

The Secret to Earning an Extra 20% a Year

Series Two: When to Buy and When to Sell

Welcome to the second video in this series, “The Secret to Earning an Extra 20% a Year.” I’m Andrew Packer, Moneynews financial editor.

In the first video of this series, I outlined a few different examples to show how options work. All of those examples were for call options. In today’s video, we’ll be looking at these options more in-depth.

Now before we get started, if the first video confused you, or if you aren’t sure what an option is, well, now is a good time to watch the first video again, read the transcript that’s available in PDF form, or refer to the tutorial guide that I sent out that defines many of the terms we will be discussing today.

As I mentioned in the first video, a call option gives the buyer the right, but not necessarily the obligation, to buy a specific asset at a specific price. If you’re looking to buy a home in a few months, you could offer a small sum of money while you line up financing and perform the inspections.

If you find out that the house is worth far more than its asking price, you can either sell the option for a lot more money or buy the house. If you find out that the house isn’t worth anywhere near its asking price, you can walk away. While you lose all the money you put on the option, it’s far less than you would have lost had you bought the house.

At its core, options can help you reduce your risk, although you can also lose all the money you put into an options trade.

While I think in terms of risk, most people who talk about options look strictly at the rewards. In a way, it reminds me of gamblers in Las Vegas.

I’ve been to Las Vegas twice. I’ve had a great time with friends and family. But I’ve never gambled a single dollar. Why? Because I know the risk involved—and the potential returns just aren’t worth it.

Take roulette for example. You can put money on red, or black. If the right color comes up from a spin of the wheel, you can double your money. If the wrong color comes up, you’ll lose. If the right number comes up, you can win 36 times your money.

But, here’s the thing. There are 37 or 38 spaces on a roulette table. The 36 red and black numbers, and then the green zero and double zero numbers that result in a win for the house.

That’s why, in Vegas, the house always wins. Millions of people flock to Vegas every year to gamble. Some even win big. But with all the people spinning the roulette table, those small instances of the ball landing on a green space give the house a slight edge. Over time, as millions of players come and go, that slight edge for the house expands into billions of dollars in revenue.

That’s why if you want to gamble in Vegas, look into casino stocks, not a weekend in the desert with a fat wad of cash. That’s because roulette players are gambling. But the house, because it has an edge, is *investing*.

With that being said, some people have really mastered the art of gambling, and with a little luck on their side, can do well.

But again, the odds are small. Yet, again, millions flock there every year to win it big.

Strange, isn’t it.

In the same way, millions of people love to buy call options with the hopes of winning it big. And they can. The thing is, only a few people can master the art of call options.

Some do...but it takes a lot of work, and they really have to watch the market closely. That's not what I call a pleasant path to financial freedom.

So let's look into more detail on call options, the risk involved, and how you can profit from that risk. More importantly, I'll show you how you too can develop an "edge" much like the "house" does when they face some hotshot gambler.

Let's take an in-depth look at one of my favorite stocks, McDonald's (MCD). As I'm making this video, shares are in the high \$80's, a bit down from their highs in the low \$100's. Let's say that between now and the end of 2012, about 4 months out from when I'm recording this video, I expect shares to bounce from their current price to \$95.00.

So, since I'm bullish, but don't want to shell out \$8,800 for 100 shares of McDonald's stock in the hope that it rises to \$9,500 in value, I'll buy a December 2012 \$95 call option on McDonald's instead.

How do I determine this? First, I look at the options chain. If you pull up Google Finance or Yahoo Finance or any site that has information on stocks, you can find a tab that lists the options available for the stock. From there, you pick the month where the option's "strike date" occurs, that is, when the option expires.

The "chain" shows the available options, first call options then puts, from lower strike prices to higher ones. The chain shows the price of recent trades, and what buyers and sellers are currently bidding and asking to make the trade.

Looking at the options chain for McDonalds in this example, I see that a December \$95.00 option just sold for \$0.41, or \$41 per contract. Based on the current bid and ask price for the next trade, it looks like I can buy options here at \$0.44 or \$44 per contract.

McDonald's Corp. (MCD) - NYSE

87.75 ↑0.39(0.44%) 10:11AM EDT - Nasdaq Real Time Price

Options

View By Expiration: [Aug 12](#) | [Sep 12](#) | [Oct 12](#) | **[Dec 12](#)** | [Jan 13](#) | [Mar 13](#) | [Jan 14](#)

Call Options				Expire at close Friday, December 21, 2012			
Strike	Symbol	Last	Chg	Bid	Ask	Vol	Open Int
80.00	MCD121222C00080000	7.80	0.00	7.90	8.00	2	179
85.00	MCD121222C00085000	3.94	0.00	4.05	4.15	47	638
87.50	MCD121222C00087500	2.54	↓0.07	2.62	2.66	15	1,189
95.00	MCD121222C00095000	0.41	↓0.11	0.43	0.45	2	4,557
97.50	MCD121222C00097500	0.24	0.00	0.21	0.24	101	2,532
100.00	MCD121222C00100000	0.15	0.00	0.10	0.14	9	2,914
105.00	MCD121222C00105000	0.07	0.00	0.05	0.07	1	857
120.00	MCD121222C00120000	0.08	0.00	0.01	0.04	0	152

I also see that at the \$95 strike price, there's been a great deal of volume in this option, as shown by the number of open interest, which totals the number of options contracts outstanding. That's good, because a higher volume means that you're less likely to overpay for an option, and it's easier to sell down the road if you want to close the trade out before it expires. The current daily volume on this one is low at the moment though, so I might want to wait a few hours and see if daily volume picks up a bit before making this trade.

Let's say that on the day of the expiration, McDonald's shares have risen to \$96.00. In that case, I have two choices. I can exercise the option, and pay a total of \$95.44 for every 100 shares (the \$95 strike price plus the cost of the options). That's a gain of about 0.5%.

More importantly, as the option moves closer to being at or above the strike price, the price of the option contract should surge as well. Let's say that option rises to about \$1.00 during this time frame. In this case, it would make more sense to sell the option and take a profit.

Why? Because if I can get \$1.00 for something I bought for \$0.44, my return is a mouth-watering 127%.

If the stock rises to the 52-week high of \$102, then the option has \$7 in value. That's because you can buy shares for \$95 and then immediately turn around and sell them for \$102. In that case, your \$7 option, compared to a buy price of \$0.44, shows a gain of \$6.56, or 1,490%. That's an extreme example, as a blue-chip company like McDonald's isn't likely to move that much in a small period of time, but it's possible.

That's way better than exercising the option and taking the stock. With returns like that, you can see why a lot of people like to trade options.

But remember, we're betting that shares will rise from \$88 to \$95, an 8% gain in about four months. In today's markets that might not be a problem.

But shares could just as easily rise to \$93 or \$94. If shares don't rise to \$95, the option would

STILL lose all its value and become worthless, even though we got the direction of the stock right. This, in part, is why options are so risky. You have to not ONLY be right about the price, but the timeframe in which that price will be reached.

With options, you have to get the direction right and the time. Timing is everything. If the stock doesn't move the direction you want in the amount of time you want, you will lose everything you paid for that option.

And that is why 80% of options expire worthless.

There are a few ways to protect yourself from this risk, which I'll explain in a later video in advanced options strategies. For the moment, the important thing is to make sure you don't pick strike prices that are significantly out of line with the recent market price.

Now let's say McDonald's shares fall. That will have the same outcome as the price not quite rising to \$93 or \$94. The option will expire worthless. But, the silver lining is that the price you paid for the option is likely smaller than your loss would be if you owned the stock.

If shares went from \$88 to \$80, owning 100 shares would put you at a loss of \$800. In this example, the \$95 calls cost about \$40. So if you simply bought the stock because you were bullish, your loss would be twenty times greater than buying the call. Yes, it's still a loss, but it's useful to think of it in this way.

So far, we're looking at making a bullish bet on one stock or on a house. But call options have another side to them as well: the sell side.

Now, most people are familiar with buying call options. But for every buyer...there is a seller.

That's true of anything. When you buy a house, someone wants to sell it. When you buy shares of a stock, someone wants to sell it.

Sometimes, the company itself is the seller, issuing new shares to fund a big expansion or some other plan. But once you're on the secondary stock market, it's usually just traders and institutions trading shares back with each other.

That's the interesting thing with investing. You can have two intelligent people who analyze an asset and come to different conclusions. One person wants in while another wants out. In the case of McDonald's shares, someone may have bought shares at the 52-week high and has decided they want to get out before their loss gets any worse. Or they may have bought shares a decade ago when the price was under \$20 and it's time to take profits.

Unless the seller is a corporate insider and they're dumping all the shares they own on the market, their motive for selling may be completely different than your motivation for buying. That's especially true of most stocks, which tend to have periods where they're growing fast and attract growth investors, followed by periods of underperformance where the growth investors dump shares and value investors eventually step in.

Hence a big irony of options...most people only think about buying options...not selling them. Even though when you buy you are aware that 80% of options expire worthless...well, the same is true when you sell an option...knowing that 80% expire worthless, the odds are in your favor. Much like "the house" in Vegas, putting the long-term odds in your favor is going to reap handsome financial rewards over time.

By selling calls, you take on the obligation to sell an asset at a certain price up to a certain date. Why would you want to do this? For starters, you may expect a stock's price to trade flat or even fall over the timeframe of the option. Let's say that I find shares of McDonald's overpriced, and that shares may fall from its current price of \$88 to \$80 by the end of the year.

Looking at the same options chain as before:

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Looking at the December call options, Let's say instead of buying the \$95 calls, you decide to SELL them. Based on the current price, instead of PAYING out around \$44 per contract, you'd instead be RECEIVING \$44 per contract IN CASH.

In theory, this sounds great. You get paid right away. The cash is in your account (you can't spend it all right away though—you'll need to keep at least some as a margin requirement). If the option doesn't get exercised, however, you WILL get to keep all that cash eventually.

But there are, of course, some strings attached. Very important ones, actually.

If you sell this call option, someone else is buying it. They don't have to exercise the call if they don't want to—but if they do, you're obligated to sell them shares at the strike price—even if the current price is significantly higher.

A few things can happen. First, if shares trade ABOVE \$95.00, the calls will go up in value. That means you'll end up at a loss, as you'll either have to sell the call options at a higher price or buy shares at \$95.. In theory, your losses could be unlimited or wildly out of proportion. If shares surged at \$120 for some reason, you'd be looking at losing over \$25 per share because I'd have to buy them at the market price and sell them for the \$95 you agreed to pay when you sold the contract.

If shares trade below the \$95, your profitability is limited. If shares trade anywhere below \$95 on the day the option comes due the option becomes worth zero. What does that mean for your profitability? It means you get to keep the \$44 per contract that came into your account when you sold the option. That's not that big of a return, for taking on the risk of a much higher price in the stock. It's like picking up quarters on the street. Sure, you're making some money, but if you don't pay attention, you could get run over by traffic.

There is a way to consistently make money by selling call options. But there's one catch, and it's a big one: you have to first own the underlying stock you're selling calls against.

This is known as covered-call writing. And it's the part of my strategy to earn 15-20% per year that uses call options.

Again, using McDonald's as an example, let's say you own 200 shares. You like the stock long-term, but expect the market to trade flat to sideways over the next few months. You could sell call options against your shares, so that even if the trade went against you, you would have the shares to offer. In essence, instead of having unlimited downside from the shares going up, you'd simply be "called away" on your existing stock position and closing it out. If you're not called away, you get to keep the income that came in from selling the calls.

If you sell the same \$95 call options at a price of \$44 per contract, you'd make \$88. That's not a lot, but if you do that trade twice a year, you could make \$88 in extra income off the stock. That's like boosting the dividend 33% from McDonald's current yield of \$2.80 per share each year! Not bad for a blue chip stock. If you had the opportunity to sell call options closer to the current price, you could make more.

Now, you may be thinking, why should I sell covered calls when I can just sell the shares and be done with it? Or, why not sell now, and buy back later when the price falls?

First, selling now means you may have some capital gains taxes to pay. So buying back the shares later, after taking that into account, may lead to no extra profits, or even a loss. Also, brokerage fees tend to range a bit higher when selling stocks than with selling options. Again, I like to keep expenses down, since most investors don't think about how that will eat into profitability.

Secondly, as long as you own the stock, you're still going to get paid dividends. As dividend-paying stocks are giving more money to investors than money-market accounts right now, that's a great deal.

What if the stock goes up more? You would have lost out on potential capital gains, and, you probably wouldn't get back into the stock again.

If you own McDonald's shares and don't mind the possibility of taking profits at \$95, you can keep selling calls against your position. If calls expire and the stock is close to \$95, you could go up to \$100. Besides getting paid, this gives you some discipline as an investor in terms of taking profits on a position and moving on.

I already hinted at how this powerful tool works in the first video when I hinted at some of my personal trades.

Specifically, I mentioned that on August 25th 2011, the value of my Roth IRA increased by \$461.49. But I had already made my annual contribution for the year. It was by using this strategy that I added this cash to a \$4,800 position in my account.

I did this by selling covered-call options against a position in Silver Wheaton (SLW). In mid-August, silver prices were coming back down after a huge surge up in the late spring. I took the opportunity to sell covered-calls against this stock to profit from the short-term as it went into a decline.

I've owned shares of SLW for about two years now. It plays into a broad theme of future price inflation and higher silver prices as a result of today's reckless spending in Washington. While the shares pay a modest (and growing) dividend, they can bounce around a lot on big changes in the price of precious metals.

So by using covered calls, I can increase the income I get from this position. I essentially get paid to sit through short-term pullbacks in the stock by selling calls when it looks like the stock is hitting a short-term peak.

Unlike the example I just showed you of uncovered calls, my downside is limited. If shares get called away, I already own them. I don't have to go into the market and pay \$20 for shares to then immediately turn around and sell at \$8.

With covered call writing, you get to set the price you'd be willing to sell shares at. If the share price is below the strike price at expiration, you get to keep the money you made from selling the calls. It's that simple.

I know some people who will do this every month or so to earn an extra 1-2% on their existing stock position. Personally, I prefer to go out 6-7 months and look for opportunities to earn 10% of my money or more. For example, if I were to sell covered calls on Intel (INTC), I'd look six months out for \$28 calls (a hair above the current price) for \$2.80 per contract or more.

I do this for a few reasons. First, I'd rather just put out one or two trades on a stock position I own every year. I'd rather have fewer financial transactions, and I'd rather do them right. I know some people who prefer to sell calls each month for smaller gains, and that's certainly a decent strategy, but with a longer time period you have more time premium on the option to sell.

Since the time premium is going to zero whether the option gets called or not, you might as well sell as much time premium as possible.

I trust this video has answered your big questions about call options. As an investor, you can buy call options to bet on rising prices. If you're wrong, you could lose 100% of the money. If you sell call options, you can make a decent income—but it's better for you if you own the underlying shares before selling call options.

One of the cornerstones of my strategy to earn an extra 20% per year is to use covered call writing to boost your returns on existing stocks in your portfolio.

In the next video, I'll show you the "dark side" of options by looking in-depth at put options. You'll see that they're more than a tool just for taking short positions. In fact, you'll see why this hidden part of the market is prime territory for easily making an extra 20% per year.