

...a note from ral...

Many of you know I have long advocated that every trader—particularly traders new to trading—make use of the **covered call income strategy**. My rationale and details of this method, as well as the accompanying **combo strategy**, are available in several seminars in the archives of UNDERGROUNDTRADER.COM.

The beginning trader should *never* risk more than 50% of available capital in learning to trade. The balance may best be used to initiate and develop *over time* the covered call income strategy. This will generally save the trader and avoid the most common error of losing so much during the steep learning curve that there is no possibility of recovery.

Because of the importance I attach to this, I thought it would be useful for you to hear from one of the members of UNDERGROUNDTRADER.COM who has made use of this strategy and has had real life experience in successfully developing and managing this approach during one of the most difficult times in market history.

Dadcat has made himself available to your inquiries should you have any questions. And, of course, I am available at any time to respond to whatever questions you have as well. I want to thank *Dadcat* for his willingness to prepare this review and to so readily share his experience with other traders.

I trust you will find this useful to you.

Best wishes and good trading,

ral

Dadcat on Covered Calls

Before I describe my strategy for covered call investing, readers should know that I do this primarily in an IRA account. Remember, that IRAs are cash accounts, and options are restricted to covered calls, and long calls and long puts. I am retired, and write calls for monthly income. I also keep a pre-determined level of cash in that account to trade stocks intra-day. I use CyberTrader because I can trade both stocks and options in an IRA with their platform. I also maintain a small margin account with Interactive Brokers.

I started developing my covered call portfolio in July 2000, with an initial investment of 325K. Since then I have received over 128K of premiums, much of which I reinvested in my portfolio. Currently, I hold the following Stocks in 1000 + share lots: ADCT, C, CNXT (3000), GE, INTC, KLAC (1500), NEWP, ORCL, SUNW (2000), VSH, and WCOM.

In this "Bear Market" period my CC premiums have totally compensated for the loss in stock price, allowed me to add to my positions, and provided supplemental income. I can't imagine why any investor would not use this strategy.

Here are the guidelines that I use:

1. I try to select good companies that have real products and services and generate income. I am not tempted by the high premiums that many stocks seem to offer. There are plenty of good stocks that have sufficient volatility to pay you a nice premium, (AMAT, CHKP, KLAC, NEWP, CIEN, HGSI, for example). I am generally looking to write a position that will pay 4% - 7% return if called out. If the first strike considered pays a larger return, I may lower the strike price to gain more downside protection. I pay attention to the "daily charts" in order to decide on my acquisition strategy and strike price, especially those studies that would indicate an overbought or oversold condition. Also look at the general market trend.
2. For overbought conditions and down-trending markets I sell calls either "at the money" or "in the money". In these situations, I want downside protection. Just because a stock may decrease in price doesn't necessarily mean it is a poor choice for a covered call.

3. For oversold conditions and up-trending markets, I sell calls "at the money" or "out of the money" one strike up. In these conditions I can take a little more risk and maybe benefit from the increase in stock price.
4. I don't worry about getting "called-out". This provides an opportunity to re-balance my portfolio, or to select a stock with a better premium. Sometimes I just buy the same stock back on the following Monday. I don't worry about missing a "potential" profit; there is always another stock. I do, however, take a second look at my positions on the last hour of each expiration date. Sometimes, because of the lapse of time value in the option, and my assessment on the market trend, I will buy the call back.
5. After I have selected the stock, and decided on a strike price strategy, I begin to look at the intra-day charts to see if I can determine a daily price pattern. Ideally, I want to buy the stock near the daily low and sell the call when the stock is higher. This is easier said than done. In all cases, when entering a new position, I will buy the stock and sell the call the same day. For existing positions, where I have not been called out, I may wait a few days to sell the next call only if the market and stock is in an up-trend.
6. I usually enter a new position with 300 - 500 shares, depending on the stock price. Over time I will try to accumulate 1000+ shares.
7. In most cases, I do not "stop-out" if a stock falls below my net cost. I use the lower price to add to my position. Although I have stopped out of a few "bad choices" in the past (CMGI, HSAC, WSTL).
8. When a stock price has deteriorated so far that the premium, at the purchase strike price, is not worthwhile, I calculate the "net cost" (original cost (-) the premiums received, and consider a strike price "one strike up" from the net cost. I also study the largest historic % of gains that the stock has advanced in the past year, and consider a strike price that would be one above that price if the stock were to equal this % of gain. Finally, I may go out two months. These strategies have allowed me to continually receive cash income with minimal risk of being called out at a loss.

What to do in a bear market? The first thing that comes to mind is that a disciplined covered call strategy can make a bear market much more "bearable" (no pun intended). But even for me, this has been an anxious time. There are three simple things you can do to get downside protection: sell primarily in "the

money calls"; buy a "put" to protect your downside; close out your position and get back to cash.

I primarily write "at the money" or "in the money" calls, I am conservative about my CC positions. This has given me more downside protection in this recent market downturn. But I didn't do this because I forecasted the market, I did it because it is my investment and trading style, conservative. I am quite pleased with a monthly 5% return on my money. This type of consistent return (60% / Year) puts most mutual funds to shame.

For research I use three web sites: www.coveredcalls.com, www.winninginvestments.com (\$30.00/month), and www.askresearch.com. I particularly like Ask Research's site for a quick screen of several stocks, they have a setup where you can view daily charts with studies. You can fix the display with a "cookie" so that your chart settings are saved. They also show option chains.

I hope this short article is helpful. This is a simple, straightforward strategy that any investor can replicate. If you have an investment portfolio and do not use covered calls, just think what your portfolio would look like now if you had been able to add 4% - 7% monthly since July 2000.

For members who have questions, I can be reached at jhmoore@bluetruck.net or just open a "private window" at the Pit. I will be vacation April 22-27.

Dadcat

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