

Creating Income from Stock using Options – Options Writing

Known as the Buy Write or Covered Call strategy. This strategy requires buying stock and writing call options to create a “premium” income, irrespective of any capital gains made with the stock.

Requirements

- Brokerage account with access to stocks and options
- Knowledge of stock and options
- Bullish to Neutral outlook for stock price
- Medium to long-term outlook for positions
- Regular evaluation of positions
- Discipline to stick to strategy

Benefits

- Creates an additional return from stock investment
- Option writing, on average, has a higher probability of return than option trading
- Establishes a sell price for position
- Benefits from Time Decay in option contracts, with minimal risk

Risks

- Locks in sell price, negating any future strong upward stock price activity.
- Writing ITM (In The Money) or NTM (Near The Money) has a high probability of position being Assigned.

How to ...

- Evaluate for a fundamentally strong company, with a Neutral to Bullish outlook
- Conduct analysis of premium return, and breakeven level
- Enter position if it meets your requirements for entry
- Monitor position on a regular basis, evaluating stock price movement against breakeven level

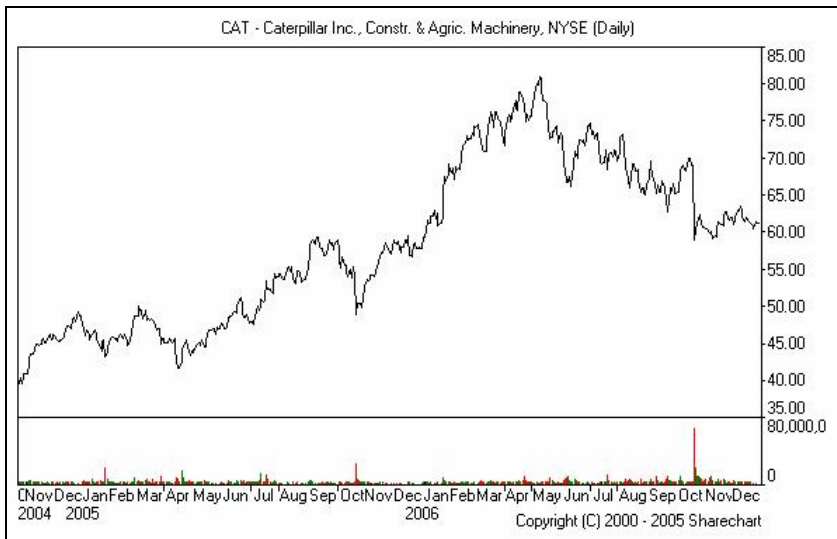
Tips & Hints

- Two approaches can be made to this strategy: 1) writing call options for one month, expecting to exit the position no matter what, or 2) writing call options on a stock position you intend to hold for numerous months.
- In a Bullish market, write OTM (Out of The Money) options as there is a stronger probability that the stock price will rise
- In Neutral to Bearish markets, ITM/NTM could be written, depending on the price activity of the stock.
- Returns should exceed 2.0% per month. Lower than this is not typically worth while the risk of the position
- For long-term positions, buy LEAP put protection to offset risk of capital loss
- Due to Time Decay in options, writing Call options at least 3 weeks from expiration, but no more than 5 to 6 weeks, is optimal

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Example



- CAT has been evaluated and selected as a Covered Call position
- Our outlook for this company is that it will remain Neutral to Bullish over the medium-term
- By purchasing the stock price now, and writing call options, we can create an additional income

Symbol	Last	Change	Bid	Ask	High	Low	Volume	CATERPILLAR®		
CAT	61.33	0.00	60.39	61.67	0.00	0.00				
CAT Expiration Months: Jan 07 Feb 07 May 07 Aug 07 Jan 08 Jan 09										
Calls										
Strike	Symbol	Last	Chg	Bid	Ask	Day High	Day Low	Vol	Open Int	
January 2007 (16 days to expiration)										
55.00	CATAK	6.50	0	6.40	6.60		0	0	6,005	Trade
57.50	CATAY	4.00	0	4.00	4.10		0	0	1,292	Trade
60.00	CATAL	1.90	0	1.80	1.90		0	0	17,996	Trade
62.50	CATAZ	0.45	0	0.45	0.50		0	0	6,124	Trade
65.00	CATAM	0.05	0	0.05	0.10		0	0	27,207	Trade
70.00	CATAN	0.05	0	0	0.05		0	0	10,883	Trade
February 2007 (44 days to expiration)										
52.50	CATBX	8.70	0	9.00	9.10		0	0	156	Trade
55.00	CATBK	6.70	0	6.70	6.90		0	0	857	Trade
57.50	CATBY	4.80	0	4.60	4.80		0	0	362	Trade
60.00	CATBL	2.96	0	2.90	3.00		0	0	3,581	Trade
62.50	CATBZ	1.70	0	1.60	1.70		0	0	5,703	Trade
65.00	CATBM	0.80	0	0.80	0.90		0	0	9,403	Trade
67.50	CATBU	0.35	0	0.35	0.45		0	0	6,916	Trade
70.00	CATBN	0.20	0	0.15	0.20		0	0	2,959	Trade

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Outlook for stock to rise in coming month ...

- Current price = \$61.33
- Jan 62.50 OTM calls = \$0.45
- Return = $\$0.45 + (62.50 - 61.33) = 2.64\%$
- Breakeven = \$60.88
- If the stock price rallies above \$62.50, our stock position will still only make the 2.64% because we have locked in our sell price for the stock
- If the stock price retraces below \$60.88, we will be in a net loss, but will retain our stock.
- If the stock price remains between \$60.88 and \$62.50, we will retain the 45 cents premium and still hold our stock to continue writing more call options in the future.

The Feb 62.50 calls are offering a far greater premium return of \$1.70 per share. But there is far greater Time Decay to experience, increasing the risk of the position.

Outlook for stock to remain relatively steady in coming month ...

- Current price = \$61.33
- Jan 60.00 ITM calls = \$1.90 per share
- Return = \$1.90 minus the difference between current price and strike price (\$1.33) = 57 cents, or 0.9% - not sufficient to consider entering
- Breakeven = \$59.43

In the above situation, writing the ITM call is not the best case scenario. However, there are many situations where it is better to write the ITM call options to lock in a profit straight away, rather than chasing some additional capital gain on the stock price.

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