

TRADING ADDICTS



Lesson 1: Introduction to Covered Calls

Welcome to the Trading Addicts Covered Call tutorial. In this chapter, we will be introducing you to an in depth introduction to the Covered Call strategy, and the Trading Addicts Dynamic Covered Call Trading Strategy.

Here are a few specifics we'll be discussing in this chapter:

- Getting to Know the Basics
- Risks and Rewards
- Time Decay, Volatility, and Option Greeks
- The Trading Addicts Dynamic Covered Call Trading Strategy

Getting to Know the Basics

The Covered Call strategy is most commonly known as a limited risk, limited reward trading strategy that has grown in popularity for the individual investor. Through the use of this strategy, it allows the trader to collect option premiums on existing stock positions, to generate better rates of return than owning the stock outright. While generating better returns, this strategy also helps to provide downside protection in volatile market conditions.

The Covered Call trade is also known as a Covered Write on most trading platforms. It is also known as a "Buy-Write" if you were to simultaneously buy shares of stock and sell a call against that position. In other circumstances, you might opt to purchase stock first, let it appreciate in value, then sell a call against it at a later date. This strategy is known as "legging-in."

Every traded option contract has a buyer and a seller. If you've purchased an option in the past, than you are likely familiar with how it works. The buyer of a call option has the right to purchase shares of the underlying stock at the listed strike price, on or before expiration. The buyer also pays a premium for this right. On the other side of this trade is the call option seller, which is the role you will play in the covered call trade.

As the seller of a call, you are obligated to deliver shares of the underlying stock to the buyer, at the listed strike price on or before expiration. In a Covered Call trade, the term "Covered" means that you own the shares that you are obligated to deliver if the contract is exercised. If you did not own the underlying stock and sold a call, you would be considered "naked" which is a trade that has unlimited risk potential.

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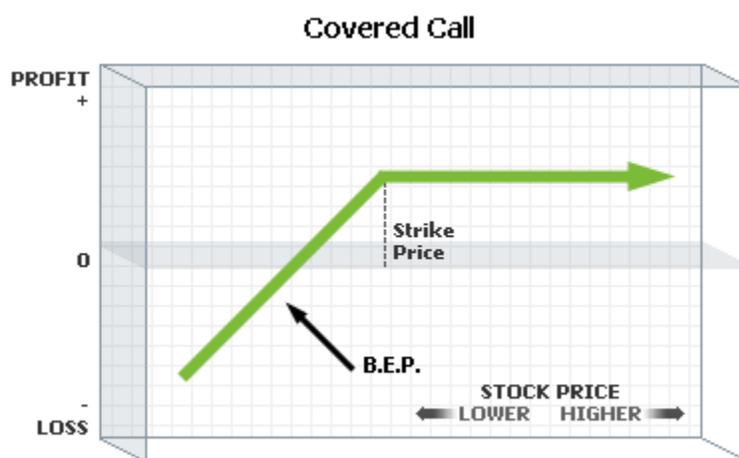


Essentially, in a Covered Call trade, you are “renting” out your stock position to generate income against your equity position. Remember, the buyer of the call option that you are selling is paying you a premium. That premium is your incentive to put on this trade. Covered Call traders use their existing stock positions to collect time premiums paid by the buyer. Option premiums decay in value; especially short dated options. It is this process that makes this strategy so attractive to the option seller.

Risks and Rewards

With any trading approach, it’s important to know up front what the potential risks are as well as rewards. In the Covered Call strategy, you are the owner of stock. This is the most important part of the trade. This is why we dedicate an entire chapter to the topic of Stock Selection. It is critical that you make sure that the stock is worth owning, and will be a worthwhile performer over the life of the trade.

Below is a risk profile for a Covered Call trade:



As the owner of a stock, the only limitation to your risk is that the stock can only go to zero. In our trading system, a protective stop will be used to insure that this does not happen, but in theory, this is where the risk comes into play. Depreciation in the underlying is what you’ll need to focus on in terms of risk. The short call will not generate risk, so long as you own shares of the underlying to cover the short call. Either the stock appreciates in value, and you are called away at a profit, or the stock depreciates in value and the call expires worthless.

Another consideration from a risk perspective is your downside protection. To see this in action, let’s use Boeing as an example.

Let’s assume we are about to initiate a Buy-Write on Boeing. Here is a look at the option chain below:

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Boeing Co. (The)												ETB	B: 64.65	A: 65.29	64.64	+1.25	+1.97%						
UNDERLYING												Last X	Net Chng	Bid X	Ask X	Size	Volume	Open	High	Low			
												64.64	N	+1.25	64.65	P	65.29	P	1 x 4	3,471,592	64.47	65.42	64.09
TRADE GRID																		Symbols					
OPTIONS												read: Single	Layout: Last X, Net Change			Exchange: Composite							
CALLS						Strik... 4	PUTS																
Last X	Net Chng	Bid X	Ask X	Exp	Strike	Bid X	Ask X	Last X	Net Chng														
SEP 10 (11) 100																				34.77%			
OCT 10 (39) 100																				35.26%			
5.68	C	+73	5.75	C	5.85	C	OCT...	60	1.12	I	1.14	N	1.14	N	-44								
3.85	A	+60	3.90	I	4.00	C	OCT...	62.5	1.76	I	1.80	C	1.85	X	-62								
2.36	N	+45	2.40	I	2.44	C	OCT...	65	2.73	I	2.77	C	2.80	Q	-1.20								
1.27	I	+25	1.29	C	1.32	B	OCT...	67.5	4.10	A	4.20	C	5.24	I	0								
NOV 10 (74) 100																				37.75%			
JAN 11 (137) 100																				43.30%			
FEB 11 (165) 100																				39.22%			
JAN 12 (501) 100																				39.95%			

Boeing is trading for \$64.64 per share, and the October 65 Call is selling for \$2.40 per share. This means that the Buy-Write order will come in at a debit of \$62.24 ($\$64.64 - \$2.40 = \62.24). With shares of Boeing trading at \$64.64, prices can drop \$2.40 and we would breakeven on this trade. This is the downside protection that this strategy offers.

This is also why timing is an important part of this trading strategy. You'll want to do your best to avoid sharp downward price movements, and focus on stocks that will outperform to the upside.

The same is true for stocks that are set to move substantially higher. As the seller of a call, once you've entered into this contract, you are obligated to sell your shares. If your stock is set to move dramatically higher, **do not sell a call**. Wait for prices to pause, or start to pull back before selling. A good Covered Call strategy is one that looks to ride out dips in a strong trending stock, as opposed to limiting upside.

Now that we understand the risks, the reward is pretty straight forward. Using Boeing as an example, let's assume that at expiration Boeing is trading above \$65 at expiration. Having sold the \$65 call, the buyer of this option will exercise their right to purchase our stock. Therefore, our stock position is assigned to the buyer for \$65 per share. Having paid \$64.64 for it, we've made \$0.36 per share in the appreciation of the underlying. However, we've also booked the \$2.40 credit received for selling the call. This totals a net gain of \$2.76 per share, or a 4.4% gain. That's 36% annualized.

If we wanted to be more conservative, or perhaps wanted to reduce the probability of being called out, we could sell the 67.5 strike, or perhaps time the trade differently. However, this example gives you an idea of what your upside is in the trade. You stand to make the difference in price between the purchase

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price of the stock up to the strike price of the option, plus the premium received. That's the maximum gain in a Covered Call trade.

Time Decay, Volatility, and Option Greeks

The price of an option is made up of two components: intrinsic value, and extrinsic value. Intrinsic value is like equity. As an example, let's take a quick look at Intel.

The screenshot displays the Intel Corporation (INTC) stock price at \$18.43, up \$0.15 (+0.82%). Below the stock price is the 'UNDERLYING' table and the 'OPTIONS' chain. The options chain is set to 'Single' read and 'Position, Intrinsic, Extrinsic' layout. The 'STRIKES' dropdown is set to 4. The options chain shows calls and puts for September 10 and October 10 expirations.

UNDERLYING										
	Last X	Net Chng	Bid X	Ask X	Size	Volume	Open	High	Low	
	18.43	+0.15	18.31	18.44	20 x 19	59,143,155	18.52	18.59	18.20	

OPTIONS												
CALLS						Strik...	PUTS					
Posi...	Intrin...	Extri...	Bid X	Ask X	Exp	Strike	Bid X	Ask X	Posi...	Intrin...	Extri...	
SEP 10 (10) 100 33.84%												
OCT 10 (38) 100 33.83%												
	1.43	.285	1.70 A	1.73 X	OCT...	17	.25 I	.27 X		0	.26	
	.43	.56	.98 A	1.00 I	OCT...	18	.53 X	.55 I		0	.54	
	0	.48	.47 X	.49 X	OCT...	19	1.02 X	1.04 N		.57	.46	
	0	.195	.19 I	.20 N	OCT...	20	1.73 I	1.77 C		1.57	.18	

Shares of Intel are trading at \$18.43. If you owned an October 18 call, this option would have \$0.43 in equity, or intrinsic value.

Intrinsic value will only change if the price of the underlying changes. If Intel does not move in price through expiration, the option would be worth at least \$0.43.

However, the option is trading for \$1.00. The remaining premium above that \$0.43 in equity is called extrinsic value, or time value.

Option premiums are derived by several different variables, all of which combine to determine an options time value, or extrinsic value. Time until expiration, implied volatility, stock price, strike price, and interest rates all determine the value of time in an option.

Let's make a quick comparison. Let's take two stocks that are nearly the same in price; Las Vegas Sands, and Kraft Foods. Let's take a look at the option chains below.

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Las Vegas Sands

Las Vegas Sands Corp											ETB	B: 31.00	30.99	+92			
												A: 31.02		+3.06%			
UNDERLYING																	
	Last X	Net Chng	Bid X	Ask X	Size	Volume	Open	High	Low								
	30.99	N	+92	31.00	P	31.02	P	9 x 7	24,124,421	30.67	31.34	30.43					
TRADE GRID																	
OPTIONS read: Single Layout: Last X, Net Change Exchange: Composite																	
CALLS Strik... 4 PUTS																	
	Last X	Net Chng	Bid X	Ask X	Exp	Strike	Bid X	Ask X	Last X	Net Chng							
▶	SEP 10	(11)	100											51.55%			
▼	OCT 10	(39)	100											47.11%			
		2.53	X	+50	2.51	I	2.54	X	OCT...	30	1.52	I	1.54	X	1.53	Z	-40
		1.97	B	+40	1.93	X	1.97	X	OCT...	31	1.94	X	1.97	X	1.95	A	-53
		1.49	A	+34	1.45	X	1.48	X	OCT...	32	2.45	X	2.49	X	2.44	A	-76
		1.05	N	+21	1.06	X	1.08	X	OCT...	33	3.05	I	3.10	X	2.94	A	-176
▶	DEC 10	(102)	100											56.01%			
▶	JAN 11	(137)	100											63.09%			
▶	MAR 11	(193)	100											58.36%			
▶	JAN 12	(501)	100											66.13%			

Kraft Foods

Kraft Foods, Inc.											ETB	B: 30.00	30.58	+23			
												A: 30.68		+0.76%			
UNDERLYING																	
	Last X	Net Chng	Bid X	Ask X	Size	Volume	Open	High	Low								
	30.58	N	+23	30.00	P	30.68	P	4 x 1	7,535,087	30.45	30.67	30.33					
TRADE GRID																	
OPTIONS read: Single Layout: Last X, Net Change Exchange: Composite																	
CALLS Strik... 4 PUTS																	
	Last X	Net Chng	Bid X	Ask X	Exp	Strike	Bid X	Ask X	Last X	Net Chng							
▶	SEP 10	(11)	100											25.25%			
▼	OCT 10	(39)	100											19.94%			
		1.63	A	+36	1.70	A	1.76	I	OCT...	29	.28	N	.30	I	.34	N	-16
		.90	I	+18	.92	A	.96	I	OCT...	30	.55	N	.57	I	.57	C	-29
		.33	A	+02	.37	N	.38	N	OCT...	31	1.04	I	1.07	N	1.03	N	-47
		.11	N	+01	.10	I	.11	N	OCT...	32	1.78	C	1.83	I	1.80	N	-23
▶	DEC 10	(102)	100											24.82%			
▶	JAN 11	(137)	100											26.98%			
▶	MAR 11	(193)	100											25.32%			
▶	JAN 12	(501)	100											28.35%			

The stock prices are not exactly the same, but differ by only \$0.41 cents. However, you'll notice that the October 31 strikes differ by \$1.59 in price. Again, the stock prices are very similar. The strike price is the same, and time until expiration is the same.

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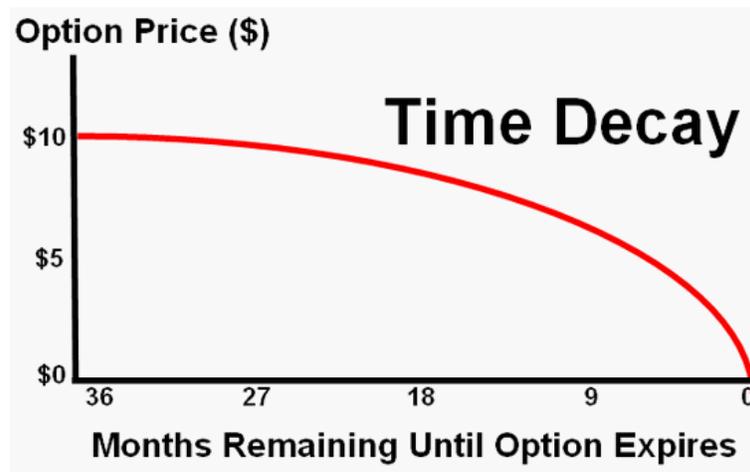


The big discrepancy between option prices comes from implied volatility. Stocks that are more volatile tend to have more expensive option premiums. This is due to higher levels of implied volatility. You notice the implied volatility levels in the images above, listed at the far right of the expiration date. Las Vegas Sands implied volatility is quoted at 49%, while Kraft Foods is quoted at 19%. This is why the option premiums differ dramatically in value.

Implied volatility will be a big consideration in the stocks and options you choose to sell. Again, with greater volatility comes a greater option premium. However, with greater volatility also comes greater risk.

As a Covered Call trader, you want to be selective in the options you sell. This is why we dedicate a whole chapter to this topic in the tutorial. Rather than get through all the instruction now, let's just focus on the fact that as a Covered Call trader, you will focus on selling at-the-money, or out-the-money options. This is because these premiums are made up of extrinsic value. That is the portion of the option premium that melts the fastest.

The graph below illustrates the effect that the passage of time has on an option premium.



This condition is one of the main reasons traders flock to the covered call strategy. They want to sell decaying option premiums as they reach expiration. This time decay is represented by the option Greek, theta. Theta is the amount of premium your option will lose per day, until expiration.

The remainder of the Greeks are not particularly relevant to this strategy. When selling calls, you'll want to remember to sell low delta options. Gamma, which represents the rate of change in the delta, will be a risk metric in the week of expiration. Finally, vega represents how responsive an option will be to changes in volatility. In short dated options, vega becomes insignificant.

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In lessons 2 & 4, we delve into the topic of selecting options and option selling techniques, which will provide additional material on this discussion, and how it all pertains to the selection process.

The Trading Addicts Dynamic Covered Call Trading Strategy

The Covered Call strategy itself is relatively straight forward. However, we've decided to take this strategy to a higher level. In future chapters we will discuss our edge in being able to better time trades to enhance returns, while providing better downside protection to our equity positions. We will be using **proprietary timing tools** to give us an edge in our trading system that can be followed on a daily basis by following us on TA Live.

In order to make portfolio returns more dynamic, we are going to use a combination of month-to-month option selling techniques, while combining the newly issued weekly options to generate greater returns. Our portfolio will consist of roughly a dozen individual equities. You can choose to follow along, or apply our techniques to your own individual lists of stocks that might be more suited to your investment strategies, time horizons, and risk tolerance.

Through the use of our proprietary timing tool, which generates signals for selling calls, as well as signals for purchasing stock, we will have an edge that helps to extract the greatest amount of premium possible, with the least amount of downside risk. The combination of weekly and month-to-month option selling will also help to boost returns beyond your standard, run of the mill Covered Call strategy.

Through the remainder of this tutorial, we'll discuss our methodologies that will help you better understand which stocks to pick, which options to sell, when to sell them, what indicators we're using, and how to enter the orders.