the deliverable on the options is changed to reflect the ratio of the reverse split. For example, if Company XYZ announces a 1:20 reverse split, the deliverable on the adjusted options will be 5 shares – the 100 shares that the standard option represented became 5 shares as a result of the reverse split. The strike prices and premiums will continue to use a multiplier of 100. If you exercised a \$2.50 call option on XYZ after being adjusted for a 1:20 reverse split, you would pay \$250 (same as with 100 shares) but you would only receive 5 shares. If you purchased this option at a quoted price of \$0.45, you would pay \$45 plus commissions (again, just as with 100 shares). Investors are encouraged to review contract adjustment memos from The Options Clearing Corporation for further information. Go to www.optionsclearing.com/market/infomemos/info_memos_form.jsp.

Q: There's been quite a few option symbol conversions lately, but no contract adjustment involved. What's causing that?

A: Since you are selling your long call to close, the positions will offset one another. Accordingly, you will not have an

open short position in the call, and you will not be obligated to deliver the underlying stock. When a call option is sold to establish an open short position, the option seller (writer) is obligated to deliver the stock at any time during the life of the option contract, if assigned. You would be selling the option to close. Remember, option holders have rights, and option sellers have obligations.

Q: I recently sold a covered call to open and noticed that the value of the option appears as a negative in my account. How can this be?

A: When you open a short option position, your account will be credited the premium of the option less commissions. However, to account for the position, brokerage firms generally show the short option as a negative in the account — essentially subtracting the market value of the call from the account net worth. Think of when you buy stock. You do not immediately make the amount of the purchase; rather there is a debit in the account equal to the cost of the stock plus commissions. If you started with \$5,000 and purchased \$5,000 worth of stock, there is a credit for the stock and a debit for the cost. The account value is still \$5,000 (assuming the stock price does not change). This should be discussed further with your broker, as OIC can only generalize how they may be accounting for your positions.

Readers' Quotes

"I've mainly done deep in-the-money puts. I made money last year but lost some this year. I really only have the confidence to make investments at major turns, not so much in uncertain markets and not in uptrending markets yet. I don't trust the current rally and would rather adhere to the bear market rule "stick with the trend." I've probably also done too many trades on hope. I've gotten attached to a certain strategy and then found an excuse to trade it with painful consequences."

Bill Foord - Melbourne, Australia

"One strategy working well for me is selling cash covered puts in-the-money or at-the-money, and also when assigned selling in-the-money calls against that. Thus far for 2009 the account is up 20% just from this since premiums are so high in this current environment. OIC is such an awesome resource, from the personal help on the phones to the information available from the web site and various seminars conducted near home. Thanks so much OIC! "

David Siniapkin - Dover, PA

Want to let others know about a strategy that worked great for your portfolio? Have an experience to share about an educational tool that gave you some insight into options trading?

The Options Industry Council invites you to submit your options experiences to be featured in *Options Central*. Send us your testimonials to be featured in our Readers' Quotes section for our next issue!

Options Central welcomes letters and questions that address articles or other options items. Submit letters to optionscentral@theocc.com.

Letter submissions may be edited for space. By submitting any letter, you consent to its publication along with your name. *Options Central* is under no obligation to print all pieces submitted.

Editor's Note - An options investor may not have typical results as stated above as there are multiple, different outcomes from strategies in options trading.

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- 15 Parsippany, NJ - Intermediate
- 16 Parsippany, NJ - Volatility

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- 6 St. Louis, MO - Basic
- 6 Los Angeles - Intermediate
- 7 St. Louis, MO - Intermediate
- 7 Los Angeles - Volatility
- 8 San Jose, CA - Volatility
- 13 Schaumburg, IL - Basic
- 14 Schaumburg, IL - Intermediate
- 14 Minneapolis, MN - Intermediate
- 15 Minneapolis, MN - Volatility
- 20 Detroit, MI - Intermediate
- 21 Detroit, MI - Volatility
- 27 New York - Intermediate
- 28 New York - Volatility

November

- 3 Baltimore, MD - Basic
- 3 Pasadena, CA - Basic
- 4 Baltimore, MD - Intermediate
- 4 Pasadena, CA - Intermediate

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Boston Options Exchange
1-617-235-2000; www.bostonoptions.com

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International Securities Exchange
1-212-943-2400; www.ise.com

NASDAQ OMX
1-800-846-0477; www.nasdaqtrader.com/options

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NYSE Amex Options
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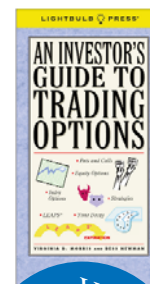
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