

# **Buy Now, Paid Later**

**Learning LEAP Leverage Strategies**

**By Markay Latimer**

**Neither Better Trades or any of its personnel are registered broker-dealers or investment advisers. I will mention that I consider certain securities or positions to be good candidates for the types of strategies we are discussing or illustrating. Because I consider the securities or positions appropriate to the discussion or for illustration purposes does not mean that I am telling you to trade the strategies or securities. Keep in mind that we are not providing you with recommendations or personalized advice about your trading activities. The information we are providing is not tailored to any particular individual. Any mention of a particular security is not a recommendation to buy, sell, or hold that or any other security or a suggestion that it is suitable for any specific person. Keep in mind that all trading involves a risk of loss, and this will always be the situation, regardless of whether we are discussing strategies that are intended to limit risk.**

**Also Better Trades' personnel are not subject to trading restrictions. I and others at Better Trades could have a position in a security or initiate a position in a security at any time.**

# I AM ABOUT TO SHARE AN AMAZING INVESTMENT STRATEGY THAT:

- You may use to make longer term investments in quality companies.
- May reduce investing costs while potentially improving leverage!
- Offers the potential to generate cash flow income while you hold the investment!
- Can offer a hands-off approach to investing!

# LEAPS

Long-term Equity  
Anticipation Securities  
(or longer-dated options)

LEAPS offer the ability to  
invest in quality stocks with  
less capital at risk

# LEAPS BASICS

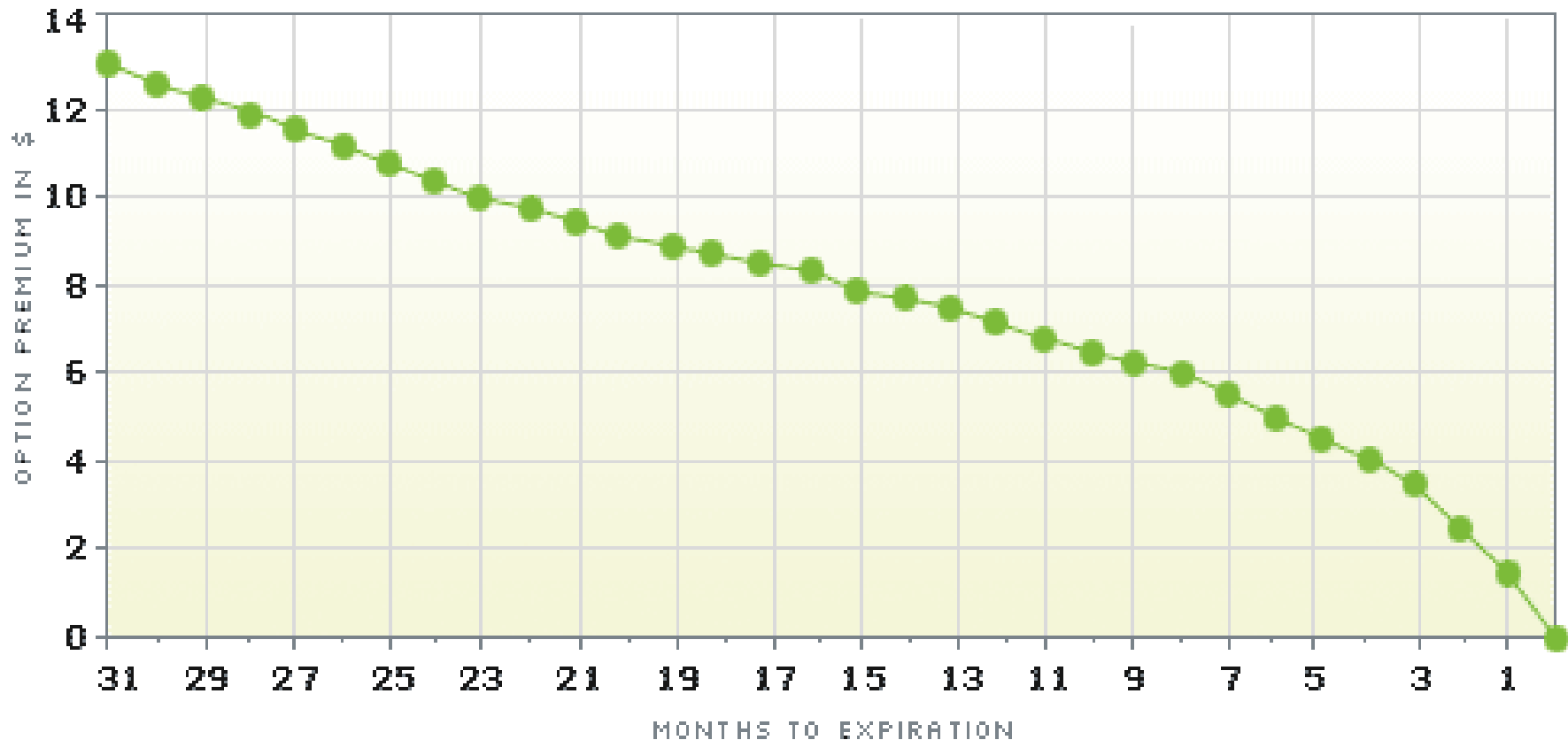
- LEAPS differ from regular options because of the amount of time they hold
- Available LEAPS:
  - 2013
  - 2014
- Because of the extended time, time decay varies from regular options

# TIME DECAY OF LEAPS

## Theoretical Call Option Time Premium Decay

STOCK=\$50 STRIKE=\$50 VOLATILITY=30% INT. RATE=6% NO DIVIDENDS

OPTION PRICE



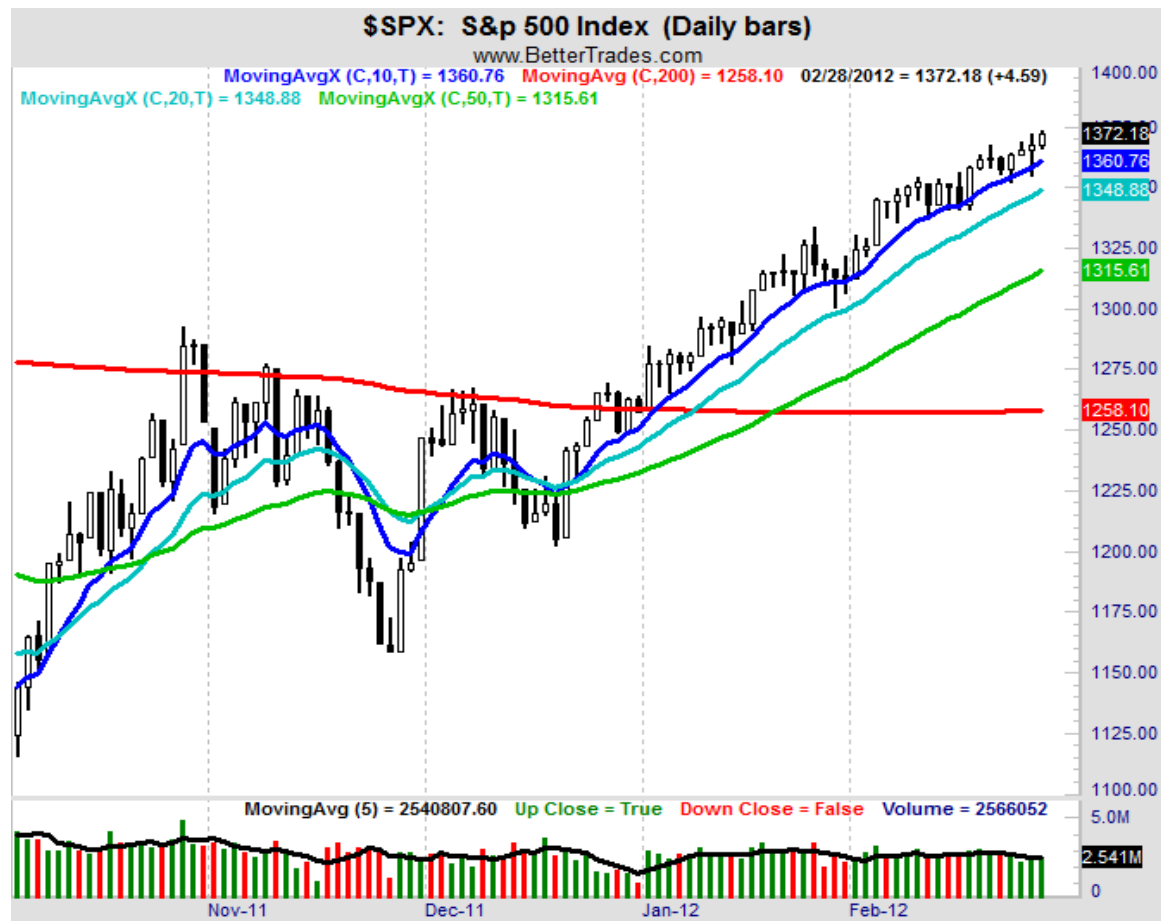
Time decay is more pronounced in the last 90 days of trading.

# LEAPS AS INVESTMENTS

- The Delta of LEAPS will not change as fast as shorter-dated options because of the time.
- Any increase in stock price will not affect the LEAPS price as much as shorter-dated options because of a lower gamma.
- Think of LEAPS as investment instruments

# LEAPS AS INVESTMENTS

As an investing tool, it may make sense to buy LEAPS on quality stocks during bullish markets





# FINDING LEAP CANDIDATES

Consider buying LEAPS on:

- Quality stocks that you already trade
- Stocks in sectors you like and you think may move higher
- Sectors that have been beaten down and are starting to show signs of strength
  - Natural Gas
  - Homebuilders

# SCANS

LEAPS candidates may be found using scans that filter for volume and strength:

- **Bollinger Band Pinch**
  - Finds stocks with low volatility
  - LEAPS may be less expensive
- **Momentum with Weekly Options**
  - Finds strong stocks in strong sectors
  - Look for uptrending patterns with room to trend
- **Low Price Momentum 5-day**
  - Finds strong stocks that are less than \$25 in strong sectors
  - Look for uptrending patterns with room to trend

# WHAT LEAP TO BUY?

For greater leverage, consider one or two strikes out of the money.

Buy one or two years of time, depending on how long you think the stock may trend.

# HOW TO MAKE MONEY WITH LEAPS

As a stock goes up, the LEAPS increase in value.

You can sell **weekly** premium against the LEAPS options for cashflow.

Ideally, both occur.

# BREAKEVEN

## Strike Price + Premium Paid

Security		Last Price	Change	High	Low	DivAmt	DivDate	AnnHI	AnnLOW	EPS	Volatility	Na	
X		28.13	--			0.05	02/08/12	58.28	18.85	-0.64	42	X	
%in	20	%out	20	<input checked="" type="radio"/> Composite <input type="radio"/> All									
Mar/2012		Mar/2012		Apr/2012		Jul/2012		Oct/2012		Jan/2013		Jan/2014	
c_iv	c_openl	c_hr	c_bid	c_ask	month	p_bid	p_ask	p_hr	p_openl	p_iv			
51	337	68	8.55	8.80	Jan14 25	5.65	5.75	32	697	49			
48	3,773	56	6.35	6.45	Jan14 30	8.30	8.45	44	579	46			

X @ \$28.13

Jan 2014 30c @\$6.45

Breakeven:  $30 + 6.45 = \$36.45$

\*The option will vary in price due to time value

# COVERED CALL WITH LEAPS

- Generate cash flow by selling an option against the LEAPS you own.
- Stocks with weekly options may possibly generate weekly cash flow opportunities.
- Time decay on weeklies makes this strategy even more powerful!

# XYZ EXAMPLE

**XYZ @ \$66.50**

**BUY Jan 2014 70c @ \$11.05**

(You have the right to buy XYZ @ \$70 anytime on or before Jan 2014 expiration)

**SELL March 02 75c @ \$0.55\***

(You have the obligation to sell XYZ stock @ \$75 anytime on or before March 2)

\*To avoid going naked, do not sell more calls than the number of LEAPS you own.

# POTENTIAL OUTCOMES

Three possibilities:

1. The stock is below the strike sold (XYZ below \$75 & options remain out of the money)
2. The stock is above the strike sold (XYZ above \$75 & options become in the money)
3. The stock is at the strike sold (XYZ closes @ \$75 & options are at the money)



# # 1 STOCK BELOW STRIKE

IF XYZ stays below \$75 at expiration, the options are OTM & expire worthless

- You keep the \$0.55
- Write a call next week

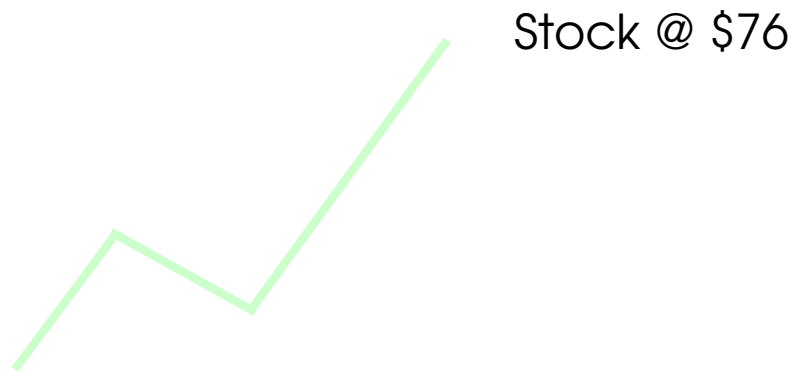


Stock @\$73

Net Credit \$0.55

# #2 STOCK ABOVE STRIKE

- IF XYZ is above \$75 at expiration, the options are ITM
- Consequence:
  - a) You either buy the short leg back at a cost
  - b) Or you get called out of the LEAPS



# #2a STOCK ABOVE STRIKE

Buying the short leg back at a cost



You lose \$0.45 on the trade but keep the LEAPS to sell a call another day

# #2b STOCK ABOVE STRIKE

- Do nothing and get called out of your LEAPS
  - LEAPS contract exercised
  - You are paid for intrinsic value of the LEAPS
  - You keep the credit from writing the call



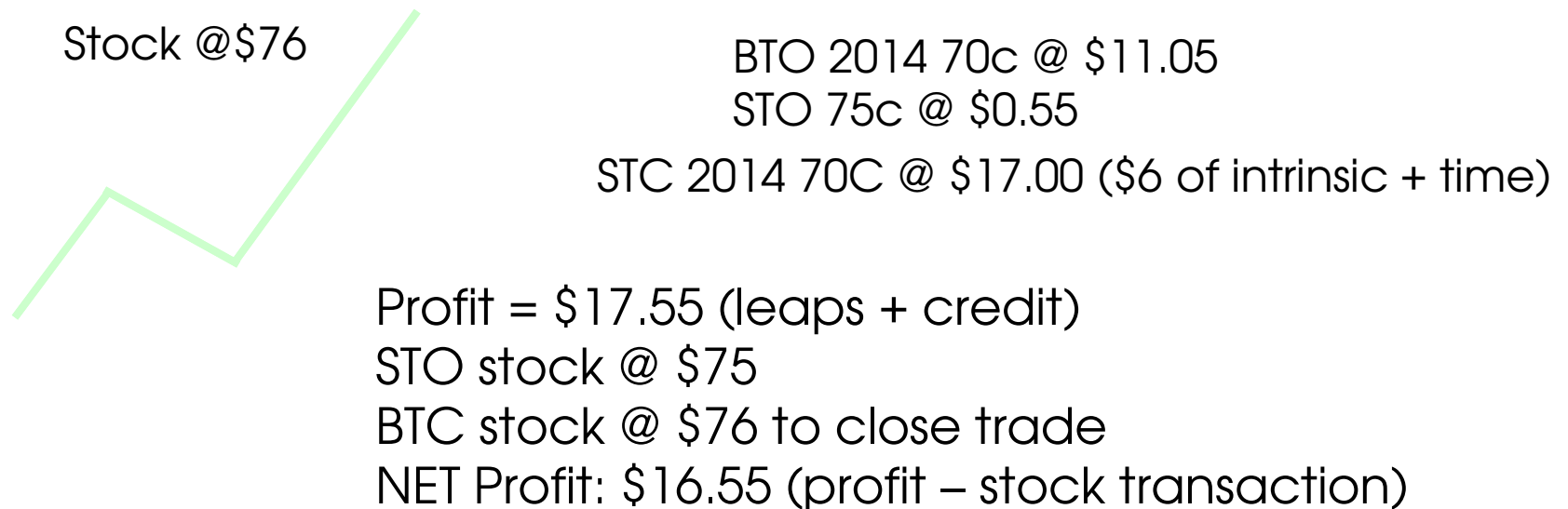
Check with your broker but unless it is a front month option, they should not automatically call you out of your LEAPS! Instead, they may let you go short stock and you have 1 day to manage the trade.

# #2b STOCK ABOVE STRIKE, cont.

Do nothing and get called out of STOCK @ \$75

Now you are short stock @ \$75!

- You have 1 day to come up with cash to cover (or stay short until the chart tells you to buy the stock back, if you can)
- How do you come up with the cash?
  - You keep the credit from writing the call
  - You sell the LEAPS for market value



# #3 STOCK AT STRIKE

- You may or may not be called out
- Some at the money options will be exercised
  - Buy short call back to avoid the risk of being called out
  - Or gamble and deal with covering stock if your options are exercised

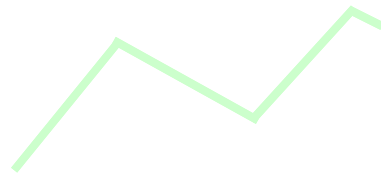


# SHORT CALL RISK

- Options may be exercised anytime before they expire
  - Weekly options expire Friday at 5 p.m. (This may change to a Saturday close)
  - Monthly options expire Saturday at 11:59 a.m.
- If news comes out and moves the stock after market hours (but before expiration) you could be called out!
- How do you handle this?

# SHORT CALL RISK, cont.

BUY YOUR OPTION BACK  
BEFORE MARKET CLOSE



Stock @\$73

STO @ \$0.55

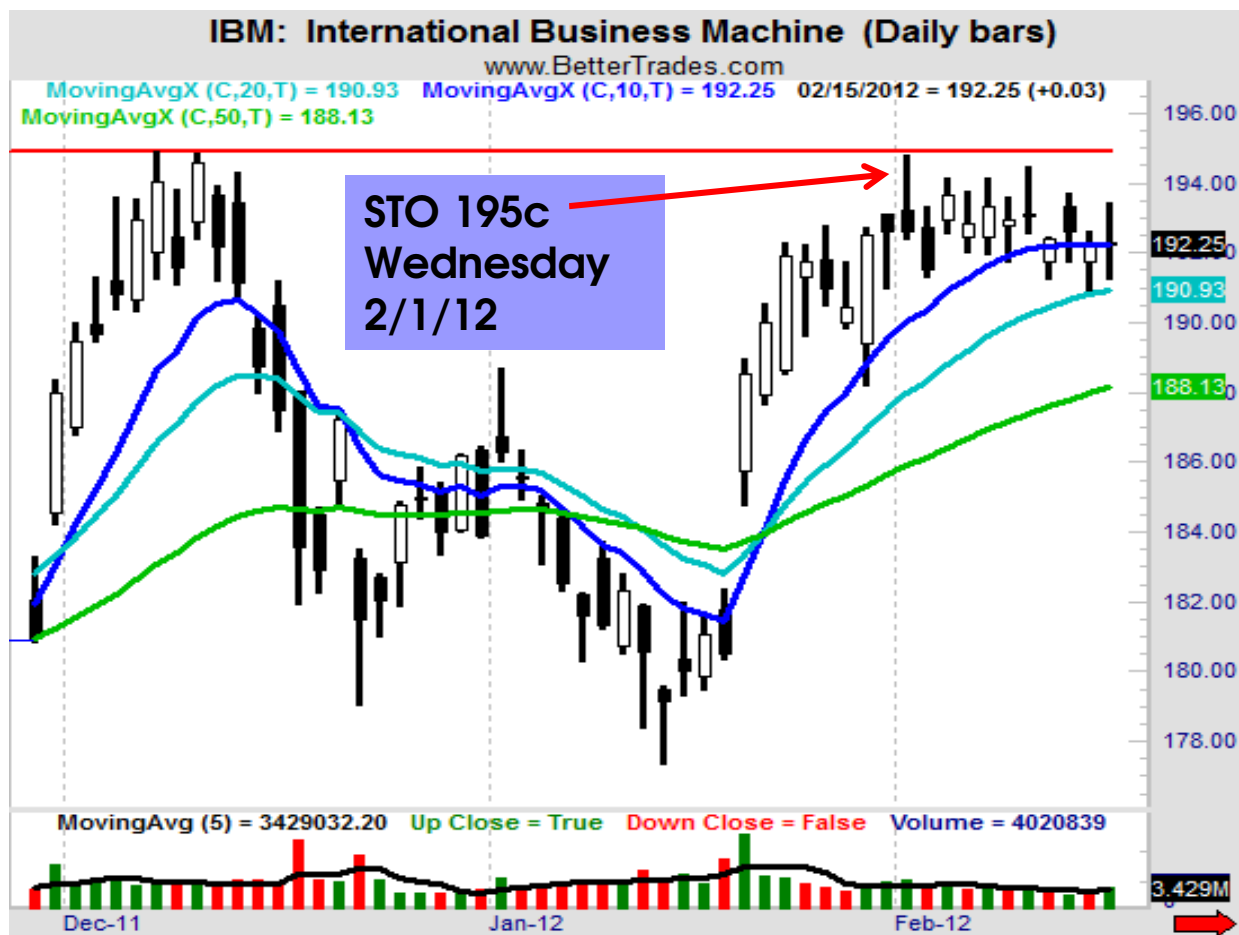
BTC @ \$0.10

Net Credit \$0.45



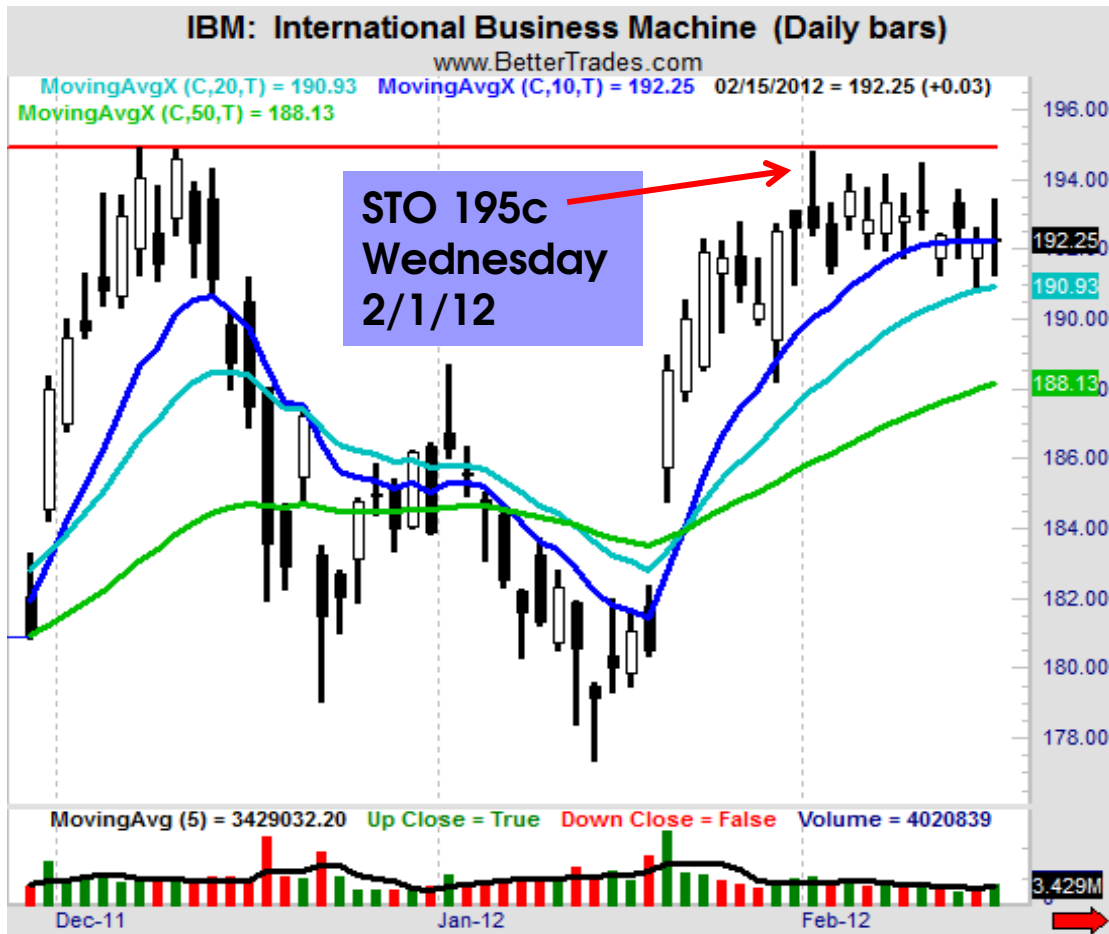
# WHAT CALL TO SELL?

- Sell a call at a strike you do not think the stock can reach (possibly above resistance)
- Sell an OTM call to minimize risk



# WHAT CALL TO SELL?

Selling a call with a strike lower than the one you own creates a margin requirement.



If you own the 190 LEAPS & sell the 195c there is no margin requirement

If you own the 200 LEAPS & sell the 195c there is a margin requirement

$$200 - 195 = \$5$$

10 contracts:  $5 \times 1000 = \$5,000$

\*MARGIN: Strike you own – Strike you sold x Number of contracts

# WHEN TO SELL A CALL

- Use the chart
  - Sell when a stock is rolling lower from resistance
  - Sell on a bearish candle pattern
  - Use the day count to help sell
  - Watch for these things especially when a stock gets over-extended from the moving averages
- Take advantage of time decay
  - Wednesday-Thursday and Thursday-Friday weekly options lose a lot of time value
  - Really slow stocks may not have much premium in their options near the end of the week, consider selling earlier in the week and possibly buying the options back as they lose value

# WHEN NOT TO SELL A CALL

Avoid selling a call against LEAPS when there is a greater risk of being called out.

Times to avoid selling a call:

- When a stock is running into earnings (usually 1-2 weeks before earnings)
- Before a MAJOR economic report (i.e. FOMC or employment numbers)
- Stocks in parabolic trends that are trending above a 5 ema

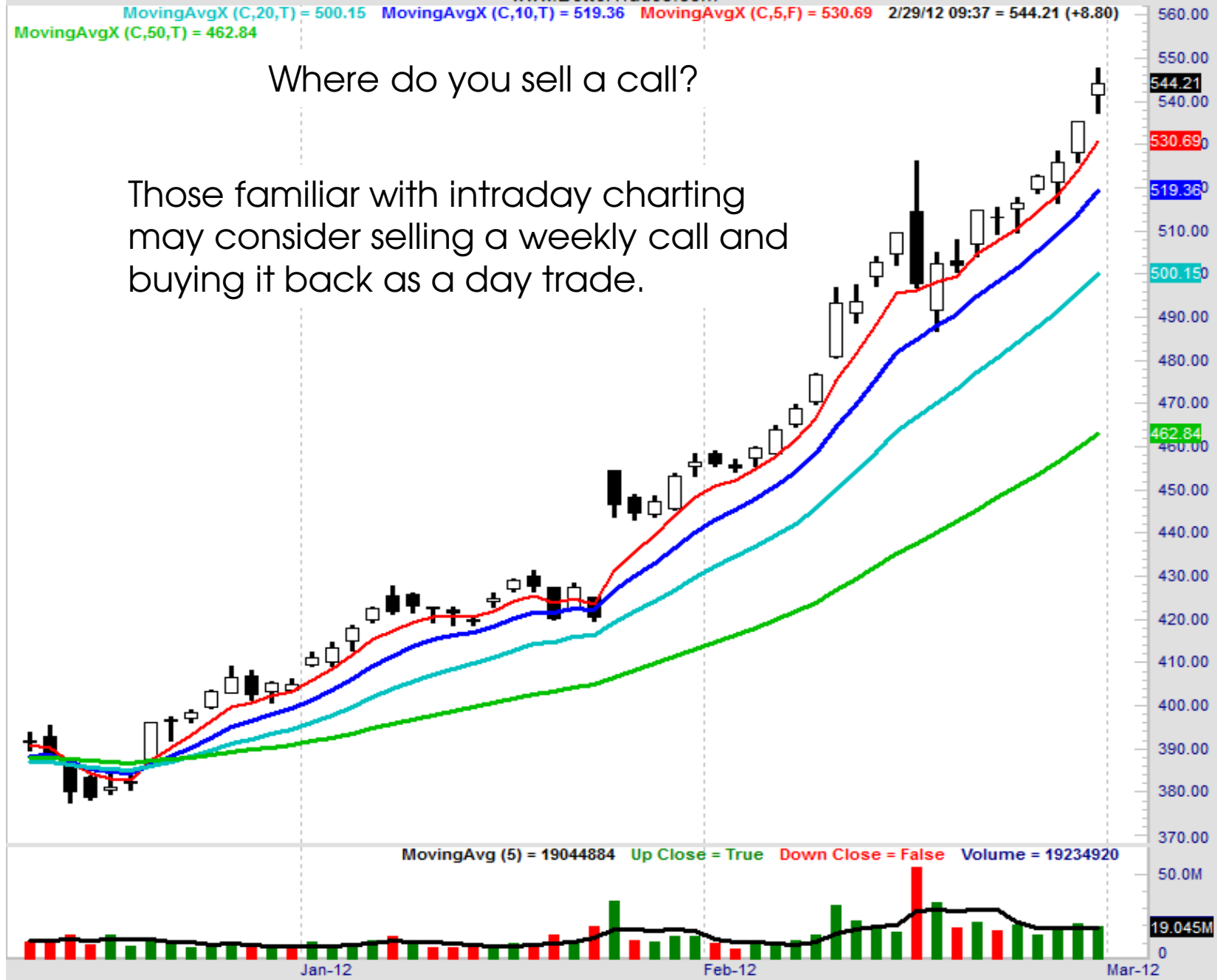
# AAPL: Apple Inc. (Daily bars)

www.BetterTrades.com

MovingAvgX (C,20,T) = 500.15 MovingAvgX (C,10,T) = 519.36 MovingAvgX (C,5,F) = 530.69 2/29/12 09:37 = 544.21 (+8.80)  
MovingAvgX (C,50,T) = 462.84

## Where do you sell a call?

Those familiar with intraday charting may consider selling a weekly call and buying it back as a day trade.



# PROFIT ON LEAPS?

What do you do if you have held onto the LEAPS for some time and have considerable profit you want to protect?

You may consider a Collar!

# COLLARS

The primary concern is protection of profits accrued from underlying LEAPS rather than increasing returns on the upside.

THE PLAY:

Write a covered call against LEAPS

Buy protective Puts with credit from the call sold

# WHY COLLARS?

Use this when you have gains you want to protect and you are willing to sell your LEAPS at a higher price.

You have to be OK being called out of your LEAPS ... which means you may want to do this on LEAPS that are WAY in the money.



# MECHANICS OF THE COLLAR

- Set up the covered call by selling an OTM call at a credit
- Use the credit to help pay for an OTM put
- This is sometimes done with a net credit or a small debit

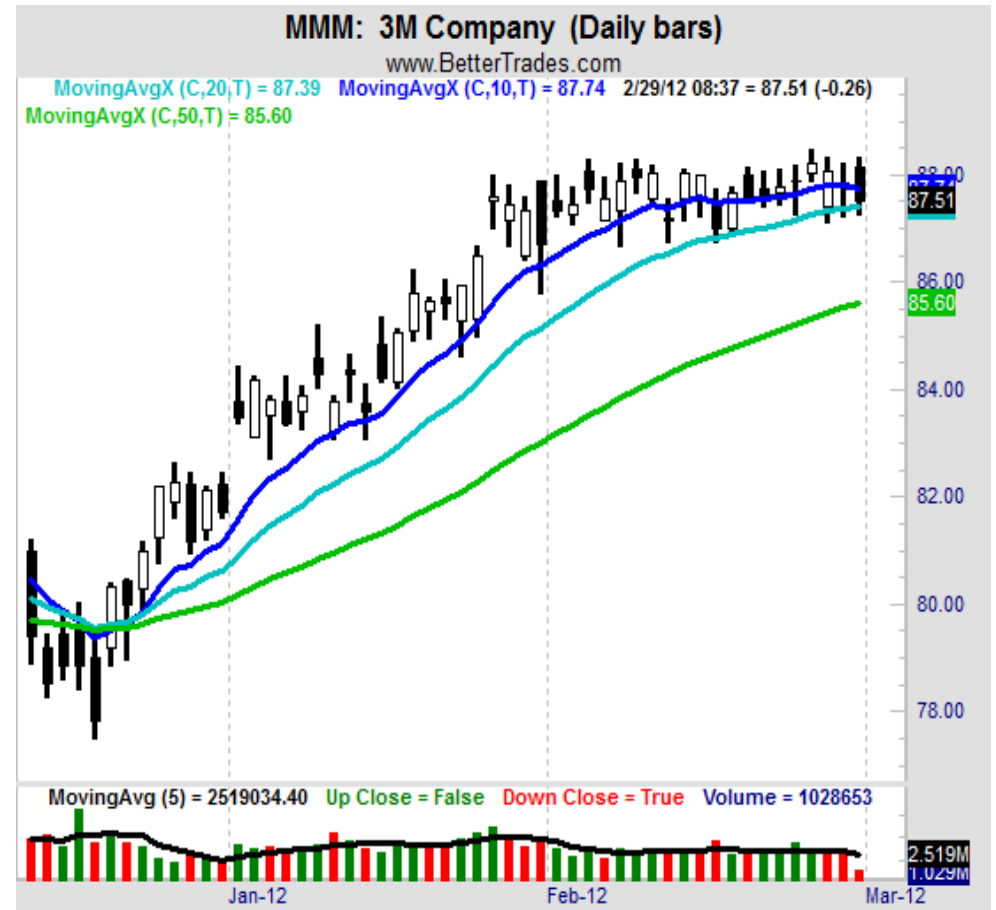
# MMM COLLAR EXAMPLE

MMM @ \$87

OWN: 2013 75c @ \$4.50 cost basis

Current value: 2013 75c @ \$15.50

STO Mar 02, 87.50c @ \$0.52  
BTO Mar 85p @ \$0.33  
NET CREDIT: \$0.19



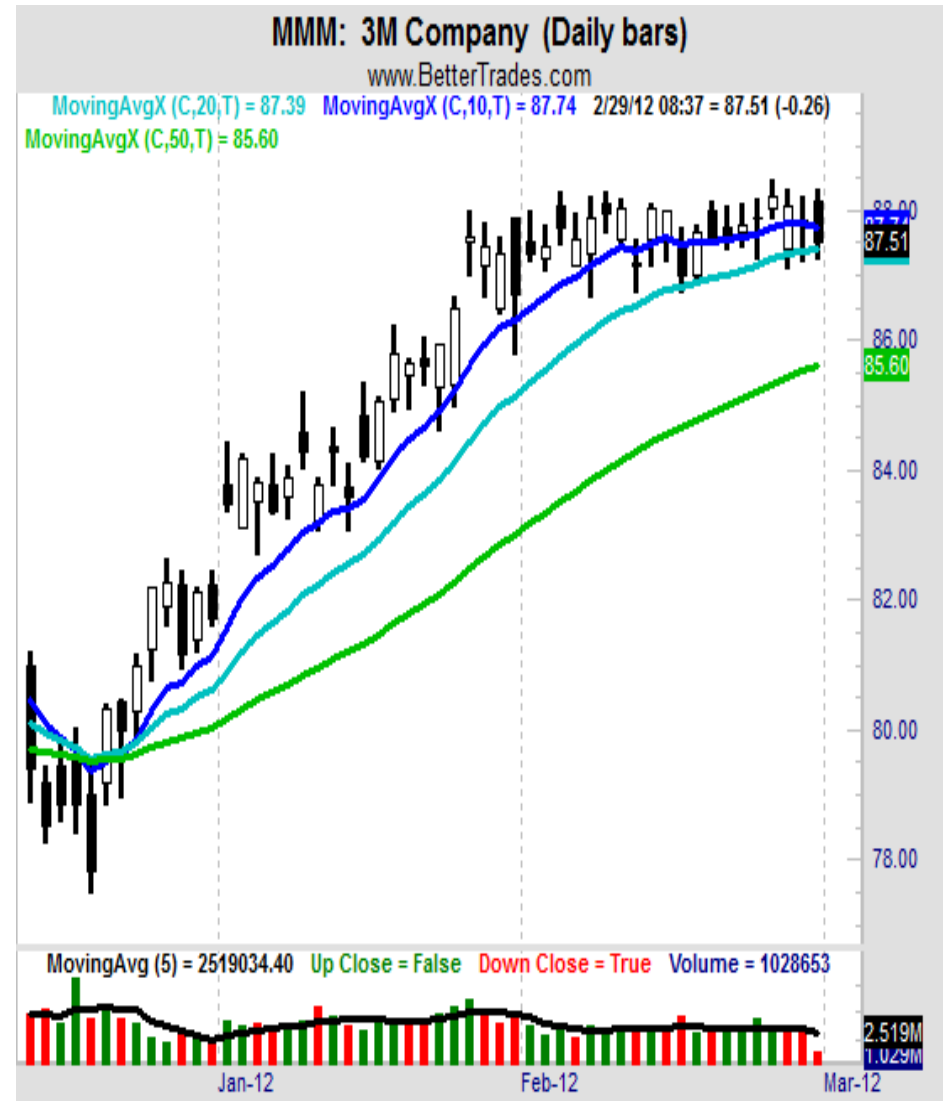
# POTENTIAL OUTCOMES

Three possibilities:

1. The stock is between the strikes
2. The stock is above the call sold (MMM above \$87.50 & options become in the money)
3. The stock is below put strike (MMM below \$85 & puts become in the money)

# # 1 STOCK BETWEEN STRIKES

- Stock stays where it is & you keep the credit.
- Write a call next week.
- Hang onto puts until they have value or they expire.



# #2 STOCK ABOVE CALL SOLD

Stock above \$87.50 and calls become ITM

Actions:

- Buy the call back at a debit OR
- Let the calls be exercised and go short the stock
  - Cover stock at higher price
  - Sell LEAPS (which have gone up in value)
  - Keep the credit from writing the calls

# #3 STOCK BELOW PUT STRIKE

- Stock drops and the puts become ITM
- Keep the credit from selling the calls
- LEAPS decrease in value but you may continue to write calls against them
- Puts become more valuable
- Sell puts for a profit to offset losses in the LEAP

Stock @ \$81  
85p @ \$4.50

Keep credit from 87.50 calls \$0.52  
STC 85p @ \$4.50  
Net Credit \$5.02

# WHEN TO PUT ON A COLLAR

- Consider collars when you have a lot of intrinsic value in the LEAPS and you don't mind getting called out
- Possibly do this before an earnings announcement
- If you don't have a high intrinsic value, consider buying an OTM put as insurance and writing calls against the LEAPS after earnings are released

# WHEN TO SELL LEAPS

- If you can still bring in weekly premium on your LEAPS there is no need to rush to sell
- An option with less than nine month of time is technically no longer a LEAPS option
- Time decay is increasing and speeds up in the last 30 days of trading
- You may want to consider selling before time decay rapidly increases



# TAXES AND SELLING LEAPS

- Think about long-term capital gains
- Investments held for more than one year qualify for long-term capital gains:
  - Through 2012 long-term capital gains = 15%
  - After 2012 rate is scheduled to increase to 20%
- Avoid the urge to hold onto LEAPS longer than you should to get the lower tax rate

# TIMING THE SALE OF LEAPS

- Use the chart:
  - Sell LEAPS when the stock and the markets begin to look bearish
  - With uptrending stocks, sell the LEAPS on a break of a moving average (1-day close below the average for confirmation)
  - Once the stock bottoms out, consider purchasing another LEAPS option
- Consider writing calls with the intention of getting called out (only when there is very little time value in the leap)

# LEAPS ON BEARISH STOCKS

If you have written enough CC's that your LEAPS option is paid for, you may want to hold onto your LEAPS and write calls on the way down.

Keep in mind the margin requirement and consider the value of the LEAPS.

If the stock and the S&P 500 turn bearish, consider selling LEAPS and switching to directional bearish trades.

# LEAPS: MORE THAN STOCKS

Interested in trading a basket of stocks, rather than one individual stock?

LEAPS are available on ETFs!

ETF LEAPS:

Reasonably priced

Large open interest

Calls and LEAPS may have one dollar strikes

# EXCHANGE TRADED FUNDS

- SPY
- QQQ
- IWM
- DIA
- XLE (OIH = low open interest)

**COMING SOON.....**

**SUPER LEAPS!**

Beginning March 1, Super LEAPS will be available on SPXpm.

Expiration is in December and they will be written out through 2016.

Register now for my next class

# Intraday with Markay

Friday, March 16

9:30-11:30 a.m.

Retail price: \$495

Discount: \$246

**Discount Price: \$249**

You must register online to receive special discounted price.

**Neither Better Trades or any of its personnel are registered broker-dealers or investment advisers. I will mention that I consider certain securities or positions to be good candidates for the types of strategies we are discussing or illustrating. Because I consider the securities or positions appropriate to the discussion or for illustration purposes does not mean that I am telling you to trade the strategies or securities. Keep in mind that we are not providing you with recommendations or personalized advice about your trading activities. The information we are providing is not tailored to any particular individual. Any mention of a particular security is not a recommendation to buy, sell, or hold that or any other security or a suggestion that it is suitable for any specific person. Keep in mind that all trading involves a risk of loss, and this will always be the situation, regardless of whether we are discussing strategies that are intended to limit risk.**

**Also Better Trades' personnel are not subject to trading restrictions. I and others at Better Trades could have a position in a security or initiate a position in a security at any time.**