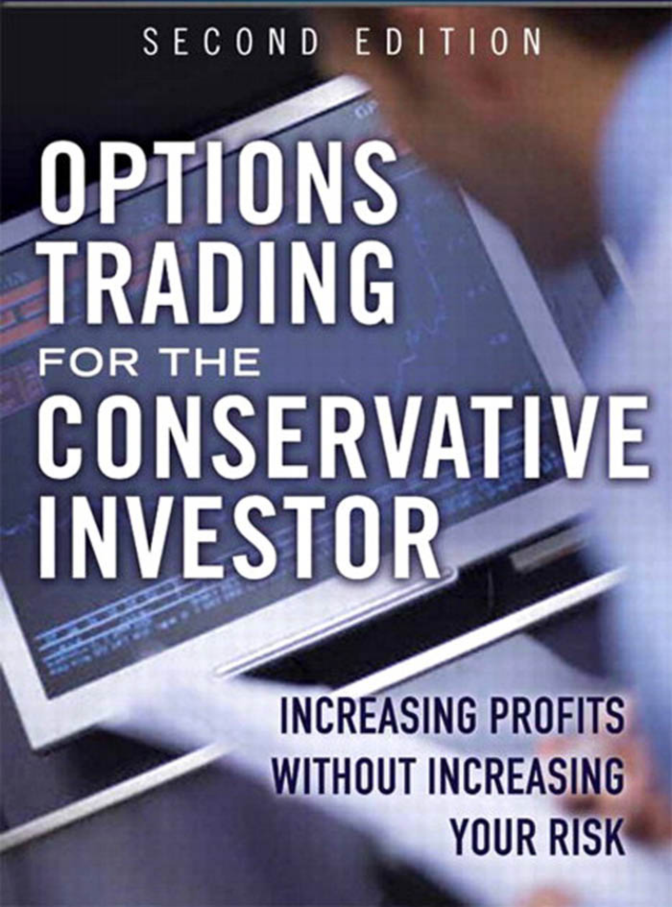

MICHAEL C. THOMSETT

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INCREASING PROFITS WITHOUT INCREASING YOUR RISK

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PREFACE

The Elusive Goal: Low Risk and High Yield

There is good news about the market. Recent stock market trends have been troubling for just about everyone invested in stocks. The traditional approach of buy-and-hold and the trusted technique of value investing based on a study of the fundamentals seemed to fall apart beginning in 2008. Does this mean that buy-and-hold is dead? Not at all. The cyclical nature of the market simply went through a strong bear cycle, but the strength of the American stock market has shown time and again that downward movements are temporary and are always followed by record-breaking upward-moving markets.

In the meantime, however, you may have seen most of your retirement savings and personal portfolio disappear. The staggering losses in even the best-known value investments brought into question the basic "safe" philosophy of the market. To protect yourself in this kind of volatile and uncertain environment, you need strategies to hedge losses; create extra sources of income; and most of all, reduce risk while increasing net yield.

Is it even possible to match low risk with high yield in the volatile markets that have dominated recent years? Most experts question the idea that risk-averse investors can outperform the market averages. However, this book challenges the conventional wisdom by demonstrating how conservative investors can exploit a narrow band of potential strategies, dramatically increase yields, and, at the same time, manage risks within their self-defined risk limitations.

To some conservative investors, options are too exotic and too risky. If a range of strategies is too much trouble or contains too many pitfalls, it is not worth pursuing. But a basic premise in this book is that a *conservative* investor is not necessarily someone who does not want to expand beyond a well-understood and short list of investment possibilities. Being a conservative investor does not necessarily mean that you are unwilling to examine new ideas, expand your portfolio, or take acceptable risks. It just means that you are not interested in speculation or in exposing yourself to the possibilities of high risk.

Investors tend to be aware of the potential for high returns without also acknowledging that such strategies are usually accompanied by unavoidable high risks. This is where the inexperienced suffer losses in the market. The lack of experience that attracts the novice to speculation in options and other high-risk strategies has caused much grief in the market. When you look back at the dot-com years, you see that many first-time investors made quick paper profits, only to lose it all in a sudden reversal of fortunes. But conservative investors know that putting all capital in a single industry is ill advised, especially if companies are chosen that have never reported a net profit, whose stock has risen more than $200 per share in a few months, or whose actual core business is only vaguely defined.

Given these observations, conservative investors naturally seek methods for using their capital that achieve some specific goals, including the following:

- Preserving spending power after both inflation and taxes
- Avoiding unacceptable market, liquidity, and diversification risks
- Protecting profits without loss of invested positions, hedging the portfolio against the possibility of loss

These goals are typical for conservative investors and actually serve moderate investors just as well. They involve strategies for avoiding loss. As a *conservative* investor, you are not averse to risk in any and every form; essentially, you are averse to unexpected surprises. This is perhaps the most important distinguishing characteristic between you and other investors. The majority of novice investors are surprised when they lose money in the market, but, in retrospect, should they have been surprised? In most situations, novices operate on certain assumptions concerning potential profits but are unaware of the related risk or the degree of risk exposure. Otherwise, their investment decisions probably would have been different.

With this in mind, this book offers a more realistic definition of *conservative* investors: those who are experienced enough to be aware of both yield and risk and who make decisions based on that level of awareness. Conservative investors are not as likely as other investors to be taken by surprise when they lose money in the market. Another aspect of this expanded definition distinguishes between risk profile and the willingness to use creative and alternative strategies. Conservative investors are not close-minded and do not reject exotic instruments like options merely because of their reputation as high-risk. Instead, well-informed conservative investors are likely to examine claims about high-yield potential with an open mind. You may be skeptical and, at the same time, willing to listen to the suggestion that the combination is at least possible. A limited number of strategies do, in fact, offer the potential for various conservative applications to meet the three goals common to conservative investors: preserving capital, avoiding unacceptable risk, and protecting paper profits. For example, this book includes 12 overall strategies (see the Appendix, "Option Trading Strategies"), qualified in terms of risk levels.

This book does not suggest that you have to become an expert in a broad range of complex or exotic options strategies. Instead, it proposes a rather limited number of strategies appropriate for conservative investors. This approach respects the risk limitations in the conservative strategy while showing how experienced stock market investors can expand their yield levels significantly, protect existing positions, and come through market down cycles intact.

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SETTING THE GROUND RULES

In any discussion of an investment strategy, you begin with a series of assumptions. Your assumptions tie in to your conservative profile: You have prequalified the stock of a limited number of companies; you believe these stocks will rise in value over time; fundamentals are essential in stock selection; you would be happy to buy more shares; and a finite number of companies meet your standards. We have identified ten companies that make up a "model portfolio" to illustrate the options strategies in this book. These serve as examples of companies meeting a few basic criteria for picking companies and their stocks, as candidates for conservative options trading.

This book explains how conservative investors can employ options strategies to (a) enhance current income without increasing market risks; (b) protect long positions through options used for insurance; and (c) create a form of contingency to survive in volatile market conditions.

The Ground Rules

Because you are a *conservative* investor, the arguments in this book are based on a series of underlying assumptions. Always keep these ground rules in mind, because they relate to your risk profile and to your investing philosophy. Five underlying assumptions are used in this book.

1. **You will limit options activities to stocks you have prequalified.** This is a necessary starting point as long as your portfolio—and the stocks you use for options strategies—includes stocks you believe in as long-term-hold stocks, and you consider these stocks permanent parts of your portfolio (as long as the fundamentals remain strong). This is an important attribute because it is not conservative to buy stocks solely to use for options strategies. A conservative approach to options must include the premise that your activities will be limited to the strongest possible stocks you can find.

2. **You believe that your stocks will rise in value.** A conservative investor naturally expects stocks to rise in value; otherwise, why keep them? But this seemingly obvious point has relevance in the underlying assumptions of this book. Many of the discussions of strategies are premised on a belief that over the long term, the subject stock's market value will rise. Many options strategies work best when stocks do not rise, so for example, covered call writing (a very conservative strategy) is most profitable when stock values remain steady or even fall slightly. This

means that you may need to time a strategy to produce profits resulting from short-term stability in prices, hoping for longer-term growth. So a second underlying assumption is in line with the conservative approach. This means you want to accumulate shares of value investments; you expect prices to rise over time; and you will change a hold to a sell when the fundamentals change. However, at the same time, some options strategies are designed to take advantage of short-term price volatility. When marketwide volatility affects short-term prices in your stocks, you have an opportunity to pick up discounted shares, take profits (without having to sell stock), or average down your overall basis. Of course, the proposal that you should average down is conservative only if the basic stock selection assumptions remain valid. You will want to employ such a strategy only for stocks in which you have a strong belief as long-term value investments.

3. **You accept the premise that fundamental analysis of stocks is an essential first step in the process of examining option opportunities.** Options have no fundamental attributes. These are intangible contractual instruments, and they have no value on their own; thus, you can only judge the tangible value of stock as a means for selecting appropriate options strategies. Many first-time options traders make the mistake of overlooking this basic reality. They select options (and stocks) based on the immediate return potential, but they ignore the real market risks of the underlying stocks. This violates the conservative tenet that stocks should be chosen for their fundamental strength and growth potential.

4. **In the event of a temporary downward movement in a stock's price, you would be happy to buy more shares.** Some investors may be unwilling to pick up more shares of a particular stock, even when the opportunity to buy discounted shares is presented. In this book, several strategies are introduced proposing that additional shares may be purchased (or exposed to contingent purchase) using options. If this is not the case in a particular situation, those suggestions should be passed over. You may have a strict formula for diversification or asset allocation that

you use to limit risks in any particular stocks, for example, so strategies aimed at increasing your holdings in one stock may contradict your portfolio management standards in such an instance. Strategies proposing that you set up situations in which more shares may be picked up work *only* if that suggestion conforms to your overall portfolio plan.

5. **You believe that an adequate number of available stocks meet your criteria.** Some investors become convinced that their short list of stocks is the only list available to them. Thus, if they were to sell shares of stock from their portfolio, they would be unable to reinvest profits in equally acceptable stocks. If you do not believe this, you are probably aware that dozens of stocks meet your fundamental criteria, in terms of price level, PE ratio, volatility, dividend payment history, and a range of other analytical tests. Accordingly, if a particular stock is sold from your portfolio, a number of other stocks that you could and would purchase upon sale of stocks you currently own also conform to your criteria.

Incidentally, this practice makes sense whether you trade options or not. The fundamentals can change for any company, so if a hold stock changes to a sell, you need to reinvest funds. As a matter of basic portfolio management, every investor needs a secondary list of stocks that would be used to replace sold stocks from the current portfolio. The need for maintaining this list relates to options trading because some strategies result in selling shares of stock. In those cases, you want to reinvest capital in a new issue on your list of qualified stocks.

A Model Portfolio

In the examples used in the following chapters, these five underlying assumptions demonstrate how options work within the conservative framework. These criteria are applied to a model portfolio of ten stocks, which are used in various combinations throughout. This helps to tie together the various examples and range of possible outcomes. This model portfolio is by no means a recommendation of stocks you should own. It was selected to include stocks with some common attributes. Many have increased dividends every year for the past ten years and reported low volatility in trading. Others have exhibited rising market value in recent years. All these stocks have available both listed options and long-term options (LEAPS), enabling you to look at a variety of scenarios for each conservative strategy.

Employing a single portfolio throughout the book is helpful in another way. Not every strategy works well for each stock in the model portfolio, so you can walk through the selection process to demonstrate how a particular strategic decision is made. Although your portfolio may contain a number of excellent value investments, some strategies simply do not work at all times or in all cases. You can compare the different potentials for strategies across a range of stocks by following the model portfolio throughout the explanations in each chapter.

The values of each stock, current bid, and asked value of every option used in this book are based on the closing prices reported by the Chicago Board of Exchange (CBOE) on April 18, 2009. Table 1-1 summarizes this model portfolio.

Table 1-1 Model Portfolio

Stock Name	Trading Symbol	Closing Price *
Caterpillar	CAT	32.29
IBM	IBM	101.27
Johnson & Johnson	JNJ	53.05
Coca-Cola	KO	45.02
McDonald's	MCD	56.09
3M	MMM	53.81
Altria	MO	16.99
United Parcel Service	UPS	54.65
Wal-Mart	WMT	50.20
Exxon Mobil	XOM	66.75

* Closing prices as of April 18, 2009

Is this a "conservative" portfolio? That is a matter of opinion—and one that depends on the timing of purchase, long-term goals, and your personal opinion about the fundamentals for each corporation. These ten stocks provide a cross section of stocks that illustrate where strategies work well and where they do not work at all. The actual definition of a conservative portfolio is (and should be) always evolving based on changes in the market, in a stock's market price and volatility, and, of course, in emerging information concerning fundamental strength or weakness of a particular company.

Is this information out of date? The data gathered on the closing date—April 18, 2009—is old, but it would be impossible to perpetually update 10 stocks and still meet the publication date of this book. However, all the information is relative. The values of options for a particular stock will probably be consistent from one period to the next—assuming the proximity between closing price and option strike price is about the same, and that months to go until expiration are the same as well. Although these relationships can and do vary based on ever-changing perceptions about a particular company, the data is valid for the purpose of illustrating strategies. The use of some measurement in time is necessary, and all these stocks were selected and summarized on the same date. Given all these qualifications, these closing prices (and the option values used in this book) are fair and reasonable. As of that same date, April 18, 2009, there were about 2,500 stocks that had options available to trade—a lot of choices for conservative investors.

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