Income Method #2: "Rolling" the Call from IM#1

This method is used after you have set up the base position and used Income Method One as follows:

- Buy the Stock
- Buy the in-the-money Put
- Sell a covered call (Income Method #1)

This Section's purpose is to show how to properly "roll" the call that was sold in Income Method #1 if it looks like the stock is heading into higher ground. Done properly, this Income Method puts more money in your pocket NOW while at the same time raising the level at which you will be assigned.

INCOME METHOD #2 CEGA MODEL -- Plus! CATASTROPHE REPORT

CONDITIONS:

A call has been written (sold) against the married put at the same or higher strike price as the protective put's strike price. Now, the price of the underlying stock is approaching or has risen above the strike price of the call.

EXPECTATION:

The stock will continue to go up.

GOALS:

Growth – willing to hold the stock for a time to let the price develop.

ACTION:

Buy back the short call, simultaneously sell a call further UP and OUT, while at the same time collecting cash in your account or at least spending nothing.

CATASTROPHE REPORT … What if the *worst* possible thing(s) happened?

If the underlying stock crashes, will we be in a worse position than before? If the underlying stock goes up, will we be called out at a more desirable price? What other Income Methods are available?

Income Method #2 – What It IS:

IM #2 is applied when we BTC (Buy to Close) the sold call from Income Method #1 and simultaneously STO (Sell to Open) a call at a higher strike price, one or more months further out. This is referred to as rolling the call 'Up' and 'Out'.

Why Would I Do This?

…To solve a problem. Any time we apply an Income Method, we give something up at the same time we lock something in. It's very important that we understand this concept. In the case of IM#1, we have given up a little control over the stock's price in exchange for some money now.

Say you sell a call against the married put at the same strike price as the protective put strike price. In the event that your stock keeps rising past the strike price, you may find yourself in the awkward position of having promised to sell your stock at a lower price than you want for it. This means that basically after you have done IM#1 and sold the call, if the stock price goes above the call strike price, the stock will be called out, i.e., it will be sold automatically.

Income Method #2's aim is to get you out of this predicament, WITHOUT spending a lot of money. In fact, the ideal IM#2 setup *adds* money to your account while reducing your exposure to getting assigned.

If you expect the stock will continue to move up in price and you want to take advantage of the appreciation, you will have to close the sold call from IM #1. You can *further* generate income by selling a new call at a higher strike price and further out in time. If the first call that you sell is done properly, then it's much easier to roll the call. So you may want to review the IM#1 Section if your aim is to hold stocks and sell calls for income.

To illustrate the DO's and DON'Ts of IM#2, let's look at a few examples from my own experience in the following pages.

Early Experience With Yahoo

I first started using IM#2 early on, when I found that I wanted to hang onto a particular stock. Instead of letting my covered call get exercised and then selling the put, I wanted to participate in the growth of the stock. That stock was YHOO. Because it kept going up in price, I had to do IM#2 a couple of times and eventually started paying more than I earned on the covered call to stay in the trade. Although this was the stock I learned IM#2 on, it's not the best example. I would have been better off just holding the married put position and letting the stock fly. So instead, here's one from the branch office…

Brew Me Another CUP of Starbucks!

I bought shares of SBUX (Starbucks) on Feb 3, 2003 and sold calls against it. The March 2003 $22.50 calls brought in income of $1.25, and about five weeks later they were trading at only $0.50 a contract.

February 3, 2003 SBUX

```
STO (Sell to Open) March $22.50 calls @ $1.25  (Feb 3)
Income from Original Call Sold  (IM#1)  $1.25
```

For most of the holding time SBUX stayed in a narrow range and it looked like the March $22.50 options would expire worthless. But, then on March 13, 2003, SBUX rose to a new high on high volume. Therefore, I had to act before the stock rose out of reach and get assigned. I executed the following trade, rolling the initial sold call up and out, and posted it on the RadioActive Trading website:

March 13, 2003 SBUX

```
BTC (Buy to Close) March $22.50 calls @-$ .50
STO (Sell to Open) April $25.00 calls @ $1.15

Net Income from Rolling the Call(IM#2) $ 1.90
```

The net after rolling came from the $.75 ($1.25 - $.50) from the original covered call and the $1.15 from the new rolled position:

Net Income = $.75 + $1.15 = $1.90

See what happened here? Not only did I close the first call, which obligated me to sell at $22.50, but I also rolled to the $25 call which:

1) brought in more income
2) raised the level at which I'd be called out if SBUX kept going up in price 'UP'
3) moved out the time to expiration 'OUT'

ITRI to lose Money… but it's HARD!

Here's another one. On February 13th, 2006 I sent out an email to my free subscribers detailing the ITRI entry:

"Look at this up and comer ITRI. I TRY to lose but it's hard! (Really bad pun, sorry) We have a stock at $50.75 and an option ($65 January 2007 PUT) at $16.90. Together the investment is $67.65 for $6,765 for an asset that's guaranteed to be worth $6,500 until January 2007. SO, we only have $265 at risk. Follow this one with me as we take it for a ride!"

ITRI RPM 02/13/06

```
100 shares of ITRI                 $ 50.75
1 contract Jan 2007 $65 put       +$ 16.90
Total Investment:                  $ 67.65
Guaranteed Return                 -$ 65.00
AT RISK Amount                     $  2.65 or 4.59%
```

Next, I sent out an update on March 10th, 2006. Less than a month into this RPM, ITRI was approaching the $65 strike price and I wanted to lock in some income with IM #1:

"Update 3/10/2006, Sold 1 May 2006 $65 call @ $2.45 -- $245 income to trading account. ITRI is $20 from bulletproof. Don't forget that the put

option is still worth something. We could close this one today for a healthy gain but I want to see if we can milk it for some income first."

The stock blew past that strike price and was showing no sign of slowing down. Now here's the problem I'm faced with after ITRI goes above $65: Let's say it's late April and ITRI is pushing $70. If I don't do anything and ITRI keeps shooting up, I COULD end up underwater at May expiration. Look:

```
 $ 245 for IM#1 (sold May $65 call)
+$6500 for assignment of 100 shares at $65
 $6745 total return
-$6765 original investment
-$  20 difference… a loss!
```

I should point out that this wouldn't actually be a big loss. In fact, I'd still make some money because I still own the Jan 2007 $65 put option after the stock got assigned. The Jan 2007 put would still have value since it is only May. But with ITRI moving up, that put's value would drop further and further. This isn't the place we want to be, unless closing the married put early is part of our goals in the first place.

Question: What if I wanted to hold the stock longer? I did, and here's the mail I sent out to Members Only on April 28th, 2006:

"Well here's a daisy Fusion' Members! If you look at ITRI, she's trading near $70 now. Remember that on 3/10/2006 we sold the May $65 call for income. NOW, with American-style options it's always possible that when a call is in the money, you could get assigned early. European style options CANNOT be exercised until the expiry date, which makes them easier to use with Income Method #2."

"Thing is, most options are not immediately exercised. If we DID get called out of ITRI, well... I guess we'd just sell the Jan 2007 put that we'd still own and call it good. Look at the chart. If we did that today with the ITRI RPM, we'd get $6 for selling the protective put and be out of this trade with a healthy gain."

```
 $ 245 from Income Method #1
 $6500 for assignment of 100 shares at $65
+$ 600 for closing put
 $7345 return
-$6765 original investment
 $ 580 or 8.57% in 3 months
```

"When we sell a call option RadioActively, it's always equal to or greater than the protective put's strike price. With ITRI, the strike price was $65. Now that the underlying stock has risen past this, we MAY have been called out, but it's not that likely. SO let's apply Income Method #2 today: Rolling the call 'Up' and 'Out'."

"…Remember that we always BUY options deep IN the money, and SELL options that are AT or OUT of the money. Remembering the forward edge of the ATM curve, let's look at the May $65 call we sold 3/10 for $245. To buy it back today would cost $570, so we've LOST money on the call trade, right? Not so. When we sold May $65, it was all time value. Today, it's so deep in the money, and time has eroded the extrinsic value so much, that $570 is truly a bargain. But I'm not going to buy it with my own money..."

"Let's buy back the in the money May $65 call for $5.70 and look out to the August, $70 call. Again, we have a call that is ALL TIME VALUE. Remember we make money by buying and selling time, not stock. We'll pick up $6.30 income for doing so, which pays for buying back May $65 and then some. With $60 more in our pockets, if ITRI is called out, it gets called out at $70 instead of $65. Sweet deal. AND... whether ITRI moves up or down there's still more income to be taken out of this trade with methods #3 and #4."

In the above case again, I was able to do all three goals of IM#2:

1) raise the strike price 'UP'
2) increase the holding time for the stock 'OUT'
3) put money in my pocket at the same time.

Let's look at the transactions:

ITRI RPM

```
STO (Sell to Open) May 06 $65.00 calls
Income from Original Call Sold  (IM#1)    $2.45

BTC (Buy to Close) May 06 $65.00 calls @-$5.70(Apr 28)
STO (Sell to Open) Aug 06 $70.00 calls @  $6.30(Apr 28)
Income From Rolling the Call     (IM#2)    $ .60
Income from Original Call Sold   (IM#1)  +$2.45(Mar 10)above
Total Income                              $3.05
```

Now the new situation for ITRI is that I have another $60 in pocket for a total of $305 (per contract). Also, if I'm called out at the $70 a share level, that will be $500 more than the initial sold call from IM#1.

These are classic examples of how to use Income Method #2 properly; to raise the strike price and also put money in your pocket. After all, this *is* an INCOME Method. However, sometimes you can't put money in your pocket by doing IM#2. Here's a different scenario, one that required a little money be put into the trade:

PCLN quotes on 10/3/2007:

```
BTC (Buy to Close) Oct 07 $85.00 calls @ $7.70
STO (Sell to Open) Jan 08 $90.00 calls @-$7.20
Net Debit to Account:                   -$0.50
```

This IM#2 was actually applied to a short call position that was opened using Income Method #5 (which will be discussed in later Sections) on PCLN. IM#2 can be applied to any short call position, not just those calls that were sold using Income Method #1. This IM#2 actually cost a little bit of cash to get into rather than putting income into my pocket. But, rather than being obligated to sell PCLN at $85.00 per share, the strike price was rolled 'Up' to $90 per share. The small $0.50 debit buys the opportunity for an extra $5.00 return ($500 per contract) provided that PCLN continued to go up in price.

When NOT to Use Income Method #2

We only want to make an adjustment when it's definitely, or almost definitely going to be a benefit. In the case of PCLN above, I was very bullish and the adjustment only cost $0.50, or $50 per contract. It was a judgment call on my part to move up the strike price even though it cost a little bit to stay in the trade. In my mind, the $0.50 investment for a potential $5.00 gain that seemed likely to occur was well worth the cost.

On the other hand, there are times where it doesn't make sense to use IM#2. Here's an example: I had a Member write in and say that he had used IM#4 to move up the guaranteed exit. It was a great move, though IM#3 would have been better in light of his goal of immediate returns. (More about these Income Methods later). Anyway, he also used Income Method #2 as follows. First, the setup and IM#1…

PX RPM

```
Bought 200 shares PX (Praxair) @ $66.75
BTO 2 Jan 2009 $70 put options @+$ 5.80
Total Invested                   $72.55
Guaranteed Return               -$70.00
Total AT RISK:                   $ 2.55 or 3.51%

STO (Sell to Open) Jul 07 $70.00 calls
Income from Original Call Sold  (IM#1)  $1.45 (Jun 6 07)
```

PX kept heading up! Then, on June 22, 2007:

```
BTC (Buy to Close) Jul 07 $70.00 calls@-$4.10(Jun 22 07)
STO (Sell to Open) Aug 07 $75.00 calls@ $1.65(Jun 22 07)
Income From Rolling the Call    (IM#2) -$2.45 negative amt!
Income from Original Call Sold  (IM#1) +$1.45(Jun 6 07)
Total Income                           -$1.00
```

See that? Bob (who, by the way, is an excellent pupil and has done many great trades) may have skipped the CATASTROPHE REPORT. This is the single most important filter for making trading decisions RadioActively: to consider what the consequences would be if the worst possible thing happened.

With $1.45 per contract IN HAND, he then gave up his income and ended up adding to the risk in the trade. His income sheet now reads negative, -$1.00 per contract.

As it turns out the PX calls expired worthless with PX trading up at $72.70. The PX trade ended up profitable, since Bob also guaranteed that he'd win $2.30 a contract with Income Method #4. So no harm, no foul. The point I want to make is this: Income Methods are for *Income*. IM#2 with a one month bump was not the best choice for this RPM: it meant staying in the trade for another month with an uncertain return… and it *cost* money to do it.

Bob may have gotten more for selling a call another expiry date further out, say September or October 2007, and that would have made this IM#2 trade one that actually brought in money. Or, by using a different IM strategy altogether, he might have closed this RPM early and received a certain, pretty high gain instead. We'll take a look at Income Method #3 in the next Section.

Using the PowerOptions Historical Suite of Tools, we can go back to June 22nd, 2007 and see, which calls Bob, might have used to:

1) raise the strike price
2) increase the holding price for the stock
3) put money in his pocket at the same time:

PX quotes on June 22nd, 2007:

```
BTC (Buy to Close) Jul 07 $70.00 calls@-$4.10(Jun 22 07)
```

Expiration Month and Days to Expire	Call Option Strike and Symbol	Call Option Bid Price	Total Net Debit from IM#2
Aug (57 days)	75 – PXHO	$1.65	- $2.45
Aug (57 days)	80 – PXHP	$0.35	- $3.75
Oct (120 days)	75 – PXJO	$2.80	- $1.30
Oct (120 days)	80 – PXJP	$1.10	- $3.00
Jan 08 (211 days)	75 – PXAO	$4.20	**+ $0.10**
Jan 08 (211 days)	80 – PXAP	$2.20	- $1.90

Source: PowerOptions – Historical Option Chain for PX on June 22nd, 2007

We already saw that rolling to the Aug 75 call for $1.65 per contract would result in a negative income of -$2.45 per contract. If the position was rolled to the Aug 80 call the net debit would be much higher since the 80 call is further OTM and the premium is much lower. This table shows that the only call option on PX to roll 'Up' and 'Out' to while still putting money into your pocket would have been the 2008 January 75 strike call that was selling for $4.20 per contract. Bob would have been able to put $0.10 in his pocket, but he might have been obligated to hold the position for an extra 211 days.

A tool that is available in PowerOptions called "Simulate a Trade", which will be very useful in comparing graphically the effect of the roll out by showing the present position along side the proposed roll out. An example of this tool can be seen in the Finding Trades tab on page 12.

Income Method #2 Summary

Sometimes a stock that we've sold a call against shoots up past that call's strike price, and we find that we've obligated ourselves to sell our stock at too low a price. Most of the time this problem can be avoided by properly selling the first call with enough coverage (see the previous Section). It is important not to let the call sold get too far ITM, because upward movement in the stock will be lost to both the calls increase in premium and the puts decrease in premium. But in case you run into this problem it doesn't have to stay a problem. Other Income Methods like IM#2 can be used to further augment the return from your RadioActive Profit Machine.

Income Method #2 helps us solve a problem that was created by using Income Method #1, IF we want to hold the stock for further growth. It consists of buying back the short call, and at the same time, selling a different call further out in expiry, further up in strike price, and ideally puts money in your pocket.

If you're considering doing IM#2, remember the CEGA model. If the "Goals" part of your CEGA is to hold for growth then IM#2 may be a good choice. On the other hand if you need money now, *check out the next Section* for perhaps a better alternative.

REMINDER: With *all* the Income Methods, we want to use our CEGA model and Catastrophe Report. Make sure that your Actions are appropriate to the Conditions, Expectations, your individual Goals, and that you're okay doing them in light of the worst possible outcome.

You're well on your way!

You are now 1/5th of your way through the 10 Income Methods discussed in this text. You just learned about the dos and don'ts of the very first Income Method and the importance of applying the CEGA model and Catastrophe Report.

Before you move forward, this would be a great time to view the second Video CD: Income Methods – The Beginnings. This Video CD will not only reinforce the concepts of the proper RPM setup, but it will also reinforce the CEGA model and uses of Income Method #1 and Income Method #2. Then...on to Income Methods #3 and #4!