Income Method #9: Rolling DOWN The PUT

The best thing about selling covered calls is that in a falling market you get to keep a lot of premium. The worst thing is that you also get to keep the stock, whose price is declining. In the case of an RPM, however, you have *two* components to work with; the stock *and* the put. Here is the setup of a RadioActive Profit Machine that my friend Ernie put together on Wyeth Labs:

04/14/08 WYE ($44.89) RPM Setup:

Buy WYE 400 Shares @	$44.89
BTO 4 Jan 09 $50.00 puts @	+$ 8.93
Total Invested:	$53.82
Guaranteed Price	-$50.00
Total AT RISK:	**$ 3.82 or 7.10%**

After this initial setup, Ernie did what any bearish options player would do in a falling market. He sold calls! He actually executed Income Method #1 (**IM#1**): Selling a Covered Call twice. On May 2, 2008 he sold four June $47.50 calls at $1.32 and subsequently bought them back for $0.47. Then on June 23rd, he sold four August $50 calls at $1.77 and got a GREAT DEAL for closing them at $0.08. Here's what that looks like:

5/2/08 WYE ($46.00)

5/2/08 Income Method #1: STO 4 Jun $47.50 Call	+$1.32
5/28/08 Buyback of 09 Jun $47.50 Call	-$0.47
5/28/08 Net	**+$0.85**

6/23/08 WYE ($48.00)

6/23/08 Income Method #1: STO 4 Aug $50.00 Call	+$1.77
7/30/08 Buyback of Aug $50.00 call	-$0.08
7/30/08 Net	**+$1.69**

Now, with $2.54 credit per share in his pocket ($0.85 from the first **IM#1** trade, and $1.69 from the second) Ernie watched, seemingly helpless, as Wyeth Labs kept falling. While Wyeth Labs was falling, the put option covering it was gaining big time. Ernie hit on a brainstorm, why not swap that put for something a little more reasonably priced?

Normally, I would not do this because rolling the puts down generally adds more risk into the trade. But in a case like this, where Ernie had already taken a good amount of credit from selling calls… rolling down the puts represented a bulletproofing opportunity. Check this out!

7/31/08 WYE ($40.50)

7/31/08 Income **Method #9** STC 4 Jan 09 $50.00 Put	$11.07
7/31/08 Roll down to Jan 09 $45.00 Put	-$6.63
7/31/08 Net	**+$4.44**

See that? Pay attention now because this gets interesting fast. Normally, as I said, if you roll down a put, you do receive a credit for selling the higher priced put and buying a lower priced put, but you increase your AT RISK amount. Risk is increased because we are buying more time value when we purchase the lower strike put and we changed the guaranteed price we can get back. But is that how this played out? Let's tally up our new picture, shall we?

4/14/08 Total initial investment	$53.82
5/28 Credit from Income Method #1	-$ 0.85
7/30 Credit from Income Method #1	-$ 1.69
7/31 Credit from Income **Method #9**	-$ 4.44
New Cost Basis of RPM	$46.84
Price Guaranteed by the $45 put options	$45.00
New Total AT RISK:	**$ 1.84 or 3.42%**

That represents an almost negligible risk. Also remember the value of the put option on 7/31/08 was $6.63. Now, with the stock plunging, Ernie was able to collect even more income from Wyeth Labs by selling calls. Isn't this remarkable…Wyeth Labs actually lost quite a bit of ground. Because the put strike price was lowered, it was easier to write calls at the put strike price or higher, as suggested in Income Method #1. Ernie took those lemons and made it into a sweet sip of lemonade.

8/18/08 WYE ($42.94)

8/18/08 Income Method #1: STO 4 Sep08 $45.00 Call	+$0.92
9/9/08 Buyback of Sep 08 $45.00 Call	-$0.12
9/9/08 Net	**+$0.80**

After buying to close those calls, Ernie rolled the puts down again.

10/10/08 WYE ($29.89 close)

10/10/08 Income **Method #9** STC 4 Jan 09 $45 Puts	15.07
10/13/08 Roll down to Jan 09 $40.00 Put	-8.73
10/13/08 Net	**+6.34**

This **IM#9** roll had some unusual circumstances associated with it. First 10/10 was the third day of a steep decline. It was a Friday and the sell off was on very high volume. WYE actually went as low as $28 on the day that the put was sold. Because it was Friday and the put was sold near the end of the day, the purchase of the replacement put was not executed until Monday the 13th when WYE went up as high as $33.50. This was a total swing of more than 5 points in 6 hours of trading. The result was a very favorable sale of the $45 put and a very favorable purchase of the $40 replacement put. In fact, a $5 lowering of the breakeven point for the put resulted in a $6.34 net, which is very unusual.

The take away lesson here is that selling on an extreme down day with increased volatility and buying back on an up day can be very sweet indeed. This trade exposed the position to additional risk over the weekend, but in Ernie's judgment it was justified.

Seven days later after WYE had a run up in price for four days in a row another covered call was written:

10/20/08 WYE ($34.86)
10/20/08 Income Method #1 STO 4 Nov08 37.50 Call +$0.85

The general rule is to write the **IM#1** call at or above the put strike price (currently at $40). In this case Ernie decided to write the $37.50 call because of the steep run up in the stock price of WYE and he was prepared to buy the call back if it went ITM (above $37.50).

To summarize the last few transactions:

Cost Basis after first **Income Method #9** play	$46.84
Minus Credit from 9/9, 10/13, 10/20	-$ 7.99
New Cost Basis	$38.85
Return Guaranteed by the $40 put options	-$40.00
Total **AT RISK** if Nov calls expire worthless	-$ 1.15

Negative AT RISK means it'll be BULLETPROOF!

The 10/20/08 covered call trade was bought back for $0.10 when WYE ($31.32) declined in price a few weeks later:

11/6/08 WYE ($31.32)

10/20/08 Income Method #1 STO 4 Nov08 $37.50 Call	+$0.85
11/06/08 Buyback of Nov 08 $37.50 Call @	-$0.10
11/06/08 Net	**+$0.75**

A week later WYE popped up in price and created another opportunity to write the $37.50 strike price again, however, this time it was the Dec. option that was written and it was written for a much better premium.

11/14/08 WYE ($35.00)
11/14/08 Income Method #1 STO Dec08 37.50 Call +$1.75

Every trade from 10/13/08 on has been BULLETPROOF! That is a far cry from losing the 7% that was at risk in this deal... as I probably would have done because I normally make no adjustments to a stock that's falling. Income Method #9 WORKS if you are paying attention to your new risk picture each time this method is used. I know that Ernie is glad that he's RadioActive. Are you?

Eventually, the WYE position was closed because Pfizer offered to purchase WYE on January 23, 2009. WYE was sold for $42, which was 6.7% less than the original stock purchase price. At one time when the stock sold for $28 in October, WYE stock was down 38% from its purchase price. The entire market was off between 40 to 50% and this trade was exited in January with a 10-month gain of 19%, which included 3 dividend payments and was not AT Risk for more than 7.1% in the very beginning.

As a general rule of thumb, for **IM#9**, it is best not to roll the put down to or under a strike price that is less than your effective cost per share for the stock. The effective cost per share for the stock is the original cost of the stock minus all of the income generated using the various income methods. If you use the PowerOptions Portfolio tools, this effective cost per share is calculated each time an income method is applied. The protective put should stay one or two strikes ITM relative to the cost per share of the stock.

When a stock declines, it is often difficult to know what to do. With the married put in place there is another degree of choice, rather than selling the entire position it's possible to roll the put down as illustrated in the WYE example above. However, in many cases it is best to simply exit the position entirely. The use of **IM#9** assumes that the stock will recover at some point because there is an increase in the maximum risk in exchange for the lowered breakeven point of the position. If the stock does not recover, it would have been better to just liquidate. Remember that the married put position is ultimately bullish. If the stock goes straight down and has no hope, just get out.

Summary of general rules for IM#9:

1. Only use IM#9 if it is expected the stock will recover in the time frame of the protective put. It is important that you still like the stock and want to hold it. The best circumstance for using **IM#9** is when the decline is not company related, but a general systematic decline. Otherwise it may be better to liquidate immediately.
2. When rolling down the protective put, go one strike at a time in order to avoid taking on too much adjusted risk. But the put should still be 1 to 2 strikes ITM after the roll down.
3. In reducing the strike price for the put down, avoid going below your adjusted cost per share for the stock. The put should remain ITM relative to the cost per share.
4. It may be required to move the new put out in time also, if recovery is expected to take some time.

When a decline does happen, it is important to assess if the decline is specific to the stock or just a general decline. A general decline gives some hope that the stock will recover with the market. Declines that are specific to the stock or its industry are much more dangerous and may call for liquidation. It is OK to liquidate with a limited loss. If you have only one position that went against you for a potential loss, you can use the search tool on PowerOptions to find a potentially better performing RPM. However, if several positions going against an investor, it may be a good time to liquidate more broadly with a limited loss and wait for more favorable market conditions. Sometimes being in cash is the wisest and safest position of all.

Advanced more aggressive techniques using IM#9:

As previously mentioned, **IM#9** is only applied if it is expected that the stock price will recover. If the stock price recovers there may be opportunities to take advantage or leverage that recovery in stock price with the cash generated when the put is rolled down.

IM#9 brings in cash, but this cash does not represent a net gain because the stock price also declined. Therefore, the cash generated by **IM#9** is not really income, but it is cash removed from the position and available in the account. Out of all of the cash generating techniques considered in the Blueprint, **IM#9** generally develops the largest cash dollars. These dollars can then be used to enhance the position in anticipation of the stock price recovery. Two methods will be considered to leverage a position after IM#9 is applied:

1. Buying more stock with the cash generated
2. Buying a long call with the cash generated

The first approach of buying additional stock has been used in Fusion and Ernie has applied the second approach several times recently in his own account. Both methods risk all the cash generated, therefore, these techniques greatly increase the maximum risk initially established for the position. However, they have the promise of greatly increasing the possible returns.

Buying more stock:

In the WYE example above, **IM#9** was first applied on 7/31/08 when the stock had fallen about 10% from its purchase price. When IM#9 was applied it resulted in generating about $1,776 (400 shares X 4.44 points) in cash. This cash could have been used to buy more shares of stock. Since the stock was selling for about $40 per share, about 44 shares of additional stock could have been purchased. Because this is not a round lot of 100 shares, it would not be possible to buy a put to protect this purchase. But a put could be purchased (based on 100 shares) and have the position over protected as an alternative. In this particular case that would have been fine because WYE did not bottom out until October or 2 ½ months later at a price of $29. WYE never made it back up to the $40 level until January 2009. The lesson to learn from this example is to be firm in your conviction of a recovery, be patient, and be sure you can financially afford the additional risk or buy the extra put protection.

There was another opportunity on 10/10/08 to again purchase additional stock when **IM#9** was applied. It would have resulted in generating $2,536 cash, which could have been converted into 85 shares that sold for about $30. In total 129 extra shares could have been bought for an average cost of $33.43 per share. One of the advantages of dollar cost averaging this way is the ability to buy more shares as the price of the stock drops, which results in a lower cost per share.

It would have taken a strong stomach to hold on to the extra shares during the ensuing months of down market. However, eventually this approach would have been very rewarding, but there was considerably more risk involved over those next few months. In the end, the extra 129 shares would have resulted in an addition $1,000 of profit to the WYE position.

Buying a long call:

Using this approach is even more leveraged than buying addition stock because options can generally be used to control 100 shares of stock with only a 5 to 10% cash outlay. Rather than buying 44 shares we could have purchased 2 contracts of the 10Jan40Calls and instead of 85 shares purchased 3 contracts of the 10Jan30Calls. The first contract purchase would have broken even, but the second purchase would have added an additional $2,500 of profit to the WYE position. It is often difficult to predict how long it will take for the stock price to recover after a decline. With the use of long calls, the choice of strike price and month of expiration can be of critical importance. If the 09Jan Calls had been used instead of the 10Jan Calls, the result would have been only a few hundred dollars rather than $2,500. Therefore, the lesson to be learned is to go further out in time for the call purchase to avoid running out of time and give the recovery time to happen…remember, don't time your trades, trade time! Also consider only using this technique on the 2nd or 3rd use of **IM#9** to assure that the bottom is closer at hand to provide a better entry price for the call purchase and also shorten the time to recovery.

A Cautious note for consideration:

There is a risk in buying a call after applying **IM#9** because the stock is in a downtrend. The use of long calls to leverage a position might actually be better applied to a rising market in place of **IM#4**, as previously discussed. **IM#4** is used to roll up the put to a higher strike price because the stock is advancing and the original put is now ATM or OTM. This allows us to take advantage of the ATM Bell Curve. Rolling the put up in strike price with **IM#4** generally results in putting more cash into the position to pay for the new ITM put, generally resulting in a Bulletproof RPM. Rather than putting in additional cash into the put you may want to consider buying a call with the additional cash. Again this creates more leverage and the possibility of greater gain. The entire call premium may be at risk, but the stock price is moving up and **IM#4** may afford better timing of the long call purchase than after **IM#9**, which is applied during a falling market. With the original put still in place, a stock price decline is still protected and the long call enables the profits to accumulate faster for a stock in a favorable upward trend.