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Smart, balanced stock ideas.

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***The Complete Growth Investor Team***

Smart, balanced investment ideas.

<http://www.completegrowth.com>

## Stock Options For Smart Investment and Income



Dear Investing Enthusiast,

Like many stock investors, I believed for a long time that stock options were not a form of investment, but of gambling, and that the most they could offer me were quick losses. As I began to learn about stock options, however, I saw how they could be excellent tools for generating steady income, for protecting profits, and for potentially outsized gains. So, I started using options along with my stock portfolio to enhance returns.

Since the turn of the millennium, I've made considerably more profit on options strategies than I have on stocks alone, and I believe that this could be the case for years to come. Options, used in conjunction with knowledge about the underlying stock, are a wealth-generating tool certainly worth knowing about. Therefore, we've officially made option selections a part of our [Complete Growth Investor \(CGI\)](#) subscription service. Our aim at CGI is to uncover stocks capable of at least doubling in three to five years, thereby doubling our portfolio that frequently. Using options as tools alongside our stocks, we have a better chance of exceeding this goal on a total portfolio basis – a goal that's in-line with the very best money managers we know.

The following report is our introduction and reference guide to stock options and the strategies we use as part of the CGI service; usually, our options strategies work in tandem with the CGI stocks we select. Frequently, our strategy is to earn income on options, but we also use options to leverage potential returns. Options are not for everyone. They're risky and an investor must have an ample portfolio to consider them. We do not suggest you use them (or any other investment), because only you know your situation well enough to make that decision. But Tom Jacobs and I are using options ourselves, and our pledge to readers from the start has been that CGI is *how we invest*. Here's how we do it. Enjoy!

*Jeff Fischer*

**Jeff Fischer**

Co-Founder & Analyst

Complete Growth Investor LLC

Smart, balanced investment ideas.

<http://www.completegrowth.com>

## Introduction to Options

Stock options are a relatively new investment tool launched in 1973. A stock option is simply this: it gives the option owner the right (but not the obligation) to buy or sell the underlying stock at a set price (the “strike price”) by a set date (the option’s expiration date). The price paid for the option is called the premium.

There are only two types of options: calls and puts. A call appreciates when the underlying stock rises, so you buy a call if you believe a stock is going to rise. A put appreciates when a stock falls. You buy a put if you believe a stock will decline, *or* to insure a stock you own against decline. One way to remember this is: “call up; put down” (as in, call something up, or put something down). If that doesn’t work, simply print our following option glossary.

Because all options expire by a set date (as far as thirty months out), and require that a stock be above the strike price (with a call) or below the strike price (with a put) to be profitable to the buyer at expiration, an option holder is often at a disadvantage.

Theoretically, the option buyer must be correct on the price of the stock by a set time, and by a large enough degree to cover the premium paid for the option. We say “theoretically” because, in the time between an option purchase and expiration, a volatile stock will often place its option holder in a profitable position long before expiration.

Even so, it is estimated that 75% of option purchases reach expiration with less value to the buyer than they paid, and often with no value remaining at all to the buyer. If this is true, however, then what about the option *seller* (the “option writer”)? Aren’t they ending with profits 75% of the time?

*A seller rather than a buyer be*

In my experience, this has proven true. *In the last five years, I’ve made money on 82% of the options that I’ve written (sold)*, and this is why I am, a vast majority of the time, an *option seller* rather than buyer. Many investors don’t even realize that they can sell – called “writing a contract” – an option anytime, and be paid the going premium (the bid) in cash to their account immediately.

No gain comes without risk, of course. As the option writer, you are in effect selling insurance to another investor. If the option plays out to the option buyer’s favor, you are obligated to sell or buy the underlying stock at the strike price you choose (unless you close out the option position before then).

Is your head spinning yet? Don’t worry if it is. Please read our glossary of terms on page 3 (study it, if need be) and then we’ll move to specifics of buying calls and puts, with examples. After that – saving my favorite for last – we’ll discuss

writing (meaning, selling) calls and puts for income while waiting for better share prices on stocks you know well. We'll then briefly go over brokerage account needs. Finally, for CGI Members, never fear: in the weeks and months to follow, each option selection that we share as part of the CGI service will be clearly explained.

*Table 1. Options Terms Glossary*

| <b>CGI Options Glossary</b>   |
|---|
| <b>Options Contract:</b> Each options contract represents 100 shares of the underlying stock, and each contract is listed at 1/100 <sup>th</sup> of its true cost. So, if you buy 1 option contract for \$1.50, it represents 100 (1 x 100) shares of stock, and would cost you \$150 (\$1.50 x 100).   |
| <b>Call option (call):</b> A call option gives the owner the right to <i>buy</i> the underlying stock at a set price (the "strike price") anytime up to the option's expiration date. A call rises in value as a stock rises.   |
| <b>Put option (put):</b> A put option gives the owner the right to <i>sell</i> a stock at a set price (the "strike price") anytime up to its expiration date. A put rises in price as a stock falls.  |
| <b>Strike price, expiration, and exercise:</b> Every option has a strike price and expiration date (which is always the third Friday of the month of expiration, after the market closes). The strike price is the price at which the underlying stock can be bought or sold. When this happens, the option is "exercised" (if this happens, it happens upon expiration most the time – 90% plus – and rarely before expiration). |
| <b>Premium:</b> Because an option is essentially an insurance policy, each option contract is sold for what's called a "premium." The more volatile a stock is, the higher the premium on its options. Also, all else equal, the longer until an option contract expires, the higher the premium paid for it, accounting for more unknowns. This is called "time value."  |
| <b>Time value:</b> The price of an option above its intrinsic value.  |
| <b>Intrinsic value:</b> An option's value in direct comparison to the underlying stock. If a call option gives the owner the right to buy a stock at \$10, and the stock is trading at \$12, the option's intrinsic value is the difference, or \$2. The option may actually be priced at \$3, with \$1 of time value because the option doesn't expire for months, and much could change by then.                                |
| <b>In-the-money:</b> This term is used when an option is in a profitable position for the owner, meaning its strike price is more advantageous than the stock's current price. (On a call option, a strike price of \$10 when the stock is \$12 is in-the-money, because it gives the owner the right to buy the stock at \$10. They could then immediately sell the stock at \$12, if they wished.)                              |
| <b>Out-of-the-money:</b> The opposite condition, where an option's strike price is unprofitable for the owner when compared to the stock's current price.   |
| <b>LEAPs (long-term equity appreciation securities):</b> These are simply stock options that, when first offered, expire at least two years in the future. Most new LEAPs become available every July.  |
| <b>Writing an option contract:</b> Selling a new option (opening a position), which any qualified investor can do, thus pocketing the premium received in cash. The new option seller is called the "option writer;" the process is called "sell to open." To close the position, the trade process is called "buy to close."   |

## Buying Calls

An investor buys call options when they believe the underlying stock will appreciate in coming months or years. Investors use call options, rather than buying a stock outright (or in addition to the stock), to obtain leverage and potentially increase returns several-fold. Because each option contract represents 100 shares of stock, an investor can control – and benefit from – many shares of stock while using very little capital.

For a real-life example, let's look at **Pfizer** (NYSE: PFE). A call option buyer – call him Clifford – believes that Pfizer's stock is beaten down too much, and will rebound in coming months. As of this initial writing, the stock was \$24.40. Pfizer's call option with a \$25 strike price, expiring mid-2005, was asking \$1.35. Therefore, one contract, representing 100 shares of Pfizer, cost Clifford \$135 plus commissions (about \$15). This contract gives the owner the right to buy 100 shares of Pfizer at \$25 between now and expiration the third Friday of June, June 19.

If Pfizer shares rise to \$26 anytime soon (6.3%), the option value would likely rise 50% or more, to \$2.20 or greater, and Clifford would be making good money. Should Pfizer hit \$29 by June, Clifford's options contract would be worth \$4 (times 100), or \$400. He'll have made 196% on his \$135 investment. If Clifford had bought 100 shares of the stock instead, it would have cost him \$2,435 (not just \$135) and he would have made only 19%. (Update: Now, in June 05, Pfizer is at \$28 and this call option is up 112%, while the stock is barely up 15%.)

But then there is the flipside. Pfizer might only be at \$25.05 by expiration. Having paid \$135 (\$1.35 per share) for \$25 strike call options, this means Clifford's break-even point at expiration is \$26.35 per Pfizer share. Given what he paid for the option, with Pfizer at \$25.05 he would still be losing money. With Pfizer above \$25, he could exercise his option, buy the stock at \$25, and hope it rises from there, using his adjusted cost basis of \$26.35. But so far, he would have made more money by just buying the stock.

Or, in the worst-case scenario, the stock is below \$25 come June (say it's \$22), so Clifford's options expire worthless. Nobody would want to exercise the option to buy Pfizer at \$25 when the stock is trading at \$22, so the options have no bidders. Clifford loses his entire \$135. However, had he bought the stock outright instead, he would have lost more (\$240 so far), though he could have hoped for a rebound.

At CGI, we typically buy (and recommend to subscribers) longer-term call options on businesses that we believe could rebound handsomely over coming months or years, in which case the options should appreciate greatly. Let's say you believe **Sun Microsystems** (Nasdaq: SUNW) will rebound the next two years. The stock is currently (in June 05) \$3.60.

Sun's January 2008 call options with a strike price of \$2.50 (so the options are already "in-the-money" – already at a favorable price compared to the stock) are asking \$1.70. The options aren't charging much "time value," given that \$1.70 plus the \$2.50 strike price is only \$4.20, or only \$0.60 (the "time value") above the current stock price of \$3.60. If Sun rebounds before expiration, the \$2.50 call holder will see gains much stronger than the stock holder, and with much less capital invested.

So, an investor buys call options when believing:

- The underlying stock will appreciate nicely before expiration date, and the options will then provide outsized gains.
- A stock will rise, but the investor would rather not buy the stock outright for some reason (whether they're seeking higher returns with options leverage, are facing capital limits, don't want to risk much capital in a stock, etc.).
- As we will do at CGI, investors sometimes buy call options – especially at opportune times -- on stocks already owned and known extremely well; this can provide an additional boost (perhaps large) to returns when right.

The most you can lose buying call options is the amount of capital invested. Where real opportunity is lost is when your timing is wrong, and the options expire before the stock rebounds, making you lose your option money and miss the stock's eventual rebound. Thus, we aim to buy longer-term calls when we buy them.

## **Buying Puts**

An investor buys put options when believing that the underlying stock will decline in value. As a stock declines, its put options – giving the option owner the right to sell the stock at a set price – increase in value. This makes put buying an excellent tool for betting against highly-priced stocks, especially when compared with the other method, "selling the stock short." When you "sell short" a stock in the traditional sense (borrowing shares from a broker, selling them, and buying them back later), your potential loss is unlimited, as the stock could rise against you endlessly; but when buying put options, as with buying calls, your loss is limited to only the capital invested.

You may also buy puts to protect an important stock position in your portfolio, one that you don't want to sell for various reasons (perhaps taxes), or because you see more upside in years ahead. If the stock declines temporarily, the puts that you purchased on it will increase in value, acting as a hedge, smoothing out and improving your returns while at the same time protecting your capital.

At CGI, we are likely to buy puts to protect existing CGI Portfolio positions at times, and we'll buy puts on stocks that we believe are due to decline over coming

months or years, thereby making our puts profitable. When we can, and when premiums aren't too high, we'll typically buy puts rather than short a stock, because there is less risk involved, and even more upside potential (an option can appreciate several times in value, while a straight short position can only earn you 100% maximum).

*Buying puts when you believe a stock will decline*

Let's use an example. Say you believe that **Starbucks** (Nasdaq: SBUX), with its 58 P/E and 20% growth rate, has too high of a valuation and is finally ready to fall to lower prices. The stock is currently (June 05) \$55. You believe that it's more fairly valued around \$40. You could short the stock outright and hope it declines, or you could buy puts. The January 2007 \$50 strike price puts on Starbucks ask a reasonable \$4.10. You buy 1 contract (representing 100 shares) for \$410.

One outcome: Starbucks declines to \$40 between now and option expiration; your put options rise from \$4 to \$14 (\$10 intrinsic value and \$4 remaining time value). You've more than tripled your money on the puts while the stock fell 25%. Starbucks is more fairly priced, so you sell the options for \$1,400 and move on happily. (And maybe buy some shares of Starbucks?!)

Another outcome: Starbucks proves mere mortals wrong, and your options approach expiration with Starbucks at \$66 per share. Your options are nearly worthless. You sell to get a few coins back. You've lost nearly \$400. But had you shorted the stock outright, you would have lost \$1,100 so far. And consider if Starbucks had risen to \$76. Your options are worthless; you've lost \$410. But had you shorted the stock, you'd be down \$2,000 and counting. At least with the puts the most you can lose is the starting investment.

Third outcome: Starbucks stays in a range between \$50 and \$60. Your options fluctuate, but as time wears on, their time value deteriorates. Eventually you sell the options at a slight profit, break-even or a slight loss. Perhaps you buy a new options contract for the future.

*Buying puts to protect an existing position*

The second reason to buy puts is to protect a position you own. Say you own shares of **eBay** (Nasdaq: EBAY) and either want to protect against a decline, or know you might like to sell the shares in 2007, and would like to guarantee a minimum price at that time. With eBay's recent decline, investors are edgy, so put prices are higher. It may not be the best moment (premium-wise) to buy the puts. But with the stock recently at \$37, the January 2007 puts with a \$40 strike price are \$7 (times 100). You buy 1 contract (protecting 100 shares) for \$700.

If eBay ends late-January 2007 at any price below \$40, you can exercise your options and still sell your shares at \$40. You protected yourself. If eBay is higher than \$40, your options expire without value, but at least your eBay shares are

fetching a higher price and you were always protected. If eBay gets clobbered long before your options expire, your put options will soar in value. You might sell the options, which have mitigated your loss in eBay, pocket the cash from the options, and keep your eBay shares, waiting for a rebound. Or, you might just exercise the options and sell the eBay shares in your account at your strike price of \$40, even with the stock at \$25, say. Your \$700 “insurance” policy paid you back handsomely.

So, one buys puts:

- To in effect “sell short” a stock, expecting the stock to decline enough for worthwhile profits before the options expire. At the same time, the bear’s potential loss is limited to the premium paid.
- To protect an existing stock position for eventual sale at a minimum price, or to mitigate a decline in that stock.

## **Writing Covered Calls**

Now we move from the act of buying options to selling them to others for immediate payment. From now on, when we’re referring to selling a new options contract, we will use the proper term, “writing.” Yes, you are “writing an options contract” – bringing it into the world yourself. Congratulations!

Once you write an options contract (called “sell to open”), you can close it (assuming it hasn’t been exercised, which it usually won’t be until expiration) by buying it back on the open market (called “buy to close”), either at a profit or loss. But you always keep the premium you received in cash for writing the contract.

The only calls we’ll ever write are called covered calls. “Covered” means you own the underlying stock. Writing covered calls is one of the most conservative options strategies available. In fact, most retirement accounts allow you to write covered calls, and many investors use the practice to generate steady (and reliable) income on a portfolio. Covered calls are used to generate income on stock positions while waiting, typically, for a higher share price at which to sell the stock.

The scenarios where writing covered calls makes sense include:

- When you estimate a fair value at which you’d be happy to sell a stock you own, and you’re waiting for that higher price, you can write covered calls and be paid while you wait for your sell price.
- Likewise, when you own a stock that is not volatile, and you don’t believe it will go far in coming months, so you’d like to make income on it while you wait for an investment thesis to unfold: you can write covered calls on it.
- In retirement accounts or elsewhere, some investors buy “strong” but stable stocks with the sole purpose of writing covered calls on them, again

and again, to make income; if the stocks rise, they may have their stocks sold, but then they take new positions, write new covered calls, and so on. If the stock holds steady, the options just do their job, providing income, and more can be written after expiration.

Here's an example of a covered call. Suppose you own 1,000 shares of **Morgan Stanley** (NYSE: MWD). You believe the \$50 stock is fairly valued around \$60. You would be happy to sell it at that price. So, you write January 2007 covered call options and are paid nearly \$2.40 (times 100, of course). If you wished to sell your full Morgan Stanley position, you would write 10 contracts (representing 1,000 shares), and you'd pocket \$2,400 in premiums before a modest commission. That money is yours to keep.

If the stock does not reach \$60, you keep your shares, and still made \$2,400. If the stock is above \$60 by the third Friday of January 2007, and you haven't closed out your options contract, you'd sell your stock at \$60 when the option holder exercises the option you wrote. Your actual proceeds on the sale, including the options premium, would equal \$62.40 per share -- or a few bucks above the fair value where you would have sold anyway.

*Not a perfect science, room for wiggle*

Since you are writing an out-of-the-money covered call (meaning the share price is lower than the option's strike price), the premium you receive is all "time value." The options you write have no intrinsic value. This is good for the options writer. This is what we aim to do with both covered calls and writing puts: sell out-of-the-money options and be paid for time value, which erodes steadily (unless volatility increases), especially starting at six months and shorter to expiration.

Selling such covered calls on Morgan Stanley means even it rises to \$60 over 8 months, for example, and for some reason you decide you don't want to sell the stock as expiration draws near, you could usually still close out your options at a profit (since the time value has eroded and the option's only priced at, say, \$1.00) and keep your shares of stock.

*Must be prepared to deliver the stock*

*But when you do write covered calls, you **must** be prepared to give up your shares at the strike price.* You must be happy to do so, because it can happen at anytime. At least 90% of options are not exercised until expiration, but at times they are exercised early, so the call option writer *must* be ready to deliver the shares at any moment. If Morgan Stanley is bought out at \$70, the covered call writer's shares could be called away from him at \$60 right away.

*Regular income writing covered calls*

Some investors write covered calls on more volatile stocks (because the premiums are larger) in order to make monthly income. Suppose you own

**Amazon.com** (Nasdaq: AMZN) and want to make steady income on it. Each month, you could write covered calls for the month or so ahead at a strike price above the current share price, thereby earning regular income on the shares via options. If the stock is called away from you at your strike price, you can buy it back and then keep writing covered calls on it again. As long as you let the covered calls go to expiration, this is a sure way to generate option income, whatever the stock does.

*Downsides to writing covered calls*

One downside with covered calls is if the stock begins to tank and you want out. You should not sell your shares of stock until you close out your covered call position. Luckily, the calls will decline in value as the stock falls, so you'll make money on the covered calls you wrote (so covered calls in effect act as a hedge against a falling stock, too: a bonus!), but you still should close the options out before you sell your shares.

It's certainly worth repeating: you never want to have call options open when you don't own the underlying stock (called "writing naked calls"). The reason: a writer of calls has an obligation to deliver the shares of stock at the strike price. If you write calls at \$35 and Amazon.com rises to \$40, \$50, or higher, and you don't own the shares to deliver, you would then be forced to buy the shares on the open market and then deliver them for \$35, a huge loss. Or, you'll have to close out your option sale at a giant loss. So, at CGI we only write calls on stocks we own. We only write covered calls.

The other downside of covered calls is if the stock soars, you can miss the greater gains. Your covered call options would soar in price, too, making them expensive to buy back and close, and your stock would be called away from you at the lower strike price. You'd still make a profit, but perhaps much less than if you had only held the stock and not written calls on it. Finally, a stock could rise above your strike price temporarily, but fall back down before the options expire or are exercised, preventing you from getting to sell your stock at your desired price. You'd miss your price. At least you were paid the option premium and can write another covered call, but this can be frustrating. If you really want to sell a stock at a set price, you should just do so, and not write covered calls on it.

At CGI, we will mostly write covered calls:

- Having determined the fair value of a CGI stock (which we do for all of our selections whenever possible), we might write covered calls with a strike price near that fair value (where we'd be happy to sell at) to earn income while waiting for the stock to rise to our desired sell price.
- When we have an investment based on a thesis that will not likely start to unfold for a year or longer, we may write covered calls in the meantime to earn income while we wait for catalysts to occur.

- A note: when we write covered calls on a position, we want to receive enough premium payment to make the option writing worthwhile (at least 3% to 5% of your total sell price). Also, it's not necessary, but it's nice to have cash on the sidelines to buy more shares of the stock if good news makes it more attractive over the life of the option. Since your existing shares could be called away, it's nice to be able to buy more shares should the situation call for it.

## Writing Puts

Finally, a fourth way to profit on options, and by far my favorite way (with an 82% success rate the past several years), is to write puts. Let's say there's a stock you wanted to buy at \$15, but it ran to \$20. You know the company well, and believe the stock is a good deal around \$15. You are waiting, hoping for that price again. This happens to all of us – we miss a stock's jump and sit waiting for a lower price again.

By writing put options on that stock, you will be *paid* while you wait for your lower price. Put options are an excellent way to buy stock at your desired share price and get paid a premium while waiting for that price, whether the price arrives or not. (Note: to write puts, you must have a margin account. You needn't use margin – which entails high risk – but must be margin-approved. This said, many option writers use reasonable levels of margin when writing puts.)

Here's a real-life example. Imagine you're watching **OmniVision Technologies** (Nasdaq: OVTI) with us at CGI. The stock is \$16 as of this writing, but you would like to buy it closer to \$12.50. To be paid while you wait, you'll write put options. You write the December 2005 OmniVision puts with a \$12.50 strike price, and you're currently paid \$0.85 (times 100) per contract. If you sell ten contracts, representing 1,000 shares, you'll be paid \$850 before commissions.

You receive the money, and now if OmniVision falls to or below your desired buy price of \$12.50 by late December, you have an obligation (assuming you don't "buy to close" your put contract) to buy 1,000 shares of the stock.

A few things might happen. OmniVision will stay above the strike price, and the options you wrote expire worthless to the buyer. You didn't get to buy the stock where you wanted, but at least you made \$850. Or, OmniVision could fall to \$12 by expiration, and you could be "put" (the same as "sold") the shares at \$12.50. Your account would automatically buy them. Subtracting your premium for writing the options, you really paid \$11.65 per share of OmniVision, even lower than your desired price, and now you can wait for it to appreciate.

In another scenario, OmniVision may tank to \$10 by December 1, but end the option expiration day above \$13.00. In this case, you would *not* have likely gotten shares put to you during this brief decline (because about 90% of options are

exercised only at expiration, not before), and so you won't own shares. You'll have missed your buy price and the stock's rebound, sadly -- but you did get paid the premium, of course.

Finally, in one of the worst-case scenarios, say OmniVision blows up and the stock is \$5.50 by your option expiration. You didn't have time or the heart to close your losing options contract, so you're put the shares at \$12.50, or \$11.65 after your premium. You're down a big 50%. You own the stock now and can hope it rebounds, or take your loss. Of course, assuming you would have bought the stock outright when it hit \$12.50, as you had wanted, you would have lost even more money doing that than you did with options strategy.

At CGI, we most often write puts when:

- A stock we follow closely (or already own a partial position in) is above our desired buy price. We'll write puts on it at lower strike prices and get paid while waiting for our desired purchase price. (We also obtain a better final share price if we get to buy it, given the premium we're paid.)
- We believe the market as a whole is overpriced, with few good opportunities, so rather than buying more stocks, we write puts and get paid while we wait for better share prices.
- We choose some stocks to write puts on again and again, to earn regular income. You can choose a very attractive purchase price (strike price) and you won't likely get the shares, but you'll continue to make the income from the options.

*Put writers must be ready to buy the stock*

*Writing puts on stocks you know well and want to own can be an excellent tool for income, but you **must** be prepared to buy the stock should it fall to your strike price. At all times, you must maintain the cash or margin buying power (obviously, we prefer cash) to buy the shares if they are put to you. Writing puts is statistically the best return-generating strategy with options, but it also entails more risk than covered calls because a stock can go to zero. If you write puts with a \$20 strike price and the stock gets unlisted before you close your option, you still must pay \$20 per share on it and you're out all that money.*

Therefore, it's important that you only write puts on companies and at valuations that you understand well, and on stocks that you will be *happy* and *ready* to buy at the prices you're targeting. Then, it's very important that you always maintain enough buying power in your account to fulfill your possible purchase obligation. Your broker will let you know immediately if you're not, and you'll face a margin call.

Writing "out-of-the-money" puts, with strike prices well below current share prices yet paying strong premiums, is how I've made most of my option income the past several years. So this is something that CGI subscribers will see fairly

frequently – and explained with each new report – as CGI selections. We'll write puts on stocks we wish to own at lower prices, and on stocks we already own and would buy more of at lower prices. We'll write puts when the strike price and premium paid to us make the position worthwhile and attractive.

#### *The four CGI options horsemen*

In summary, those are the four most basic options strategies we use at CGI: 1) buying calls when we believe a stock will appreciate; 2) buying puts when we believe a stock will fall, or to protect a stock we own; 3) writing covered calls to earn income while waiting for a higher sell price on a stock we own; and 4) writing puts to earn income while waiting for lower buy prices on stocks.

#### **Broker Requirements, Taxes, and More**

To qualify for options trading in a brokerage account, you typically need a minimum balance (which varies by broker) and should have years of experience as an investor. Applying for options permission involves filling out forms with your broker. CGI Members use brokers across the gamut, from Ameritrade, to Brown & Co., to the newer optionsXpress.com. Commissions should be a flat rate plus a few dollars per contract, or about \$15 to \$30 per typical trade. The bid and ask on options is always a minimum five cent spread, and option prices always go by five cent intervals. The bid and ask spread means you usually start at a small loss when you buy or write an option. Finally, not all stocks have options: a stock must have enough trading volume and interest.

When *writing* any options, the brokerage terminology used to start the position is “sell to open.” To later close the position, you would use “buy to close.” Writing options – put writing specifically -- requires a margin account and ample buying power for any trade. Be sure to review your margin buying power before writing a put option to see how it is affected by the new position. Writing puts, the broker will typically require 20%-30% of the potential stock purchase value (should the option be exercised) in buying power in your account upon opening the put position, and then the margin requirement will move as the underlying stock moves, up or down. So, you should always make sure you have the resources available to make the stock purchase.

#### *Taxes*

Brokers are not required to report options trades to the IRS, so you must keep good records and report them yourself. Any buys and sells are reported similar to the way stocks are reported, except that options are always considered short-term investments for tax purposes. When you write covered calls or puts, the income you receive is recorded upon *expiration date* (so, it could be next year or even two years after). If you close out a contract earlier, the income (or loss) is recorded at that moment.

When the underlying stock is sold or bought by you (ending the option contract), the premium for the option is used to simply adjust your cost basis in the shares

of stock, and you needn't worry about that option transaction for taxes any longer. The adjusted stock price becomes your transaction. Taxes are not simple with options, though – and many nuances are involved -- so it is strongly suggested that you use an accountant. They're affordable these days!

*Return calculations*

When buying calls or puts, return calculations are the same as stocks: current price versus purchase price. But when writing puts or covered calls, returns can be calculated by different, various means.

Typically, when writing puts, the return is based on the buying power (the amount of leverage reserved in a margin account) needed to write the put. So, when a put expires perfectly for the put writer, rather than a 100% cash gain – which it is -- it's typically recorded as a 25% to 33% gain on the buying power used to open the trade (at CGI, this is the calculation we use, as it is the more conservative calculation). With covered calls, the calculations can vary as well. We have more on returns in our official CGI Options Selections for Members.

Table 2. *Options summary table*

|                           | <b>Call Option</b>  | <b>Put Option</b>  |
|---------------------------|---|--|
| <b>Option buyer</b>       | The right, but not obligation, to <b>buy</b> a stock at a set price (the strike price); calls appreciate as the stock rises ("call up") | The right, but not obligation, to <b>sell</b> a stock at a set price (the strike price); puts appreciate as the stock falls ("put down") |
| Option writer (or seller) | The obligation to sell a stock at the strike price; must hold the stock in the account in case (called covered call position)           | The obligation to buy a stock at the strike price; must have the buying power at the ready in case (called writing a naked put)          |
| <b>Option buyer</b>       | Believes the underlying stock will rise   | Believes the underlying stock will fall  |
| Option writer (or seller) | If the stock rises, is ready to deliver (sell) the shares at the strike price (always keeps the premium paid for writing the option)    | If the stock falls, is ready to buy it at the strike price (always keeps the premium received for writing the option)                    |

**Summary**

This overview is just that: an overview, meant to be an introduction to options and basic options strategies. Options are volatile, often moving with much more severity than the underlying stock, and they present risks as well as potential reward. At *Complete Growth Investor*, we use options as part of our business-based, valuation-centric investment approach. Combining options with our CGI stock selections, you'll see how we use options as a tool to complement our value-based investing by adding leverage, protection, or by adding income as we wait for desired buy and sell prices on stocks. Though you don't hear that much about options elsewhere yet, we believe they'll become much more mainstream in years ahead, as investors learn more about them.

If you have any questions, the CGI Member Forum, for subscribers, has new stock options boards open and ready for discussion. The discussion so far has been tremendous.

| Strategy                                  | When...  |
|---|--|
| Buy Calls                                 | Believing a stock will rise in due time before option expiration, and wanting to leverage returns                        |
| Buy Puts                                  | To “short” a stock, or to protect a current stock holding  |
| <b>Write Covered Calls (sell to open)</b> | To earn income while waiting for a higher share price (your desired sell price) on shares you already own and would sell |
| Write Puts (sell to open)                 | To get paid while waiting for a lower share price (your desired buy price) on a stock you would buy                      |

Best wishes,

*Jeff Fischer*

**Jeff Fischer**

Co-Founder & Analyst

**Complete Growth Investor LLC**

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[Complete Growth Investor](http://www.completegrowth.com) works to deliver market-beating, profitable stock and option investments to its subscribers year-round, averaging two new ideas per month (about 24 to choose from every year), but only issuing new ideas when we truly have strong ones. On top of, and in conjunction with, our in-depth stock selections, we use option strategies to smartly increase returns and generate extra income. To date, our options have a 90% success rate. Members are very happy.

Today, investors should not rely on stock appreciation alone for steady gains. Even Warren Buffett expects a sideways stock market for years to come, with values hard to find. So, as he does, progressive investors are using other instruments to generate additional income and better returns. We use options alongside our carefully selected stocks -- stocks that we believe will appreciate whatever the market does. With stocks and options, we're building a portfolio

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Thank you, share this report if you wish, and invest well!

***Jeff, Tom & the Complete Growth Investor Team***

Options are risky instruments that should not be invested in by inexperienced investors or investors who cannot accept large, sometimes sudden losses. Options are not for all investors. This report is not a recommendation to use options now or in the future.

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