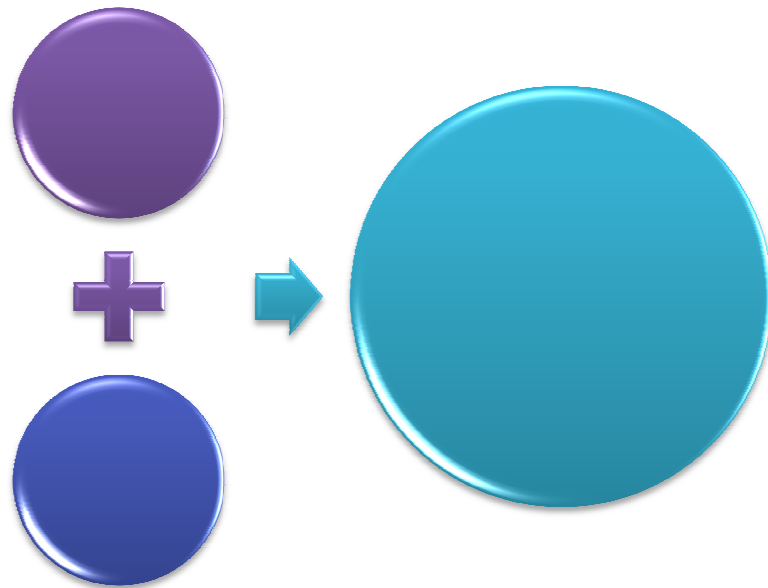


2009 EDITION

Covered Call Fast Start

**A Simple, Step by Step System
For Better Investment Results**



Kevin Simpson

Capital Wealth Planning LLC

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About the Book

I know what you're thinking, "Oh great, another book on how to invest! As if there aren't enough of them available already. After seeing my wealth essentially disappear overnight, the last thing I want to do is invest." I'm sure that little crevice underneath your mattress seems to be the safest place to stash your money right now, but you would be doing yourself an incredible injustice without first reading this book. This book is unlike any other because the strategy is unlike any other. We've boiled down seemingly complex ideas into easy-to-understand investment strategies. What you'll find in the following pages is information that will teach you how to make the most of your investments using options.

Typically, option strategies are made out to be very risky, very complicated investment tools used by traders on Wall Street or highly specialized money managers. We will explain an option strategy that reduces risk and is regarded as the most conservative use of options: selling covered calls. Also, we'll talk about Exchange Traded Funds which have become extremely popular in recent years, and for good reason. The best part is, you can learn and implement these strategies on your own! We have been investing exactly this way for quite some time, and can provide additional assistance if needed.

Separately, these two investment vehicles can and should be used in almost everyone's portfolio. What makes this book unique is that we inform you how to combine both. More specifically, we show you the benefits of selling covered calls on ETFs. There are various strategies that can be employed using options, some of which carry great risk. The farthest thing from your mind right now is probably taking on risk. Covered calls, however, are not risky and can actually minimize downside risk. You'll learn why! Combining the use of covered calls with Exchange Traded Funds offers investors a number of advantages, the greatest being diversification.

If you've seen considerable investment gains vanish over the past couple of years, you're not alone. Actually, you're in the majority. For someone approaching retirement or funding a child's college tuition, the recent turmoil is deflating to say the least. Using the tools and suggestions in this book would have substantially cushioned the losses experienced in the recent market turmoil. What we love about the strategy in this book is its focus on three things:

1. Diversification
2. Minimizing downside risk
3. Bringing in monthly cash flow

There is a plethora of information available on options and ETFs, and it can be confusing. We believe this book explains these two investment choices as clearly and easily as possible, and the best part is it's *FREE!* If after reading this book, you'd like more information or anything explained further, we're here. Without further ado, we wish you the best on your future investments and hope that we have helped in some small way. Enjoy!

What you can do for me.

The conventional wisdom says that a free book just isn't taken seriously by its readers.

I am giving this book away, because I think everyone should have this information... but you can do something for me in return.

Get on our blog (**www.covered-call.com**). Ask questions, give feedback.

Let me know what you think of this book. Let me know what you think of the strategy.

Let me know how it's working for you. Tell your friends about it.

Most importantly, do us both a favor, by reading my book, using my system, and growing your investments. We've used this system over and over. It works.

Introduction

Every investor – from Warren Buffett to the guy down the street who claims to make thousands each week from day trading (but who still seems to struggle to make ends meet) – seeks to maximize return while minimizing risk.

That's the name of the investing game.

The problem is, of course, that risk and return almost always go hand in hand. Safe investments – like savings accounts, Certificates of Deposit (CD), or money market funds – offer very small returns. As I write this, a 5-year CD yields a little over 3%. On a historical basis that's barely enough to cover the rate of inflation.

Look at it a different way: If you put \$5,000 into a CD, at the end of the term you will be lucky if your initial \$5,000 will still be worth \$5,000 in future dollars... much less worth *more*.

That's why so many people invest in individual stocks, mutual funds, commodities... they hope to get a better return so they can overcome inflation and create wealth. Building wealth is especially important if the bulk of your investment capital is made up of your 401(k) or IRA funds. The faster your money grows the more you'll have when you retire... or possibly better yet, the *earlier* you can plan to retire.

The problem is stock and mutual fund investments carry a lot more risk than a CD or savings account. (Ask anyone whose 401(k) funds were cut in half – or more – due to the financial meltdown.)

Here's the dilemma we all face. We can put your money into safe investments; while we won't get an appreciable return we at least probably won't lose money. Or we can put our money into riskier investment vehicles in the hopes of getting a decent return; except it is entirely possible we could lose money, especially if there is a short- or long-term dip in the market.

So, the average investor appears to be stuck between a low-return rock and a high-risk hard place.

Then again... *maybe not*.

Using relatively straightforward techniques, savvy investors *can* achieve double-digit rates of return while minimizing risk. How?

Writing covered calls on Exchange Traded Funds (ETF).

Sound intimidating?

It's not.

In the next pages you'll learn about Exchange Traded Funds and writing covered calls. For now, here's the bottom line: By writing (selling) call option contracts on ETFs, you'll get:

- Dividends from stocks owned by the ETF
- Capital appreciation if the stocks rise in value, and
- Premiums from covered calls you write

What does that mean? You minimize risk by owning a diversified portfolio of stocks, you receive income from dividends paid by the Funds you own, and you get guaranteed cash flow from selling covered calls. In the end your investment is safer, more stable, more predictable, and more profitable – *especially* in a flat market. While others tread water you can forge ahead and continue to build wealth – and without taking unnecessary risks.

The difference in return can be substantial. Here's a quick example. Say you have \$100,000 in your 401(k). (We'll use round numbers to make the math easier.)

Here's the difference in how much your retirement funds will grow at single- and double-digit growth levels:

	5%	10%
10 years	\$162,889	\$259,374
20 years	\$265,330	\$672,750
30 years	\$432,194	\$1,744,940

As you can see, the difference is staggering – especially after twenty or thirty years. Even if you do not contribute another penny to your account, after thirty years you'll have over **\$1.3 million more in your retirement savings** simply by earning a higher rate of return.

And don't worry – while writing covered calls on ETFs isn't your father's investment technique, it's absolutely legal and ethical. (It's also *smart...* so feel free to clue your dad in.) Over the past few years ETFs have become one of the fastest growing segments of the investment industry; experts predict ETFs will reach \$1 trillion in total value by the end of 2009.

Why are ETFs so popular? Exchange Traded Funds are like mutual funds: They offer diversity and relative security – but also allow investors the freedom to buy and sell shares just like they would buy shares in a publicly-traded company. (Try doing *that* with a mutual fund.) Plus you can earn dividends. And, ETFs also tend to have lower fees, meaning more of your money stays in your pocket...

...and best of all ETFs allow owners of shares to write covered calls.

Mutual funds do not.

The key, of course, is to know what you're doing. That's what I'll teach you.

Turn the page and let's get started!

--- *Kevin*

Chapter 1: Understanding Covered Calls

Let's start with the basics. *Calls* are a form of options trading. To understand calls, you need to understand *options* – so let's start there.

Options

An option is a contract that gives the buyer of that option the right – but not the obligation – to buy or sell the contracted asset at a specific price on or before a specific date. An option creates a legally binding contract.

That's the dictionary version.

Let's make it simpler. In plainer terms, an option is paying for the right to do something – if you choose to do whatever that "something" is – within a specific period of time.

Say your neighbor has a car for sale. You'd love to buy his car. You don't *need* the car... but you *want* the car. It costs more than you can afford right now, but your employer has promised to pay you a year-end bonus; if the bonus comes through, you'll have the money to buy the car. If your bonus is cut you won't.

While you're waiting to find out, you don't want him to sell the car.

What can you do? Reach an agreement that gives you the option to buy the car on or before a certain date and at a certain price. The catch, of course, is that you will have to pay for that option; your neighbor is willing to wait to see if you come up with the money, but he also doesn't want to lose out on opportunities to sell the car to other buyers – so you'll have to compensate him for waiting. So, for example, your contract could stipulate that you have the right to purchase the car for \$20,000, on or before January 10, 2010, and for that right you pay \$500. The \$500 is non-refundable and does not go towards the purchase price of the car.

That's the essence of an option.

Once you reach agreement, a number of different outcomes are possible:

- You don't get your bonus, you don't purchase the car, and your neighbor keeps the \$500 option premium. (Even though you look sad whenever he's around.)
- You do receive your bonus, you purchase the car for \$20,000, and your neighbor keeps the \$500 option premium. You don't mind – that's the deal you made.
- Your neighbor receives, on December 1, an offer of \$21,000 for the car. He'd love to sell it for that price, since it's more than you will pay... but he can't, since you have the legal option to purchase the car until January 10th. He has to wait; now *he* looks sad.
- In December you decide to check out the car thoroughly and you realize it was wrecked and repaired. After some thought you decide you're not interested after all. You don't purchase the car, and your neighbor keeps the \$500 option premium. And you're sad, but also glad.

So: When you buy an option you have the *right* but not the *obligation* to perform some action (usually to make a purchase or sale.) You can always choose to do nothing until the expiration date; after that date the option becomes worthless and the contract becomes null and void.

The same thing happens in the stock market. Say shares of General Electric (GE) are trading at \$17 per share. You feel the share price will rise over the next month or so. Instead of buying actual shares of GE stock, you could purchase an option from another investor to buy 100 shares at \$20 per share at any time during the next sixty days. That option might cost you \$.10 per share, or \$10 total. If the price of GE stock does not go above \$20, you won't exercise the option – why pay more than you would pay on the open market? In that case you'll let the option expire. On the other hand, if the price of GE stock goes up to \$23 per share, you could exercise your option, buy the owner's shares at \$20 each, and enjoy a \$3 per share profit.

Again: The option gives you the right, but not the obligation, to perform a certain action.

Now let's dig a little deeper. There are two basic types of options: Calls and puts.

A **call** gives the owner of the call the right to **buy** an asset at a certain price within a specific period of time. In investment terms, people who buy calls hope the stock price will increase before the option period expires.

A **put** gives the owner of the put the right to **sell** an asset at a certain price within a specific period of time. In investment terms, people who buy puts hope the price of the stock will fall before the option expires.

Puts may sound counter-intuitive, so think of them this way. Puts are simply the option version of selling a stock short. If you think the price of a stock will fall, you could sell shares you don't currently own; if the price falls, you can buy those shares at a lower price, replace the shares you sold for a higher price, and pocket the difference as profit.

Here's a quick example. Say Microsoft is currently trading at \$26 per share. A friend of a friend who knows Bill Gate's chauffer says Bill is planning to retire next month, and you think the stock value will be hit hard by the announcement. You could sell Microsoft short at \$26 per share; in effect another investor buys shares you "borrowed" from another investor. (Again, you don't currently own the shares.) If Bill does retire and Microsoft stock falls to \$20 per share, you buy stock on the open market for \$20, replace the shares you borrowed, and pocket the \$6 per share difference.

You can do the same thing with a put – except instead of *buying* actual shares you'll buy a put giving you the option to *sell* shares at a specific price. If the share price falls you make money.

So let's break it down. Where options are concerned, investors can:

- Buy calls
- Sell calls
- Buy puts
- Sell puts

If you buy an option you are considered a *holder*, if you sell options you are considered a *writer*.

And remember: If you **buy** a call or put, you're a holder and are in no way obligated to take action. You have the *right* but not the *obligation*.

If you **sell** a call or put, you *are* obligated to sell if the buyer of that option decides to exercise their option.

Now a few more terms:

- **Premium:** The cost of the option, paid by the buyer. If you write a call on Microsoft stock and are paid \$50 total by the buyer, the \$50 you receive is the premium. (And you don't have to give it back, even if the option expires and the buyer doesn't take action.)
- **Expiration date:** The date until when the option can be exercised. An option with an expiration date of May 31, 2010 cannot be exercised after that date; it expires and the contract becomes null and void.
- **Strike price:** The price at which the underlying asset can be bought or sold. For example, you may write a call on Microsoft stock at \$30; if the price of Microsoft stock rises to \$30 per share, it has hit the strike price and the option buyer may choose to exercise their option. You are required to sell the stock for \$30 per share even if the share price rises higher. If the share price is higher than the strike price, the option is considered to be "in the money." (We'll discuss "in the money" and "out of the money" in a moment.)

Confused? Let's try a real-life situation. We'll use an example from years ago.

In November 2001, shares of Microsoft traded at \$65. If at the time you thought the price of Microsoft stock was going to go up, you could have simply purchased shares for \$65 and waited to see if you were right.

Or, you could have purchased a call.

At the time, a \$65 call (the option to buy shares at \$65) expiring on January 31, 2002, cost around \$5 per share. If Microsoft stock rose higher than \$65 a share by January 31, you could have exercised your option and bought the stock for \$65 a share. (In the real world you probably wouldn't have exercised the option and actually bought the stock; you would have instead just sold the option to another investor since that option would have increased in value. But because you purchased a call, you did have the right to buy the stock if you wanted.)

If Microsoft stock didn't go higher than \$65 a share by January 31, your option expired and you lost your \$5 per share. But, on the other hand, if Microsoft stock fell to \$50 per share, you didn't lose \$15 a share by owning the actual stock. In effect you risked losing \$5 per share... but no more. And your upside was unlimited.

One last important point: The expiration date has a huge effect on the value of an option. In the first Microsoft example, a \$65 call option for January 2002 cost about \$5. A \$65 call option for January 2004 was priced at \$17.

Why the big difference in price? The \$5 option was set to expire in three months, not two years, so the person selling the option took on less risk – there was a much lower probability that Microsoft would rise significantly in three months than it would in two years. With the two-year option time was on the buyer's side, so the buyer was willing to pay more for a two-year option than a three-month option.

In relative terms: The longer the term, the higher the option price.

Time is a critical factor in determining option values. Assuming the underlying value of an asset does not change, options tend to decrease in value – even if just fractionally – every day. After all, if an option is out of the money, on expiration date it becomes worthless.

Covered Calls

Now that you understand the basics of options, let's look at a form of options trading you'll use to significantly increase your investment returns: Covered calls.

As you know, writing a call involves selling another investor the right to purchase an asset at a specific price (the strike price) on or before a specific date (the expiration date.)

A call you write can either be *naked* or *covered*.

Naked calls aren't as exciting as they might sound. If you sell a naked call, you give the buyer of that option the right to purchase an asset *you do not currently own*.

Here's the problem: If the buyer chooses to exercise the option you granted, you have to then buy the asset on the open market in order to deliver it *at the strike price*. Say you sell a naked call on for 100 shares of Microsoft stock at \$20 per share; if the stock jumps to \$30 before the expiration date, you must purchase shares at \$30 per share and sell them to the option holder for \$20 per share... and you lose \$10 per share, or \$1,000. In theory you face unlimited risk, since there is no limit to how high a stock can rise in price. If the stock goes to \$100 per share, you're out a ton. (Hopefully you would get out of the position long before that happened, though.)

In other words, "naked" is, at least in this case, a bad thing.

Covered calls are strategies based on selling options on assets *you currently own*. Your "cover" is the asset itself; if you have to deliver the asset, you're covered – because you already own it. In effect you have no risk, other than the risk of losing the asset – but at least you'll be happy with the price you receive for the asset. (Otherwise you shouldn't write the call in the first place.)

Think of it this way: If the holder of the option decides to exercise the option, you're "covered."

When you sell, again, also called "write," a covered call you instantly increase your investment return and cash flow.

Here's a quick example; we'll stick with Bill Gates et al and use Microsoft stock.

Say you purchase 100 shares of Microsoft stock for \$26 per share. Your total investment (to keep the math simple, we'll leave out commissions) is \$2,600. So far so good, right?

Microsoft stock pays a dividend of .52 per share, or approximately 2% (based on the current stock price. If the price of the stock rises or falls, the dividend won't necessarily change – unless Bill and the Board of Directors decide to raise or lower it – so the rate of dividend return will automatically change as the stock price fluctuates.)

So, if the stock price stays flat, you'll at least get a 2% return on your investment.

Not bad, but you'd like to get a higher rate of return so you decide to write a covered call on the Microsoft stock you own. (And as you now know, the word "covered" followed by the word "own" is redundant; you can't be covered if you don't own it.)

You know, of course, that if the stock doesn't hit the strike price you'll keep the option premium, plus any dividends paid on the stock. If the stock does hit the strike price, the option holder may decide to exercise their option... but you'll still be paid the strike price and you'll keep the original option premium. When you write a covered call option, you have to be willing to sell the stock... but you'll be selling at a profit, and you will also profit from the option premium you were paid. (Win-win!) Just keep in mind covered calls increase your *guaranteed* profits – because you'll always keep the option premium – but they do limit the *maximum* amount you can make on a rise in share prices, since you may have to sell the stock before it reaches its peak in value.

Bottom line: Covered option writing limits your theoretical upside but in the meantime automatically adds to your income – it's a great strategy in a flat market or for investors who want to increase their income and rate of return on a long-term basis. (But hey – by now you know that.)

Now back to your options. The first thing you do is consult the current options trading price chart for Microsoft. Here's what the chart and prices might look like for call options that will expire in thirty days:

Current Stock Price: \$26 per share (Expiration Date: Thirty Days)

Strike Price	Option Premium
\$5.00	\$20.95
10.00	16.20
15.00	10.75
20.00	6.18
25.00	1.21
26.00	0.50
27.50	0.12
29.00	0.04
30.00	0.02

(Keep in mind I've simplified the chart to make it easier to follow.)

You'll notice the strike price goes as low as \$5 per share, even though the stock is currently trading at \$26 per share. Those options are "in the money" and can be exercised right away; that's why adding the strike price (\$5) to the option premium (\$20.95) yields a total lower than the price of the stock; why should anyone buy the option if they can simply buy the stock on the open market?

Now let's look at the other end of the scale. An option to purchase the stock at \$27.50 costs .12 per share, or \$12 for 100 shares. While that's not a lot of money, the rate of return is actually fairly high. If the option isn't exercised in the next month, you keep the \$12. Your return is only .46%... but that's on a monthly basis. Do that twelve times and your annual rate of return is 5.5%. Add that to the dividends you'll receive and your annual rate of return is 7.5% - without incurring any risk due to writing those covered calls.

While not shown on the chart above, if you write a covered call that expires in sixty days, the premium for a strike price of \$28 per share is .39 per share, or \$39 dollars for 100 shares. If the option is not exercised, the rate of return is

1.5%, and on an annual basis computes to 9%. Add the dividend and your rate of return is now 11% - again without facing any risk.

Of course you may have to sell the stock if the option is exercised; if that's the case, you'll also make a profit on the higher per share price. Covered call: Win. Dividend yield: Win. Profit on higher share price: Win.

Win-win-win!

In the Money vs. Out of the Money

Different investors use different covered call strategies depending on their goals and their outlook on the market.

Let's say you're a speculator: You like trading stocks of companies you feel will rapidly rise or fall in value. Writing covered calls may not be right for you; if you buy a stock at \$5 per share and truly believe it could jump to \$15 per share in the next few months, writing a covered call with a strike price of \$10 doesn't make sense – if you're right, you'll lose the stock at \$10 because the option will be exercised, and you won't enjoy the additional appreciation as it climbs to \$15.

So, the first key to writing covered calls is selecting assets you are willing to sell for the right price.

Then, decide what you feel the asset will do in the short term – that will help you decide whether to write an in the money or out of the money call.

Let's say you own Microsoft stock and are concerned **shares will decrease in value**. (I could ask why you own a stock you think will decrease in value in the first place... but for now we'll let that particular discussion go.)

You could "lock in" a price on the stock by selling an in the money call. An in the money call is one where the asset value is currently at or above the strike price for that asset. As a result, the premium you receive will be high; check out the chart for Microsoft from earlier and you'll see, for example, that a call with a strike price of \$20 is selling for \$6.18 per share; if Microsoft falls to \$20, you're not out any money because you "covered" yourself by writing a covered call. (A \$20 strike price plus \$6.18 option premium equals \$26.18, slightly higher than the current price of the stock.) Of course if the stock price falls below \$20 you

lose money – but not as much as you would have lost if you had not written the option.

On the other hand, since it is in the money it is also very likely the option will be exercised, so you must be willing to let the stock go or you shouldn't write an in the money covered call.

Now let's say you expect Microsoft **shares will stay flat**. In that case you might want to generate extra income by writing a covered call. You could write an at the money call, which will yield a moderate option premium and increase your overall return. Of course, if the price of Microsoft shares rises, the option will probably be exercised and you'll miss out on those profits.

Finally, let's say you expect Microsoft **shares will stay flat or rise by a small amount**. In that case, you might write an out of the money call. An out of the money call is one where the strike price is higher than the market value of the underlying asset. You'll receive a relatively low premium but you'll also enjoy more of the appreciation in the asset value. For example, say you write a thirty-day covered call on Microsoft with a strike price of \$30; you'll only get .02 per share in option premium, but if the stock does rise to \$30, you'll make \$4 per share in profit...offsetting the lower premium you received.

That's why the key is determining what you think will happen to the value of the asset and then factoring in your investment goals. If you want to sell covered calls to earn a little extra money on an asset you hope to hold on to, then in a perfect world the stock price will get very close to the strike price... without going over. That way you keep the option premium *and* enjoy the gain in stock value. If you sell covered calls to increase your guaranteed return, you'll choose a strike price and expiration date that offers the greatest return; if you lose the stock, you lose the stock... but you will have received the return you wanted regardless of losing the stock, even if the call buyer exercises his or her option.

Not bad, eh?

Here's another example of a covered call transaction. Say you own 1,000 shares of Dominion Resources, an energy company based in Virginia. The stock sells at \$34 per share and the dividend is \$1.75, or 5.1%. Owning 1,000 shares means each year you receive \$1,750 in dividends. (Sure beats a Certificate of Deposit.)

But since you'd like to further increase your rate of return, you decide to write a covered call on your shares.

Here are the current call option prices with an expiration date a little less than four months away:

StrikePrice	Option Premium
\$25.00	\$9.00
30.00	4.30
35.00	1.25
40.00	0.10

To decide which covered call to write, first consider your goals.

Let's say you want to maximize your income. Sell options with a strike price of \$35.00. You do run the risk that the stock price will increase from \$34 to \$35 and you'll be forced to sell, but in the meantime you'll receive \$1.25 per share for the options, or \$1,250 total. If the stock doesn't hit \$35.00 per share, then your earnings for three months are \$1,250 plus the dividends you receive. If you were able to receive the same option price, without having to sell the stock, for the next twelve months, your total return on selling covered calls would be around \$4,000 – *plus* \$1,750 in dividends. Your total annual return would add up to \$5,750, for a 15.9% annual return.

If the stock does hit the strike price – which it very likely could, *and that's okay* – then you'll have to find another stock to buy so you'll continue to receive income... or else you could simply purchase more Dominion Resources shares and start the covered call investment cycle all over again.

Two last premises to keep in mind:

1. **You won't lose money simply from writing covered calls.** Once you write the call, you receive the premium and it is yours to keep. If the underlying asset value declines, you may lose money on *that* decline... but

you would have lost money regardless of whether you sold an option on that asset. (If I buy Microsoft stock at \$26 per share and it falls to \$20 per share, I've lost \$6 per share. *Period*. If I sold a covered call, I keep that money... and it actually helps to offset losses in my share value, and at least slightly reduces my total loss.)

You *can* miss out on potential profits, though. If I buy Microsoft stock at \$26 per share and write a covered call with a strike price of \$30... and Microsoft goes up to \$35 per share before the expiration date of the call... and the option is exercised... I will have to sell the stock at \$30 per share, giving me a profit of \$4 per share... but I will miss also out on the additional \$5 per share in appreciation.

But what are the odds that Microsoft stock will jump from \$26 to \$35 in a short period of time – in, say, thirty days? Not very high ... and if that does happen, I will still have made a \$4 per share profit, and I'll keep the option premium... which means I will have made over 15% in profits in thirty days. (On an annual basis – assuming I could pull that trick off twelve more times – my rate of return would total 180%.) Instead of regretting the loss of additional profits, I'll happily pocket that kind of return and move on to another profitable covered call investment.

2. **Buying individual stocks is inherently risky.** I'm sure you've heard experts say you should diversify your portfolio, and I agree; buying individual stocks, unless you have substantial sums to invest and can afford to buy shares in a wide variety of companies, makes it tough for the average investor to build a diversified investment portfolio and minimize the risk of exposure to an under-performing market or investment sector. That's why you'll focus on writing covered calls on Exchange Traded Funds – diversification is a given when you choose the right Funds.

Now that you understand the basics of covered calls, let's look at the benefits and risks of this investment strategy. My goal is for you to understand the upside *and* the potential downside and make the smartest decisions possible – so let's forge ahead!

Chapter 2: Covered Calls – Benefits and Risks

Writing covered calls on Exchange Traded Funds can generate double-digit annual rates of return through the combination of dividends, option premiums, and capital appreciation. Options trading can be risky, but writing covered calls is the least risky form of options trading (in fact, done properly there is no downside risk), and is a great way to protect from market downturns and to generate solid returns in almost any market.

At the same time, every investment strategy involves both benefits and potential risks – so let's look at both, focusing on the positives and negatives of writing covered calls on Exchange Traded Funds.

Benefits of Writing Covered Calls on Exchange Traded Funds

1. **Generate additional income or return.** Covered calls generate a guaranteed stream of income. Regardless of changes in the market or economy, you keep the premiums from any covered calls you write. Your rate of return is always higher than if you do not write a covered call.
2. **Receive income immediately.** When you write a covered call the premium is credited to your account within a day or so; you can reinvest it, draw it from your account to increase your household cash flow... whatever you choose. Since you don't have to worry about paying the premium back, you can do what you want with the money.
3. **Predictably generate guaranteed rates of return.** Say you buy 100 shares of an ETF for \$25 per share, and you sell a covered call with a one-year expiration date, at a strike price of \$28, for \$2. Your rate of return is 8%, *guaranteed*; you've already received the money. (In fact, if you put that money in another investment vehicle your rate of return will be even higher.) And, if the ETF increases in value to \$28 or more, your capital appreciation will be \$3, or 12%. In effect you'll know your initial rate of return as well as the maximum rate of return you can expect if the option is exercised, as soon as you write the covered call.

4. **Reduce risk.** If the value of your ETF falls, writing a covered call – and receiving the premium – helps to limit the total loss in your investment.
5. **Receive dividends until you sell the ETF.** When you write a covered call on an ETF you give another person the right to purchase your shares under specific conditions; in the meantime, you receive any cash dividends distributed by the Fund.
6. **Convenient trading.** Covered calls are traded on the open markets; you can buy and sell options just like you sell individual stocks or ETFs. You can use a broker or handle your own trades online.
7. **Diversification.** Exchange Traded Funds are available for all major stock indexes, including the Dow, the S&P 500, and the NASDAQ Composite index. Plus you can buy ETFs for large U.S. companies, small companies, real estate investment trusts (REIT), international stocks, bonds, and even commodities. Almost every asset class is represented by an ETF.

Risks of Writing Covered Calls on Exchange Traded Funds

1. **Requires an underlying investment in stocks.** Exchange Traded Funds are stock market investments (unless you purchase, for example, a commodities-based Fund.) If the market dips, the value of your ETF is likely to decrease as well. On the flip side, writing covered calls does provide some amount of protection against losses since premiums can offset some or all of the loss in value of an underlying ETF. In short, if you plan to purchase shares of an ETF, writing covered calls automatically reduces your level of risk, even if by a small amount.
2. **Upside gains might be limited.** If the value of an ETF exceeds the strike price, the option may be exercised by the buyer and the shares will be sold; if the value continues to rise you will miss out on those gains since you will no longer own shares in the ETF. In some cases you may

have been better off *not* selling covered calls, especially if the market explodes upwards... but on the other hand you will be able to predict your rate of return when you write the covered call, so you enjoy the benefit of making an informed decision about the level of return you hope to – and will be happy to – receive.

3. **Covered calls can be exercised at any time.** (Assuming the strike price has been reached, of course.) While most of the time options are exercised at the expiration date, the holder of the option is entitled to exercise his or her rights at any time up to the expiration date. You could, then, lose the ETF shares before you think you will, but if that happens you will also immediately be paid the strike price for those shares. So while you did lose the shares... you also received money to reinvest elsewhere so you can continue to generate high rates of return.
4. **Trading could be thin.** Options are in general traded less widely than normal stocks. Plus, options for some stocks are more widely traded than others, and options for some ETFs are less widely traded than others. (But some ETFs have extremely active option trading.) On thinly-traded ETF options, the difference between the “bid” (what someone will pay) and the “ask” (what you want to receive) could be fairly large. A broker can help you place a limit order (specifying the terms of your call pricing) to ensure your calls are sold at a price you are comfortable with.
5. **Premium amounts vary as the market varies.** When the market is volatile option prices tend to be higher; when the market is stable option prices tend to be lower. (Predictability – or at least *perceived* predictability – tends to create lower prices.) The premium amounts you receive for options of a particular ETF may vary over time and your rate of return could increase or decrease over time as you write subsequent covered calls. But keep in mind once you write a covered call, your rate of return for *that* option is guaranteed – money in your pocket is guaranteed income.
6. **Commissions can vary.** In order to execute a trade, whether in stocks, ETFs, options, or covered calls on ETFs, you will need to pay a commission to the executing firm or broker. Commission rates vary

widely – make sure you find a brokerage that offers the services you need at a price you feel is reasonable for those services.

Chapter 3: Writing Covered Calls for Exchange Traded Funds

Now that you understand the basics, the underlying principles – and most importantly, how you can build real wealth while minimizing risk through writing covered calls on ETFs – let's put what you've learned into practice.

In other words, we've covered most of the theory; now it's time to turn theory into reality.

Keep in mind we'll focus on writing covered calls on Exchange Traded Funds. You *will* own the underlying shares of the ETFs you write options on; you *won't* sell naked calls and as a result will *not* face unlimited risk. (In fact, your goal is to minimize your risk while maximizing your return – I can think of very few instances where being "naked" doesn't involve a certain degree of risk, no matter how great the reward may be.)

Here's what you'll learn:

- How to select the right ETFs for your goals and your willingness to take on risk
- How to determine the right terms for the option contracts you write
- And in a later chapter, how to execute trades

In a sense – even though it can get extremely complicated – that's all there is to it: Pick the right ETFs to invest in, determine the terms you want for the options you'll sell, and make the right trades.

And rinse and repeat as you build real wealth.

Choose the Right ETF

Where there are problems there are opportunities.

The problem is there are hundreds (currently more than 800) Exchange Traded Funds. (And the number is growing all the time as ETFs become more and more popular with institutional and individual investors.)

That same problem creates an opportunity – because so many different Funds are available, the odds are great that you can find one or more ETFs that fit your goals and your investment outlook. (But if you need guidance, just ask – we'll help you find the right ETF for your individual needs.)

Since the list of Exchange Traded Funds is constantly growing, we've chosen not to include a breakdown in this e-book. One easy way to see all the available Funds is by visiting [Morningstar's ETF website](#). (Or you can do a search using a search term like "complete list of ETFs".)

Exchange Traded Funds are broken down into categories depending on the goals and investment outlook of the fund. Here are some of the most common:

- **Bear market:** Designed to take advantage of market downturns.
- **Bond:** Focus on buying and selling government and private-sector bonds.
- **Commodity:** Focus on buying and selling commodities like oil, precious metals, farm products, etc.
- **Currency:** Focus on buying and selling foreign currencies, companies engaged in foreign exchange, and taking advantage of changes in exchange rates.
- **Index:** Invest in stocks representing a cross-section of the stock market as a whole; for example, an Index ETF may invest in shares of companies represented in the S&P 500.
- **Growth & Value:** Focus on stock investments in stable companies, blue-chip companies, and companies that pay moderate dividends – or on the other end of the spectrum, companies that are expected to enjoy high growth rates. Some ETFs may focus more on value stocks that can

generate long-term appreciation with lower risk; others may focus on higher-risk companies with greater potential upside.

- **Investment style:** If you have money in a 401(k) you are probably familiar with “style” funds. Examples are small-capitalization funds, large-capitalization funds, lifestyle funds, etc. Some ETFs follow the same structure, letting you invest in, for example, a collection of large-capitalization companies.
- **Industry:** Focus on investments in companies that represent specific industries, like energy, pharmaceuticals, banking, etc.
- **International:** Focus on buying stocks of foreign companies, or purchasing shares in index funds based on foreign exchanges.
- **Leveraged:** Use borrowed capital, combined with investor capital, to spread the administration and transaction costs over a larger number of investors and reduce overall fees (and hopefully increase the overall return.)
- **Specialty:** Innovation is critical in any industry, and the investment business is no exception. In recent years new ETFs include tax-deferred ETFs, actively managed ETFs, ETFs made up of other ETFs... variations will continue to be created.

Since the list of available Exchange Traded Funds is so large, let’s look at a few of the most popular ETFs:

- **Standard & Poor's 500 Index Depository Receipts.** This is the first, and it remains the biggest, ETF. Commonly called “spiders” (the acronym for its name), it tracks the S&P 500 index, which is generally considered the standard for large-capitalization U.S. stock market performance. In general terms this ETF is made up of the 500 largest publicly-traded companies in the U.S.
- **NASDAQ 100 Index Tracking Stock.** This ETF tracks the NASDAQ 100, the largest companies (based on market capitalization) listed on the

NASDAQ exchange. Since the NASDAQ includes a relatively high percentage of technology companies, this ETF is a good way to invest in a diversified blend of computer, software, telecomm, and biotech companies.

- **DIAMONDS Trust.** The Dow Jones Industrial Average is made up of thirty blue-chip stocks. This ETF tracks those companies; if you want to follow the Dow, choose this ETF.
- **iShares S&P 500.** Similar to the “spiders” ETF, this Fund, set up by Barclays, also tracks the S&P 500.
- **Standard & Poor's Mid-Cap 400.** This ETF tracks the S&P Mid-Cap 400, made up of mid-size U.S. companies. If you prefer investing in medium-sized companies, this ETF might be right for you.
- **iShares Russell 2000.** The Russell 2000 is a popular benchmark for mid-cap and small-cap companies. (Defined as companies with market values between \$20 million and \$300 million.) Companies on the list tend to turn over fairly regularly as their fortunes rise and fall, but this ETF is a popular way to invest in shares of small companies.
- **iShares MSCI EAFE.** This Fund (I won't repeat the multiple acronyms – oh, okay, here's what they mean: Morgan Stanley Capital International and Europe, Australasia, and Far East) tracks the shares of non-U.S. companies in major world economies. If you want to invest in foreign stocks, this ETF is a convenient way.
- **Total Stock Market VIPERs.** This ETF is set up by Vanguard Group and tracks the Wilshire 5000, which is the broadest index for U.S. stocks; the majority of U.S. companies are included. If you want to invest in the U.S. economy as a whole, this might be the Fund for you.
- **Consumer Services Select Sector SPDR.** Standard & Poors has established a wide variety of sector ETFs; this one tracks consumer services companies. Other services sector Funds include:

- Consumer Discretionary
- Energy
- Financial
- Health Care
- Industrial
- Materials
- Technology
- Utilities

So, which ETF should you choose to invest in? Again, the answer depends on your goals and investment outlook.

In general terms, if you're bullish on the U.S. economy a Fund made up of a broad cross-section of U.S. companies might be a good choice; if you think oil stocks are poised to explode (pun intended), then a sector fund focusing on oil or energy stocks could be a good choice.

And it always makes sense to diversify: You might choose to buy shares in a broad index fund, an international fund, and a commodities fund – that way you have some level of protection from specific downturns in the U.S. or foreign economies, or from a rapid drop in commodities prices.

Different ETFs also provide different dividend amounts; check out the dividend rate each pays – the amount you receive in dividends is part of your total income and return from a particular Fund.

Deciding which individual Funds to invest in is outside the scope of this e-book; if you need specific guidance, contact us: We'll review your specific financial situation and your goals and will help you make an informed choice.

Speaking of choices – it's time to choose the terms for the covered calls you write!

Buying Covered Calls – What the *Buyer* is Thinking

Even though you'll *write* covered calls, understanding what the buyer is up to will help you get a good feel for the ins and outs of the process – and the psychology

that underlies the process. (And who knows – someday you may decide to dabble in buying calls, too.)

Keep in mind to make the math simple we've left commissions out of all the upcoming calculations. (Options trades necessarily involve paying commissions.) We'll also use relatively round numbers just to make the math a little easier to follow; after all, the math isn't important; the underlying reasoning and decision-making process are what really matters. So you focus on the process and not unnecessary details, we'll use a fictitious ETF, too.

Here goes. Say today is January 1. Shares of Mobile Phone Fund are currently selling for \$20 per share.

Our theoretical buyer, Mr. Speculator, has been following the Fund for some time and feels it is poised to rise in the near future; sales of mobile phone apps have been spectacular and Mr. Speculator feels new apps and advances in technology will continue to take the consumer market by storm. Instead of buying shares of Mobile Phone Fund itself, Mr. Speculator decides to purchase call options for that Fund. He buys a call option contract to purchase 100 shares of Mobile Phone Fund at \$25, with a June expiration date. (That makes it a six-month contract.)

The premium he pays is \$3 per share, or \$300.

Here's the breakdown of terms:

Current share price:	\$20
Strike price:	\$25
Option premium:	\$3
Expiration date:	June 30
Total cost:	\$300

Keep in mind the option premium price is based on a number of factors: The volatility of the Fund (how much it tends to rise and fall), how far away the strike

price is from the current price (today, about \$5), and the length of the contract (six months).

Generally speaking, volatile Funds and their underlying industries tend to command higher option premiums. While the strike price is 25% higher than the current Fund price, that's not a huge jump for volatile industries; on the other hand, options with a strike price of \$30 will command a much lower premium amount, since that kind of rise in value requires a 50% increase in Fund price in just six months.

Plus, since the option will expire in six months the premium is higher than, for example, an option expiring in thirty days – the longer the time period, the greater the chance the Fund may rise in value. (And the more time the buyer has to sell the option to another investor if he changes his mind about the prospects for the Fund.)

Option premiums will also vary greatly depending on investor outlook. If the market has declined recently and economic news is grim, option prices will be affected, just like stock prices and ETF prices. In general, option prices tend to trend lower when the market is down or when the economy is struggling. Uncertainty breeds fear, and fear causes investors to be more conservative. Don't expect to see the same option prices in good times and bad times... you'll only be disappointed.

One last note: While a significant amount of high-level math goes into determining option prices, in the end the option premium is determined by what a buyer is willing to pay and what a seller is willing to accept. That's the true definition of value.

Once the option is sold the option writer pockets the \$300 option premium. It's now his money to do with as he pleases. (Hopefully for his sake he owns the underlying shares of the ETF and has not written a naked call.)

So now what happens? If the Fund price doesn't hit \$25 per share, then from the call writer's point of view... nothing happens. The buyer has the right to purchase shares at \$25 per share, but only if that strike price is reached.

In the meantime, the value of the option contract the buyer owns fluctuates according to changes in the underlying value of Mobile Phone Fund. If the price

of Mobile Phone Fund rises, the value of the option will rise; if the Fund price falls, the option value will fall.

Mr. Speculator, of course, hopes the Fund price will rise.

So let's say after one month shares of Mobile Phone Fund have gone up to \$25 per share. Mr. Speculator can exercise the option and buy the shares... but he's not likely to.

Why? Remember, he purchased the option contract for \$3 per share. If he exercises the option contract, he pays \$25 per share for the stock... and if you include the \$3 per share he paid in option premiums, his total cost is \$28 per share. Exercising the current contract would actually cause him to *lose* money, at least on paper.

Instead, he may choose to sell his option contract to another investor. Since the share price has reached the strike price, and there are still five months left to go, the value of the option contract may now have risen to \$4 or more. Mr. Speculator could sell the option contract to another investor and pocket a \$1 per share profit. While that doesn't sound like much, it's a 33% return in less than a month – not bad! In fact, that's a better rate of return than if he had purchased the stock itself; the stock has risen by 25% but the value of the option contract increased by 33%.

In the meantime, the person who wrote the covered call simply waits to see if Mr. Speculator – or another investor if Mr. Speculator sells the contract – chooses to exercise that contract. (And enjoys the option premium he was paid.)

That's why investors buy options contracts. In this case Mr. Speculator made a greater rate of return and tied up a lot less capital in the process. (Buying 100 shares of Mobile Phone Fund would have cost \$2,000; he only tied up \$300 buying the options.) On the other hand, if Mobile Phone Fund rose to \$24 per share over the length of the contract, Mr. Speculator would be out \$300 if he purchased options; if he had purchased actual shares of stock, he would be up \$4 per share, or \$400.

And that's why speculators buy calls – they can control a lot of shares of ETFs while putting down very little money... especially when compared to the amount required to buy actual ETF shares. They can make big profits – and, of course,

suffer big losses. Since options expire, if the ETF shares don't move as a speculator hopes at some point those options are worthless and the speculator loses his or her investment.

Think of it this way. If you buy call options you have to be correct in two different ways: You have to speculate accurately that share values will rise to a certain level... and you also have to speculate accurately that shares will rise in value to a certain level *by a certain point in time*.

Not so easy.

A Quick Digression: Time Value and Intrinsic Value

The value of an option contract is based on two main factors: Intrinsic value and the value of time. Let's take a quick look at both.

Intrinsic value is what an asset is worth in and of itself. For example, if you buy shares of an ETF, those shares have an intrinsic value: The amount you, or another person, are willing to pay to own those shares. If you purchase 100 shares of Mobile Phone Fund for \$20 per share, the intrinsic value of those 100 shares is \$2,000.

In options terms, an option contract has an intrinsic value when the price of an ETF is above the strike price for that contract. Why? Because the contract can be exercised and shares of the ETF purchased for the strike price. In effect, the intrinsic value is the difference between the strike price and the current market price: If the market price is \$21 and the strike price is \$20, an option contract for a single share of ETF stock has an intrinsic value of \$1.

Time value is what an option contract is worth based on the amount of time left before it expires. An easy way to calculate time value is to subtract the intrinsic value of an option from the premium price. For example, if an option contract has a strike price of \$20, the market price is \$21, and the contract still has four months left before it expires, the option premium may be \$2 (or more). In that case, the time value is \$1 (\$2 option premium minus \$1 intrinsic value).

What if the option is currently out of the money? The entire premium is based on time value since there is no intrinsic value.

Here's a simple way to differentiate the two: Intrinsic value is the amount the ETF option is in the money. Time value is the additional amount of the option premium.

Why do you care? In most cases you'll sell covered calls at out of the money strike prices; that way you can hold on to the underlying shares, enjoy dividends, pocket the option premiums as additional income, and gain from appreciation in the underlying value of the Fund. In those cases, buyers pay you for the time value of the option; there is no intrinsic value.

Back to the Buyer

Where were we? That's right – we were following the adventures of Mr. Speculator. When we left him, he was enjoying the fact that shares of Mobile Phone Fund rose to the strike price.

But what happens if the Fund shares don't hit the strike price?

For one thing, no one will be surprised. Well over 80% of options contracts that started as out of the money contracts expire as out of the money contracts. ETFs – just like stocks – just don't tend to appreciate rapidly, especially over the short term.

So Mr. Speculator has a few choices as time passes. If he starts to doubt whether he made a good investment, he could choose to sell the contract to another investor. Let's say he waits three months; because the time until expiration is now shorter, the time value of the contract is likely to be lower – possibly well more than half. He may be able to sell the contract for \$1 or \$1.50 per share; while he does lose money, at least he won't lose his entire investment.

Or, he could decide to hang on... but keep in mind the longer he waits, the less time value the option contract has... and the less it will be worth.

Of course, the stock could rise to \$23 or \$24 a share – in that case, the value of the option is likely to increase, since the chances of the stock hitting the strike price have become much greater.

What's the bottom line? The value of an ETF option contract is a complicated dance between the value of the underlying shares of the ETF and the time remaining before the contract expires. Because the option will eventually expire, buying options is a risky proposition... which is why it's a lot more fun to be on the selling side.

That's you.

So let's take a look.

Writing Covered Calls – What *You're* Thinking

Now let's pretend on January 1 you bought 100 shares of Mobile Phone Fund for \$20. You're delighted the Fund pays a dividend of 2%, but you want to increase your rate of return so you decide to write covered calls on those shares. (Good decision.)

First you give the matter some thought. You're bullish on the technology sector, and in particular the mobile phone sector, but you don't think it's likely those stocks will rise significantly in the near future – you know telecomm companies are making handsome profits on cell phone sales and app sales, but you feel those considerations are already built into the value of their stocks. So you think it's unlikely the price of shares of Mobile Phone Fund will go up more than 25%, or to higher than \$25 dollars per share.

Let's take a look at the possibilities open to you:

	Expiration Date		
	Feb	April	June
Strike Price			
\$20	\$0.50	\$1.40	\$4.00
25	0.10	0.30	3.00
30	0.04	0.12	0.30

(Keep in mind the above is a hypothetical chart, and I've skewed the numbers slightly to make a point and make it easier to identify a good opportunity. With practice you'll quickly spot the right strike price and expiration date for your situation and goals – and if you can't just ask us for help.)

You check the different option prices and are immediately drawn to the return you could get from selling a six-month call at \$25 a share. \$3 per share in option premium is an outstanding return. After all, that's a 15% return in just six months. (Sound too good to be true? Cases like that are relatively rare... but they do happen.)

You're more than happy to make that deal, so you write a covered call under those terms. Within a day or so the \$300 hits your account; you can spend it, invest it in another ETF, park it in a money market fund for the time being... whatever you want to do. It's your money!

What has happened so far? You spent \$2,000 on shares of Mobile Phone Fund. You will receive a 2% dividend (on an annual basis) on those shares. You also received \$300, or a 15% return, from writing covered calls.

Now you simply wait and watch. If the shares:

- **Stay flat:** You're a little disappointed, but you're still the proud recipient of a 15% return.
- **Fall by \$2 a share, to \$18:** You're more disappointed, but you still haven't lost money; the option premium covered the loss in underlying value of ETF shares. By writing covered calls you've hedged your investment, at least to some extent.
- **Increase by \$2 a share, to \$22:** You're happier – not only have you already made a 15% return, but the underlying value of your shares has increased by 10%.
- **Rise to \$25 per share, and the contract is exercised on the expiration date:** You're a teeny bit disappointed to see shares in such a great-performing ETF go, but you console yourself with the fact you sold those shares for a 25% profit... plus you received dividend payments... plus you made 15% writing covered calls. (So in the end you're really not

that disappointed, are you?) You take your proceeds, buy shares in another ETF... and rinse and repeat.

As I mentioned a moment ago, most option contracts expire out of the money. If that happens, and you still want to hold on to shares of Mobile Phone Fund, you'll repeat the process. Keep in mind option premiums will have changed, possibly dramatically, depending on the underlying value of the Fund's shares.

For example, if the share price has risen to \$24, a six-month contract with a strike price of \$25 could be worth more than \$3 per share. If you want to increase your chances for holding on to those shares, you may choose to write a covered call with a strike price of \$30 per share; you'll receive less in option premiums, but it's more likely the option won't be exercised.

Here's an easy way to make general decisions about which option contract terms are right for you. Ask yourself these questions:

Do I think the ETF will rise dramatically in value over the short term?

If yes:

1. Don't write covered calls at first; give the ETF the chance to increase in value without any risk of an option being exercised.
2. Write out of the money calls; for example, if the current price is \$20 per share and you think \$28 is a likely near-term target price, write covered calls at \$30 per share; you'll receive less in option premiums but you'll enjoy a greater upside if the Fund does increase rapidly in value as you expected.

Do I think the ETF might fall in value in the near future? If yes:

1. Consider selling those shares and investing in a Fund you feel has better prospects. (Why own what you think will decrease in value?)
2. Write in the money calls; the premium price will be higher and will help to offset any short-term losses in share price. (Of course, if you're wrong and the Fund increases in value it's likely the option will be exercised and you'll lose those shares.)

Do I think the ETF will stay flat or only increase slightly in value? If yes:

1. Maximize your return by writing calls with strike prices relatively close to the current market price; that way you'll maximize the option premium you receive and as a result your rate of return. (Even if the market stays flat, you'll do better than the average investor – and with no risk.)
2. Consider writing calls with short-term expiration dates; if the economic climate changes you won't be locked into long-term calls at lower than current market value premiums.

Keep in mind no investment system is foolproof (or should I say "loss proof"?) If the market tanks and your ETF shares decline in value, you may lose money. But if you have written covered calls you will always lose less money than if you had not written covered calls – the option premium will help offset some of your losses. A covered call is not just "covered" because you own the underlying asset; writing a covered call also offers you some amount of "cover" from falling share prices.

Writing Covered Calls – Digging Deeper into the Process

The examples we just worked through were fairly straightforward. Now let's use a real-world example to help you determine the right covered call option terms for your situation.

We'll use the iShare S&P 500 Index. (If you're scoring at home, the ticker symbol for this ETF is IVV; we'll use that symbol to refer to this Fund from now on.) You chose the iShares S&P 500 Index Fund because it "seeks investment results that correspond generally to the price and yield performance, before fees and expenses, of U.S. large-cap stocks, as represented by the Standard & Poor's 500 Index."

Currently the share price of IVV is \$105.45. (Keep in mind by the time you read this the IVV share price, option prices, etc are certain to be different, so please understand the following example should be used for informational purposes only.)

In other words, you think the U.S. economy as a whole is headed for better times and you want to profit from those better economic times. So you buy 100 shares of IVV for a total cost of \$10,545.00. (We're leaving commissions out to make the math easier.)

Here are the current option prices. We'll assume the date you're reading this falls in late September; the first expiration date in October is less than a month away.

Expiration Date	Oct
Strike Price	
\$102.00	\$5.30
104.00	3.10
105.00	3.00
106.00	2.90
107.00	2.50

Expiration Date	Nov
Strike Price	
\$108.00	\$3.20
110.00	2.15
111.00	1.80
113.00	0.95

Expiration Date	Mar
Strike Price	
\$103.00	\$8.70
105.00	6.20
107.00	4.10
110.00	4.00

If you look closely you'll notice a few interesting situations. The option premium for an October contract is nearly the same for a strike price of \$105 and \$106. That's partly due to low options trading volume, but it also could be due to the fact investors see little effective difference between those two strike prices; note the premium for a \$107 strike price dips to \$2.50 per share. Don't expect option premiums to rise or fall in linear fashion as strike prices change; they often don't.

A similar phenomenon occurs with the March options; the option premium for a \$107 strike price is only slightly higher than the premium for a \$110 strike price. It's only .10 a share, but if you think about it, shouldn't you have to pay more for a significantly higher strike price? Situations like this don't happen often with ETF options, but they do occur – so pay attention and take advantage of opportunities like that when they arise.

So: What should you do? First let's do some math. We'll use the same information from above, we'll assume you paid \$105.45 for your shares, and we'll apply some simple calculations.

First, we'll determine the value of the option. For example, the premium for an October Strike Price of \$102.00 is \$5.30. While you will receive \$5.30 per share, the strike price is \$3.45 below what you paid for the stock in the first place. If the option is exercised you'll receive \$3.45 less than you paid per share; as a result, the option is only worth \$1.85 in total to you (\$5.30 minus \$3.45 equals \$1.85). The value is \$1.85.

Then we'll determine your rate of return. To keep things simple, we'll just apply the value to your purchase price; as an example, \$1.85 divided by \$105.45 is .0175. Keep in mind that rate is for about a month; we'll annualize that rate (in this case multiply it by 12) to calculate an Annual Rate of return. (That way you'll always compare apples to apples.) So, .0175 times 12 is 21%; in that instance your Annual Rate is 21%.

Expiration Date	Oct	Value	Rate of Return	Annual Rate
Strike Price				
\$102.00	\$5.30	1.85	1.75%	21.00%
104.00	3.10	1.65	1.56%	18.70%
105.00	3.10	2.55	2.40%	28.80%
106.00	3.00	3.00	2.80%	34.00%
107.00	2.50	2.50	2.30%	28.40%

Expiration Date	Nov	Value	Rate of Return	Annual Rate
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Strike Price

\$108.00	\$3.20	3.20	3.00%	18.00%
110.00	2.15	2.15	2.00%	12.20%
111.00	1.80	1.80	1.70%	10.20%
113.00	0.95	0.95	0.90%	5.40%

Expiration Date	Mar	Value	Rate of Return	Annual Rate
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Strike Price

\$103.00	\$8.70	6.25	5.90%	11.80%
105.00	6.20	5.75	5.40%	10.90%
107.00	4.00	4.00	3.70%	7.50%
110.00	4.10	4.10	3.80%	7.70%

Wow, that's lots of data – and with a red herring or two thrown in for good measure.

First look at the **October** options. The rates of return seem too good to be true... and in fact they are. While those are the last premium prices those options traded at, in the last twenty-four hours no buyers or sellers stepped up to complete transactions at those prices. (If you were a call buyer, would you pay that kind of premium for an option about to expire? I would certainly hope not.) Make sure you check the recent volume column to see how many options have traded; that will give you a good indication of whether you can find a buyer willing to make a trade at those prices.

By the way, that's also a great reason to include limits in your options trades – if you just place a "market" order, you may find yourself writing a covered call at a dramatically lower price than you expected.

If you're unsure and need some backup, we'll help you write your covered calls at price levels you're comfortable with.

Now let's move down to the **November** category. The \$108 strike price option generates a pretty nice annual return rate; that one might be worth exploring. But keep in mind since \$108 is only a few dollars higher than the current price of the ETF, the contract may very well be executed. But if you get the kind of return you want, that is one situation where taking part in an execution is fine by you.

But what if there are no buyers at that rate? That's okay; what about the \$110 strike price? The annual rate of return is over 12%; combine that with the 2% dividend yield for this ETF and your annual return is over 14%. Plus, if IVV does hit \$110 per share and the contract is exercised, you'll make a profit of \$4.55 per share, or \$455. Here's the end result if all those things occur:

Option premium:	\$215
Dividend yield:	\$105
Share value profit	\$455
Total profit	\$775
Rate of return	7.3% (in two months!)

For that kind of return, do you mind if the option is exercised?

I didn't think so.

So what should you do? First, as I did, do some basic math. Then step back and consider the possibilities.

The key is to analyze rates of return, along with your investment goals and your short- and long-term outlook for the underlying ETF. As I mentioned earlier, if you think IVV is likely to rise dramatically in value, you might be better off choosing a higher strike price and a shorter expiration date. In this example, a nice balance between the two could be the November \$113 option with a

premium of .85; you'll enjoy a 5.4% rate of return, you'll receive dividend payouts, and the shares can increase by almost \$8 per share before the options could be exercised; if they rise by \$7 per share by the expiration date, you'll have made a paper profit of \$700... plus an additional return of over 5% in option premiums. Then you take a breath after that last sentence... then rinse, repeat, and make more money.

Let's look at the opposite case; say you feel IVV could possibly tread water for the next six months or so. You hope not... but it is possible based on current market conditions.

No problem: Increase your return by writing a covered call with a strike price close to the current price – but with a longer expiration date.

A good choice could be the March \$107 strike price – or our new friend, the March \$110 strike price option with an oddly larger option premium. If the shares stay flat, that's okay; you'll receive an option premium with a nearly 8% return, plus you'll receive dividends... and if the Fund does rise to \$110 per share, you'll make a profit on the underlying shares as well. Since you don't think the shares will perform well in the next six months, you feel there is little risk the stock will jump dramatically in value – say, to \$120 per share – and there is little risk your contract will be exercised before you enjoy all those profits.

And if it does, oh well – you still made a nice return on your covered calls... without facing any risk from writing them.

General Strategy Guidelines

Hopefully following a few specific examples gives you a better feel for the process. (If you're still unsure, we'll be glad to help you determine the right strategy for you.) Now let's step back and look at some basic guidelines you can apply to writing covered calls – my goal is to help you understand what to do in your specific situation. Remember, your goal is to follow a strategy that lets you reach your investment goals... so let's cover some of the basics of making that happen.

Guideline #1: Expiration Dates – What They Mean to You

While your goal is to maximize the rate of return on the covered calls you write, at times you may want to accept a lower rate of return in order to take advantage of Fund appreciation possibilities. (As I mentioned earlier, sometimes it makes sense to write a covered call for a lower price if doing so gives you room to enjoy a rise in the Fund value.)

The key is to maximize your *overall* return – not just your *covered call* return.

Expiration dates are one of the keys to making that happen.

As a general rule of thumb, the shorter the expiration date, the lower the price of the option. If an option will expire in a week, that's not a lot of time for the Fund to rise in value... so option buyers won't be willing to pay a lot to own that option. That's not necessarily bad for you – if you feel the ETF is likely to rise significantly in the next few months, you may be willing to take a small return now while you hold the Fund and enjoy a greater return later.

If you think that might be the case, write short-term covered calls at strike prices several dollars higher than the current market price of the ETF. For example, if you own a Fund with a market price of \$36 per share and you write a covered call with a strike price of \$40 per share, expiring in a month, the chances are slim the Fund will jump in value to \$40 a share.

That's why just about all the options for every ETF increase in price as the expiration date gets farther out; investors are willing to pay more for a contract that expires at a relatively distant time in the future. And the reverse is true; investors will pay less for an option that expires soon than they will pay for an option that expires at a point somewhere down the road.

But the differences in premium amounts do tend to flatten out; for example, the difference between the premium for an option expiring in a month and an option expiring in six months is much greater than the difference between options expiring in four months and six months.

Here's a quick example:

Strike Price	1 month	2 months	4 months	6 months
\$100	\$0.85	\$2.20	\$3.40	\$3.80

The difference in return slows down between the four-month and six-month options... and it speeds up between the two-month and one-month options. If you think about it, it makes sense; as the expiration date gets closer, the option is worth a lot less because the likelihood it will expire out of the money increases dramatically. On the other end of the scale, investors typically assume a stock that has stayed relatively flat for four months will remain relatively flat for six months; they'll pay a little more for a longer expiration date... but not *that* much more.

So let's take a quick look at differences in writing short-term covered calls and long-term covered calls:

Short Term Covered Calls:

- Are less likely to be exercised, especially if you write the call at an out of the money price.
- Can provide a higher total investment yield (the individual rate may be lower, but you can sell repeated covered calls over the course of a year.)
- Make it possible to enjoy higher appreciation in Fund value, since the likelihood of the option being exercised is lower and you can adjust your strike price higher each time you rinse and repeat, giving you a better chance of holding on to the underlying shares of the ETF.

Long-Term Covered Calls:

- Generate a higher total premium and produce immediate income, since that income is placed in your account almost immediately.

- Require less brokerage transactions and commissions, since you will write less total covered calls over the course of a year.
- Provide greater downside protection in case the value of the underlying shares decreases; after all, the higher the option premium, the more “covered” you are in the case of a market downturn.
- Can offer tax advantages due to subsequent-year expiration dates (call us or see your accountant for more information on tax planning.)

So – what should you do? In my opinion, diversification applies not just to ETF categories but also to expiration dates. If you own shares in four different ETFs, write covered calls creating a balance of shorter-term and longer-term expiration dates. That way you’ll enjoy larger premiums in some cases while keeping your options open (pun intended) by writing covered calls with shorter expiration dates in other cases.

If the market dips, you’ll have a little more protection because you wrote calls with higher premiums; if the market explodes, you should be able to hang on to some of your ETFs, enjoy the capital appreciation, and continue to write covered calls at higher strike prices and maximize your capital returns *and* your option returns.

The same logic applies if you own hundreds of shares in one ETF. Feel free to write covered calls on a portion of the shares with short-term expiration dates, and write covered calls on the remaining shares with longer-term expiration dates. You’ll spread your risk, maintain flexibility, and no matter which way the market goes you’ll be able to take advantage.

Guideline #2: Strike Prices – What They Mean to You

Now let’s look at general guidelines where strike prices are concerned.

Here's a sample chart for an ETF currently trading at \$102, with an expiration date about six months out:

Strike Price	Option Premium	Return Rate
\$102.50	\$6.10	5.90%
\$105.00	\$4.20	4.10%
\$107.50	\$2.95	2.80%

The best return rate is generated from writing a covered call for an option with the \$102.50 strike price; that makes sense, since the Fund will only have to increase in value by .50 before the option is in the money.

But let's take it a step farther. What happens if the underlying Fund rises in value and the option is exercised at each strike price? Here's the result:

Strike Price	Total Return	Return Rate
\$102.50	\$0.50	0.40%
\$105.00	\$3.00	2.90%
\$107.50	\$5.50	5.30%

For fun, let's add the option premium to the Fund appreciation and calculate the total return (without taking dividends into account):

Strike Prices	Appreciation	Return Rate
\$102.50	\$6.50	6.30%
\$105.00	\$7.20	7.00%

\$107.50

\$8.45

8.20%

Keep in mind all the Return Rates are shown on a six-month and not an annual basis. To calculate an annual rate of return, simply double the Return Rate shown.

What did you learn? For one thing, something you hopefully already understood by now: Your total return is based not just on the premium you receive from writing covered calls but also on capital gains from a rise in ETF values (and from receiving dividends from those Funds.) Balancing the strike price with the expiration date gives you the best chance of maximizing your return while maintaining flexibility.

But what you also should recognize is the Return Rate column, in these examples, is based on the Fund hitting the strike price and the options being exercised (and therefore you receiving the strike price in return for selling your shares.)

If the Fund does not hit the strike price, you keep the option premium... but you won't receive any capital gain from selling the ETF shares themselves. So in basic terms, the rate of the option premium should play heavily into your decision-making process; and that rate is heavily influenced by the expiration date.

Think of it this way: If you write a covered call at a strike price of \$55, expiring in six months, for 100 shares of an ETF currently trading at \$50, and you receive \$3.50 per share in option premiums... the \$350 you receive is a guaranteed return... and at an annual rate of 14%. If the ETF rises in value and the option is exercised, so much the better – but your option premium provides a guaranteed, risk-free return.

So pay attention to expiration dates and strike prices, but pay the most attention to your rate of return – that's what, over the long term, will help you build wealth.

Conclusion

As recently as last week... did the thought of investing in the stock market scare you?

After what's happened the last few years, it probably should have.

Now that you know what you know, should investing wisely in the stock market – by buying ETFs and writing covered calls – scare you?

Absolutely not.

Instead, you should be *excited*.

Sure, every investment carries risk. (Even putting money in a savings account carries some amount of risk, however small – ask people whose deposits exceeded FDIC limits about what happened when their banks failed.)

That's why I've said it before and I'll say it again and again: The key to building wealth is to maximize return while minimizing risk. Not *eliminating* risk, because that's impossible. *Minimizing* risk.

Buying shares of Exchange Traded Funds is a great way to diversify your investments and minimize market risk.

Writing covered calls is the best way to further minimize risk *and* achieve double-digit returns, year after year... and in the process watch your wealth grow and grow.

Remember the table I showed you in the Introduction? If you invest \$100,000 in a 401(k) and get a 5% return, after thirty years you'll have over \$430,000. If you invest the same \$100,000 and get a 10% return, you'll have over \$1.7 million in your account.

That's a *huge* difference.

I've always felt the pain of discipline is far less than the pain of regret. So here's my challenge to you: Think about your goals and dreams for yourself and your family. Think about what you've learned and what you now know how to do. Think of the difference in return you'll enjoy, year after year.

And get started! Don't let the pain of investment discipline... wait. I don't think you'll find buying ETF shares and writing covered calls painful at all. But let's pretend you will. Which would you prefer: Avoiding the pain of discipline and, in the example above, ending up with a small nest egg... or avoiding the pain of regret and ending up over \$1 million wealthier – just because you put your knowledge to use and made wise investment decisions?

That's what I thought.

And keep in mind we'll help you – all you have to do is ask. After all, helping investors reach their goals is what we do best.

Here's to your success ----

-- Kevin Simpson

How You Can Help

If you think this is a good thing... if you believe as I do that there's a real benefit to the world when the basic information is made available for free, then you'll want to help me out.

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