

Income Method #1 – Selling a Covered Call or Creating a Collar

This is where most folks (like me) began their options trading career: Selling Calls against stock they owned.

Income Method #1 is applied when you own a Married Put (long stock, long put option) and sell a call against the stock. When a stock, long put, and sold call are executed simultaneously the position is called a collar. However, we are generating income by selling the call against the stock we already own, which is most frequently termed a covered call.

INCOME METHOD #1 CEGA MODEL -- Plus! CATASTROPHE REPORT

CONDITIONS:

You own a RadioActive Profit Machine and want to cancel some of the risk you took on at its inception.

EXPECTATION:

Price of the underlying stock will not exceed the strike price of the call you're selling by more than the premium you collect within the time to expiry.

GOALS:



Income in the near term to reduce risk, but don't necessarily want to get called out yet.

ACTION:

Sell to Open a near term call or calls, "covered" by the corresponding number of shares in your Married Put.

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

If the stock's price finishes *below* the lower strike calls, you have received income, have no obligations, and your AT RISK amount has been lowered or eliminated. If the price of the underlying stock moves up, the short call obligates you to deliver the stock at that strike price. Can you do this at a profit or very small loss?

There's a lot to consider BEFORE you sell a call against your Married Put.

Premium

RadioActive Income Method #1 is ATOMIC: At or Out of the Money In Calls. Your put option may or may not be In the Money, but it is important that the calls you sell are ATOMIC. They will then have the maximum in both premium and room to move if necessary.

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Selling In The Money (ITM) calls do collect a higher premium, but also puts a lower cap on your gains. I like to give my stock as much grow room as possible in case the stock spikes up. Covered Call investors sometimes write ITM calls to get increased down side protection. However, in the context of a married put it does not make any sense to sell ITM calls. Down side protection is provided by the put that is purchased rather than selling ITM call premium.

Also, selling a call at a strike price below the strike price of one's protective put is a risky proposition. If the stock price spikes higher than the call strike price you could wind up obligated to deliver stock at a lower price than you need to cover your whole investment for the stock plus the put... not cool. There is a correct way and an incorrect way to apply Income Method #1. Many experienced options investors that have purchased The Blueprint or attended one of the free Webinars tend to wonder why we **wait** to apply IM#1 to an RPM instead of selling an ATM call as soon as the RPM is opened to start generating income.

There are several reasons:

1. You expected the stock to go up when the position was created. Give it a chance to move without limiting your gains with a covered call. Adding a covered call limits the up side potential by creating an obligation to deliver your stock.
2. Generally the best call premiums are ATM, but with an RPM in place writing ATM or under the strike of the put can be very dangerous if the stock suddenly goes up in price. If a stock buy-out happens, the stock will rise and the call will also rise, while the put will decrease in value. We want to avoid the situation where the rise in call obligation and loss in put exceed the gain in the stock (a loosing position).
3. One wants to write the call at the put strike price or higher, but the premiums are generally too low to write those strikes immediately. You need to let the stock price rise a little to get a reasonable premium.

Why is it incorrect to write a call below the strike price of the protective put? Let's take a look at the **IMPROPER** way to apply IM#1 with the following example. The following is a trade that was made by one of the PowerOptions' staff members and that he listed for us on the RadioActive Trading Blog:

December 26, 2008 KFT (Kraft Foods Inc.)

Bought 100 shares KFT	\$26.29
Bought To Open 1 2009 June 30 put	+\$ 4.80
Total Invested:	\$31.09
Guaranteed Value until June 19, 2009	-\$30.00
Total AT RISK:	\$ 1.09 or 3.5%

If Kraft (KFT) suddenly dropped in price due to any unforeseen event, I was never at risk for more than 3.5% of my initial investment amount. Between December 26th and June expiration I have the opportunity to take advantage of unlimited upside potential if the stock price rises, or make adjustments using the Income Methods to pay for the minimal \$1.09 I have at risk. Everything was great, the married put was in place with unlimited gains possible, but then three days later, KFT had moved up in price and was trading for \$27.00

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or so. Instead of being patient and waiting to apply IM#1 correctly by selling the call at the put strike price or higher, I jumped at the chance to write the Feb 27.50 call for \$0.95.

IM#1: STO 1 Feb 2009 27.50 call	-\$0.95
Original Per Share At Risk	\$1.09
New AT Risk Amount (if call expires)	\$0.14 or .45%

If everything worked out to my benefit, Kraft (KFT) would remain below \$27.50 per share through February expiration. My call would expire worthless and I would still have over 5 months to adjust the position and pay for the remaining \$0.14 at risk. But I had succeeded in changing a Neutral to Bullish position into a Bearish position!

I was not trading time, I was timing my trades...a relative sin for a RadioActive Trader! So, what happened? Over the next 2 weeks I watched as Kraft moved up almost \$0.40 / day.

"Surely Kraft won't break \$27.50," I thought. Kraft did.

"Surely Kraft won't go above \$28.00," I pondered. Kraft did

"Surely Kraft won't go above \$29.00," I hoped. Kraft did

My position turned into a nightmare. I was losing on the call **and** the put as the stock rose in price over the call strike price of \$27.50. The loss on the put and the call exceeded the advance of the stock. I did not follow the rules of IM#1 and now I was in a losing situation. If I moved to buy back the short call option I would add extra risk to my position. If I liquidated the collar spread I would lock in a significant loss. All because I was greedy and took a great RPM position and turned it into a Bearish trade by selling a call below the protective put strike price.

Let me tell you how embarrassed I was when Kraft was trading at \$29.60 per share on January 28th, 2009 and the Feb. 30 call could have been sold for \$1.10. This would have completely bulletproofed the position and adhered to the rules for applying IM#1. Instead, I was holding a position that if liquidated would have a loss of 2.8%, or added to my risk if I bought to close the call.

Be smart and only sell calls against the stock at or above the strike price of your protective put. Alternatively be prepared to act quickly as soon as the stock price moves over the call strike price and the call goes **In The Money (ITM)**. Buy it back and consider applying IM#2.

I like to sell calls on most of the stocks I play for a nice fluffy income of .20 - .25 cents per week. That is, if there's five weeks until expiration, put me down for a premium of \$1.25 or better for each call I sell. Also, I don't normally bother with less than \$1.25 in premium, although there are exceptions. Note how the KFT position above also broke this rule, as the premium was only \$0.95 for a 5 week time period.

Remember I said *most* stocks I want .25 cents a week for. But for some it just doesn't make sense to take that little money. When I wrote the first Blueprint, most every stock I

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was playing was in a range of \$20-\$50. But last year when I publicly played GOOG on the website, that was a totally different animal! I got GOOG in a paper trade at \$428.93 plus a Jan 2008 put for \$93.90. As GOOG's price approached \$500, the first call I sold was a March 2007 \$500 call at \$21.00.

Although I do look at the actual dollar amount of the calls that I sell, now on higher priced stocks I don't stick to .20 - .25 cents a week anymore, but more like a percentage of the stock's total value. Every stock is different both to insure and to collect premiums because of its individual volatility, so it's as much art as it is science for me at this point. A good guideline for premium return is 1 percent of the stock's total value for every month of exposure as a minimum. The further out the put is in time gives you more months to write and collect another 1%.

Exposure

The RadioActive Trading term **Exposure** refers to this fact: your short call represents an obligation to perform. Every day before expiration, your stock has the risk of being assigned if it goes ATM. Although this risk can be "managed", one must consider the balance of risk vs. reward. There is less risk of assignment if the strike price is far OTM, but this will generally result in a lower return. See the chart below: This chart represents data from a large company that is selling for \$20 per share

Strike Price	Bid Price	% Time Value	Prob. Above The Strike	% Return Annual
17.5	\$3.25	3.0	69%	36.5
20	\$1.62	7.3	51%	80.1
21	\$1.09	5.4	44%	57.8
22	\$0.69	3.4	38%	35.5
23	\$0.40	2.0	32%	20.3
24	\$0.21	1.0	27%	11.2

Source: PowerOpt.com option chain

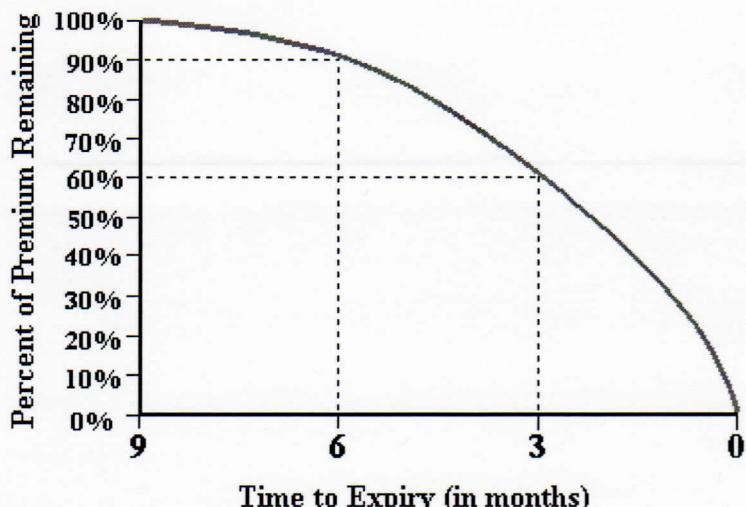
The chart above illustrates the risk vs. reward in the choice of the strike price. The At The Money (ATM) strike price is \$20. Strikes over 20 are OTM and strikes less than 20 are ATM. The largest time value (7.3%) and return (80.1%) are received for strikes ATM where the probability of assignment is 51%. At the higher strike prices the time value, return, and the probability of assignment all go lower. This means that for OTM strike prices the more you decrease your probability of assignment the lower the return you can expect.

This chart represents data from the same large company selling for \$20 per share and for the \$20 strike price for each month shown.

Month to Expir.	Bid Price	% Time Value	Days to Expir.	% Return Annual
Nov.	\$1.62	7.3	36	80.1
Dec.	\$2.01	9.2	64	58.7
Jan.	\$2.36	11.0	92	49.2
Mar.	\$2.80	13.2	155	36.0

Source: PowerOpt.com option chain

Time Decay Curve



The ideal place to sell time is in the near months where the returns are *highest* and the time decay is the *fastest*. Even though the premiums are higher further out in time, the returns are lower because the premiums did not go up enough to compensate for the increased time to expiration. An additional benefit of the early expiration dates is less exposure to assignment. There is less likelihood of the stock's price developing (rising!) given a shorter time for it to happen.

Guidelines for selling the call to open:

- Sell the call OTM to allow room for growth.
- Choose a strike price that is at or greater than the Married Put strike price.
- Keep the time of expiration short, only 3 to 10 weeks out in time where the time decay is most rapid.
- Target a premium of about 1% of the stock price per month.

Therefore when we sell calls, using Method #1, the strike prices are OTM or ATM and about 1 to 2 months out in time. The ideal outcome, if we want to keep the stock, is that it goes up *to*, but doesn't *exceed*, the short call's strike price. We keep the stock and continue to sell it every month for income until we approach the expiration time of the put.

How to close the call:

There are four possible outcomes after selling a Method #1 covered call:

- The stock stays below the strike price and the call expires worthless
- The stock goes down big time and you manage by buying to close
- The stock goes above the strike price and you get assigned
- The stock goes above the strike price and you manage with another Income Method

How you adapt to the changing Conditions above will depend partly on the Goals part of your CEGA: for example, your Goals may not include allowing the stock to be assigned so this is an important piece of your decision making puzzle.

Here's the history of an actual RPM:

First, the setup:

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August 14, 2006 TRMB (Trimble Navigation) RadioActive Profit Machine

Bought 100 shares TRMB	\$48.00
Bought To Open 1 February 2007 \$50 put	+\$ 5.60
Total Invested:	\$53.60
Guaranteed Value until February 16, 2007	-\$50.00
Total AT RISK:	\$ 3.60 or 6.7%
Income Method #1: STO 1 Nov 2006 \$55 call	-\$ 1.40
IM#1 reduces investment/risk	\$ 2.20 or 4.2%

The total investment for this particular RPM was only \$5,220, of which \$220 was AT RISK because I sold the call immediately. Normally, I wait a while first, but this seemed like a winner to sell calls against... and I was right. Just over two months later, Trimble took a tumble and I closed the obligation by buying the call back. Here's an excerpt from the *Fusion*' email I sent out moments after executing that trade:

Quotes as of 10/24/2006 1:51:17 PM ET.

I'm closing the sell obligation on TRMB by buying to close the Nov 55 call @ .25.

TRMB has taken a tumble. If she comes back, GREAT. The income from selling the call will still be in our hot little hands. If not, exercising the put option will get us out of TRMB with a less than 4% loss. Look at a chart! Ouch, if you're using stop orders or holding without a put...

Interestingly, the very next day TRMB jumped back up! I re-sold a call, this time the November \$50 call. Check the following *Fusion*' email:

Quotes as of 10/25/2006 12:45:35 PM ET.

Well, it happened: A precipitous plunge followed by a spectacular spike! Yesterday we closed the Nov call from TRMB's open, and today it gained over 10%.

SO, I'm selling again: The November \$50 call at .95. That makes \$210 of total income to the account. Check yesterday's numbers...

Just a week later, Trimble was again in trouble, at least temporarily. I noticed that it kept getting knocked down, then finding support again. Nice for taking advantage of short-term moves. With the hit she took, I used the opportunity to close the obligation and lock in the income I had received from IM#1 for a second time. Again, here's selected text from the *Fusion*' Members Only email I sent out right before sewing up that trade:

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Quotes as of 11/01/2006 10:18:03 ET

...I want to buy back the Nov \$50 call on TRMB. Again. Actually, last call I bought back was the \$55, and then I sold the \$50 the very next day. The Nov \$50 is bidding at .25, so we lock in a leedle more... I'm betting that TRMB will find her legs again and I'd rather not have the obligation to sell if she starts moving.

This further brought down the risk in the RPM. I was still bullish on TRMB and didn't sell any more calls.

I did feel a little skittish as the expiration was approaching and decided to just close the whole deal early on February 6, 2007. I sold the stock and left the \$50 put option alone, as it would have cost more commission-wise to close it than I could get for selling it. Here's the final email:

Quotes as of 2/6/2007 3:58:43 PM ET.

Hi, I just closed the TRMB RPM a few weeks early. Sold just before the close at \$56.07. I'll be showing this RPM's rise to glory (after several falls) in the next YouTube Video. Watch for it!

The TRMB RPM is a good example of using Income Method #1 to ride the stock up and down, and then bail out for cash or at a tiny loss. In the following history remember that IM#1 was applied at the very beginning AS the RPM was opened, so there were actually two instances of it being used.

08/14/06 open TRMB RPM Total	\$5220	(\$220 AT RISK)
10/24/06 buyback of \$55 call	+\$ 25	(closed 1 st IM#1)
10/25/06 IM#1 STO Nov \$50	-\$ 95	(reduced AT RISK)
11/01/06 buyback of \$50 call	+\$ 25	(closed 2 nd IM#1)
Final Total cost of RPM:	\$5175	
Final sale of closed RPM:	\$5607	
Minus Total Final Cost	-\$5175	
Total Profit/Loss	\$ 432 profit	
% of Original Investment	\$ 432/\$5220 = 8.275%	

Here's a good homework project: Apply the **Trade Simulator Tool** Calculator available on the RadioActive Trading site to the percentages above: 4.2% maximum risk with 8.275% gains. See if that would profit you over the long haul, WITH round-trip commissions factored in.

Okay... But What if the Stock Goes UP?

We've handled one way to manage an Income Method #1 RPM in which the stock falls down. Another way to go is to simply allow the call to expire worthless, then sell again or close the RPM. I prefer the above method when there's a dramatic dip to the support line (see your Appendix on chart reading) but sometimes I do just let a short call stay until expiry.

So what do we do if our stock rides up hard toward, even PAST the strike at which we've sold the call? We have different Conditions then, don't we... and that demands a different menu of Actions.

It's for this reason I began coming up with other Income Methods. If you decide you want to KEEP the stock, see if it makes sense to do so with Income Method #2... next Section. If you want to get out with the biggest return possible right away, consider combining your present Conditions with Income Method #3... next Section after that.

Of course, you could also just do nothing... let your stock do what it wants to and make a decision later after there's a clear direction from the market that makes sense to your CEGA. This course of action (even *inaction* is an action) could be best if you are bulletproof or at least have done your Catastrophe Report ahead of time.

Bulletproofing Examples... Vikas, Kevin and Juan, Oh My!

One great thing about ALL of the Income Methods is that they can be employed to eliminate even the original AT RISK amount.

When this happens, I call the RPM **Bulletproof**. It's in a state that allows the RPM to continue to grow, without the threat of ever losing money from the original investment.

It's really difficult to buy stock, buy a long term ITM put, and sell a near term call all at the same time. Even if you could (it's sometimes possible), normally you give up upside potential by obligating your self to sell at too low a strike price. For these reasons I normally will set up the RPM first, then wait for it to move in a clear direction.

I could fill these pages with examples of me totally canceling an RPM's risk the first time I sell a call. But I thought it might be better to give examples of Members doing it recently instead. Check out these three:

Vikas – EBAY on 3/13/07

Buy 100 shares EBAY @	\$ 30.62
BTO 1 Jan 08 \$35 put@	+\$ 6.00
Total Investment	\$ 36.62
Guaranteed Return	-\$ 35.00
Total AT RISK:	\$ 1.62 or 4.42%

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Two weeks later on **March 27, 2007**, Vikas sold a July 2007 \$35 call option for \$1.75. That canceled ALL of the risk in the trade... in fact, it guaranteed at least a $\$1.75 - \$1.62 = \$0.13$ return. Now, that may not seem like big bucks but wait! ... as they say, there's more. See, this obligation to sell ends in July, but the put option is open until January 2008. As we'll see in following Sections, Vikas has several ways to close this RPM at least this much, but most likely an even greater profit. And that's regardless of what EBAY was going to do from there on out.

Juan – AKAM 3/24/06

Buy 100 shares AKAM @	\$28.91
BTO 1 Nov 06 \$35 put@	+\$ 7.40
Total Investment	\$36.31
Guaranteed Return	-\$35.00
Total AT RISK:	\$ 1.31 or 3.6%

I should mention that Juan L. of Hawaii put this together as a paper trade, but he was doing it according to the Ten Commandments of Paper Trading. That means that both he and I were treating it as real time, real money. Two weeks after recording this trade, Juan was able on April 3, 2006 to record the virtual sale of a May 2006 \$35 call at \$1.80... BULLETPROOF! Again, there was only \$1.31 AT RISK to begin with, and a skew between the expiry dates of the call and the protective put. Before May expiration, AKAM took a dip and I wrote Juan saying, now would be a good time to (virtually) Buy to Close that call.

Later on AKAM was ripe for call-sellin' again, and I sent out an update to Members, treating the trade as if it were my own in terms of managing it. Juan's trade ended up closing early at a great profit.

Kevin – TASR on 5/25/07

Buy 500 shares TASR @	\$10.50
BTO 5 Jan 08 \$12.50 puts @	+\$ 2.45
Total Investment	\$12.95
Guaranteed Return	-\$12.50
Total AT RISK:	\$.45 or 3.47%

On **6/22/07**, one month later, Kevin sold 5 August 2007 \$15 calls at \$.50 apiece, totally canceling his AT RISK amount. He was BULLETPROOF and could not lose!

Kevin wrote me with this trade just after his June call sale. Here's one of the great benefits of **Fusion'** Membership and bouncing ideas off other experienced RadioActive Traders: I pointed out to Kevin that his RPM was in prime position to also apply Income Method #3, which he did. He pulled in another \$500 that day... good for Kevin.

These trades all actually have two things in common: beside being made BULLETPROOF on their first covered call sale, they each were closed early at a solid profit by combining the IM#1 trade in place with IM#3 for added kick. Here's how they ended up:

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- ⇒ Vikas closed EBAY with a 31 day, **7.31%** real money profit.
- ⇒ Juan and I closed AKAM with a four month, **15.12%** paper profit
- ⇒ Kevin took TASR down on August 17, 2007 with a 3 month, **20.46%** return

I said that each of these *trades* had two things in common, but what's even more important is what each trader had in common:

- 1) willingness to try new things
- 2) open to share their results
- 3) acceptance of input and improvement ideas
- 4) the courage to take responsibility to act (or *not* act!) at the right times.

These traits, if continued, are what will make these traders into Twenty Percenters.

Income Method #1 Summary:

The very first Income Method of RadioActive Trading is covered call selling. It's every bit as profitable and nowhere near as risky as what thousands of folks are doing already with their hard earned money. Congratulations for learning a much safer alternative.

Covered call selling can be an excellent way to bring in income on stock that you own. Doing it within the structured framework of a RadioActive Profit Machine protects your assets from the worst possible thing that could happen... your somewhat volatile stock turning into moose pasture, minutes after bad news.

Some companies have based entire businesses on teaching people how to get into the practice of selling covered calls, packing "cheeks in seats" at seminars charging upwards of \$3,000. We call this Income Method #1 and actually give this part of RadioActive Trading away for free!

There's a lot more to receiving income on stock than selling covered calls alone can offer. Though selling covered calls does make money, it also gives up the potential for further growth unless managed properly. You've learned how to manage loss by using married puts. You've seen how Members like you have BULLETPROOFED their holding by using a combination of the married put and covered call selling. Keep reading beyond this Section and you'll learn how to go far beyond covered call selling and truly maximize your upside potential.

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.



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