CANADIAN INVESTORS' COURSE

Session 12: Options

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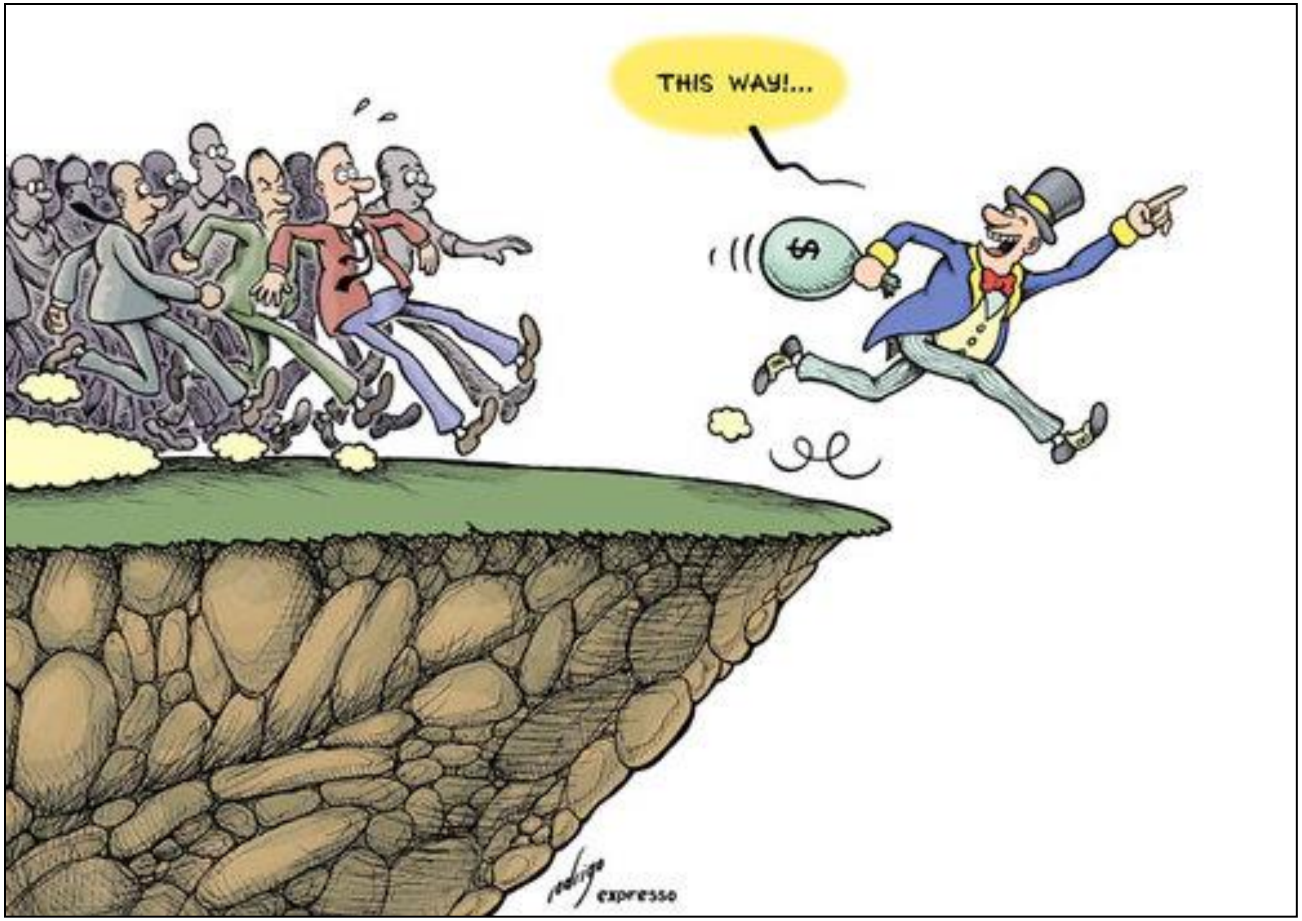
Stock Market Optimism



Options Market

- **Leveraged investments with a defined lifetime**
- Limited liability; when buying, the most you can lose is what you put up

Terminology:

- CALL – buy if you think the investment will go up
- PUT – buy if you think the investment will fall
- CONTRACT – one contract represents 100 shares
- TIME PREMIUM – extra money you pay for time to expiry

Options – An Example

- An investor likes Potash Corp. of Saskatchewan (POT on TSX) Nov.14th, 2016 price = $23.95
- Dividend is 2.25%, at $23.95 and investor wants to buy 1,000 shares; thinks it will go to $26 by Mid January, 2017

What to do?

1. Can buy 1,000 shares = $23.95
2. Can buy 10 $21 CALL contracts that expire Jan. 20, 2017
   – Cost of options = $3.10 or 10 x 100 x $3.10 = $3,100

Buying An Option

Buying an 'in-the-money' CALL option:

- Buy 10 POT January $21 CALLS for $3.10
- Gives you 'a right … but not the obligation' to buy 1000 shares at $21 before Jan.20, 2017
- $3.10 premium broken down into $2.95 intrinsic value + $0.15 time premium
- if POT goes to $26 by Jan., then option will sell for a minimum of $5 (26 - 21) for a minimum 52% return
- $1.90 profit on $3.10 invested

Buying An Option (Continued)

Buying 'out-of-the-money' call options:

- buy 10 POT $24 May CALLS for $1.00
- cost = $1.00 x 10 x 100 = $1,000 (most you can lose)
- if POT goes to $26 share price, option will sell for a minimum of $2,000 for at least a 100% return

What if you think POT will fall to $21 by Jan. 2017?

- **buying in-the-money PUTS:** 10 POT May $26 PUTS @$2.50 per contract = $2,500
- gives you the 'right, but no obligation' to sell 1,000 POT @ $26
- if POT goes to $21, then option will be worth a minimum $5,000 or 100% return

What about the 'Other' side?

There are 2 sides to options:

- The speculator
- the conservative investors

Which are you?

There are buyers (speculators) and sellers (conservative investors)

Sellers of options are called 'writers'

Option Writing requires a Rules Based Investing approach

- Practice a Rules Based analytic approach to determine what is a proper time and price to WRITE a Put option.
- We cover Rules Based Investing in Session 16.

Option Writing – POT example

- Fertilizers prices have come down because of a Recession fear, POT stock plunges and then settles down
- Investors fear China is slowing economically, and Commodity prices are falling as a result
- Food demand, however, has not slowed down
- Fundamental and technical analysis indicate that POT is now a BUY.
- POT trades at a 4 year low, the stock price drop in POT is probably overdone

Option Writing – POT example continued

- Stock is fundamentally cheap
- Fertilizer prices will rebound eventually (worst case scenario in next economic cycle)
- Stock has already fallen from $61 (April 2011)
- Food demand is still high

Option Writing – POT example – 3 very conservative strategies

Strategy #1 – Writing Puts for Income

1. Want to own 1,000 shares of POT

- write (sell) 10 Apr, 2017 $22 Puts for $1.00 or $1,000 in premiums (this income is taxed as a capital gain). Also set aside $22,000 in your account to cover the potential purchase of POT shares

- if investor gets exercised at $22, than the breakeven price is another $1,000 below purchase price from the premium

- $22.95 is the adjusted cost base

- Assume stock goes to $21 by May

- Called a 'cash covered PUT write'

- YOU will not be 'PUT' by April because the stock does not go to $22, therefore, you keep the $1,000. Calculate the profit…NEXT slide

Option Writing – POT example – Profit from Strategy #1

Profits:

- capital gain: $1,000 (from premium)
- $22,000 set aside in case of being PUT
- Total profit return = $1,000 or 4.75% in 4.5 months or 12 % annualized

Option Writing – POT example – 3 very conservative strategies

Strategy #2 – Writing Calls for Income

- Purchase 1,000 shares of POT at $23.95.
- Cost is $23,950.
- Write (sell) 10 POT $25 April 21st Calls for $1.00 and receive $1,000
- Now purchase cost of POT is $22,950
- assume stock goes to $25.50 by April 21. What is the profit?

Option Writing – POT example – Profit from Strategy #2

Profits:

- POT goes above $25 and gets 'Called'
- keep $1,000 in option premium
- total gains = $1,000 + $1,050 gain from stock sale in 4.5 months + $135 CDN in dividends
- Total gain on $23,950 invested = $2,185 or 9.12% in 4.5 months or 24.32% annualized!

This technique limits your upside potential but is very Conservative

Note1: Dividends = 1000 shares * $0.10USD/share *1.35 CDN/USD = $270 CDN

Note2: POT dividends are paid on Feb 2nd and May 2nd 2017 (you only receive the Feb dividend)

Option Writing – POT example – 3 very conservative strategies

Strategy #3 – Ultra Conservative Approach to POT acquisition

Acquire stock through partial acquisition and writing both PUT and CALL options.

Investor wants to own 1,000 shares of POT (current price on Nov.14, 2016 is $23.50)

1. buy 500 shares at $23.95, cost is $11,975
2. write 5 out of the money Apr. 20, 2017 $25 POT Call contracts (covered by stock purchase), receive $500 in premiums
3. write 5 out of the money Apr.30, 2017 $22 POT cash covered Puts (covered by cash), receive $500 in premiums

Option Writing – POT example – Profit from Strategy #3

Profits:
Total Income generated = $1,000 (from option writing) + $135 in dividends from the 500 shares

3 scenarios can unfold:

Scenario 1: POT moves to $25.50 by April and you will be Called to sell the original 500 shares you bought at $25
Profit generated: $525 (stock sale) + $1,135 (premiums + dividends) = $1,660 or 6.93% in 4.5 months

Scenario 2: Pot trades between $22 and $25 and both options expire worthless
Profit generated: $1,000 (premiums) + $135 (dividends) = $1.135 or 4.74% in 4.5 months

Scenario 3: POT Puts get exercised at $22. Average cost of shares are now $11,975 + $11,000 - $1,000 (premiums received) - $135 (dividends) = $21.84

If you liked POT at $23.95 as a great stock investment that qualifies for Rules-Based Investing, then you'll love it at a $21.84 breakeven!

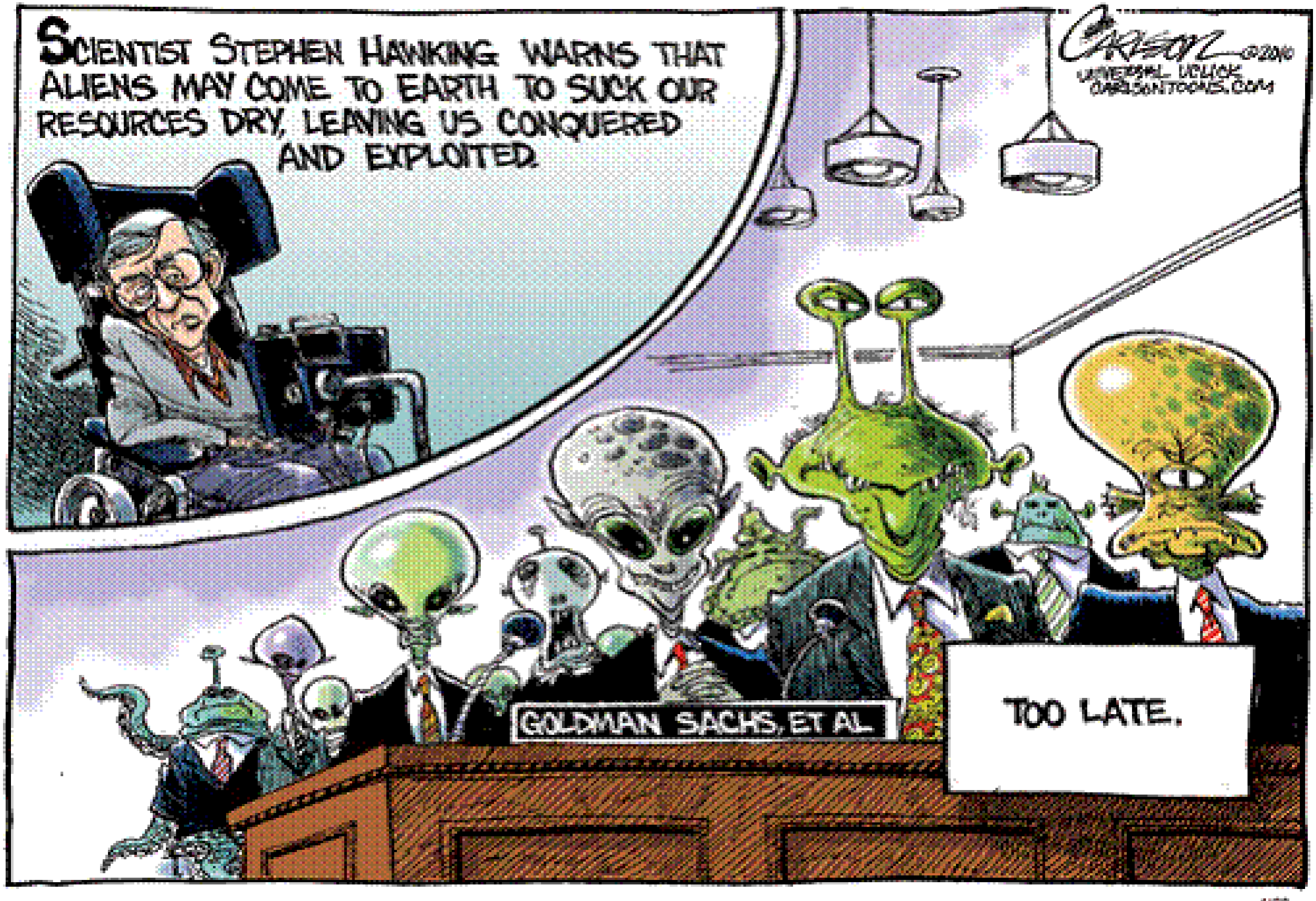
This 'Art' is NOT all lost

Option writing portfolios can provide excellent, low tax, returns over time. The best program, in our opinion is the Cash-covered Put writing portfolio (Strategy #1 from the POT example). It does require an experienced Wealth Professional to perform and requires work, diligence and experience. Unfortunately, most firms don't teach their rookies this technique anymore.

These are the important points for the investor and advisor:

1. Find which stock to buy (Rules Based)
2. Shop on the option exchange for a good premium to receive. (this alone justifies the fee to pay for this service)
3. Stick to large capitalized, liquid, blue chip companies
4. **Should only be performed in a FEE-based investment account where there is one annual percentage fee which covers all transaction and admin costs.** This maximizes your net return and is preferable to the advisor.

Put Writing Portfolios can make for great steady long term returns.


SCIENTIST STEPHEN HAWKING WARNS THAT ALIENS MAY COME TO EARTH TO SUCK OUR RESOURCES DRY, LEAVING US CONQUERED AND EXPLOITED.
GOLDMAN SACHS, ET AL
TOO LATE.
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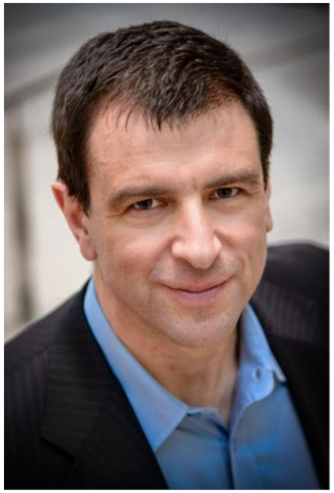

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