Stein Whittington Deniel, Inc.

Registered Investment Advisor

A Discussion of Covered Call Investments

This discussion is intended to expand on what you just heard on Rick Stein's interview with Randy Alvarez. Therefore, if you haven't done so, we urge you to start by watching the video first.

Our task here is to explain and clarify in more detail what you have just seen and heard as well as address questions that you may have. The Q & A that follows represents common questions we hear most often from prospective clients and during Seminars.

Please bear in mind that throughout the discussion below, when we refer to a 'stock' we mean an equity security, either shares of stock in an individual company or an ETF – shares in an Exchange Traded Fund representing stocks of many companies. When we refer to the 'investor' we are talking about a client's portfolio as it would be managed by our Company.

Q: What is a Covered Call and how does it work?

A: A Covered Call is a type of option. It gives the holder or buyer of the call, the ***right*** to buy a stock (or ETF) at a fixed price for a limited period of time. To buy that right, the call buyer pays a ***premium.*** The seller of that call has the obligation to deliver the stock at the agreed price during that period of time. To assume that obligation, the seller of that call receives the premium. When the seller of the call owns the stock that he has agreed to sell, then the call is ***"covered".*** In our company's portfolio management strategy, the seller of that call is our client.

Q: Yes, but how do they work? Why do you call it an 'income strategy'? Can you provide a 'real' example?

A: This example is based on prices as of 7/18/08. An investor [our client] purchases 600 shares of XLE (the ETF on the S & P Energy Sector). The price per share is $76.90. Total cost, including Schwab's $13 commission of $46,153 [600 X 76.90 + 13].

Just after purchasing the XLE shares, the investor sells 6 covered call contracts [each contract represents 100 shares]. The investor agrees to sell the XLE at a price of $77 a share up until 8/15/08 [option expiration]. The premium offered is $2.90 per share, or $1,740. The investor will receive a net of $1,725 after Schwab's commission for executing the option transaction. This is real cash received immediately; it is income generated by the portfolio.

Now what happens next? Time passes and by 8/18/08, the time of option expiration, the price of XLE is either a) at or below $77, or b) it is over $77.

In case a), if the price of XLE is at or below $77, the holder of the call will not exercise the option; that is, he will not buy the stock. The option expires worthless. This is obvious; the holder of the call can buy the same stock cheaper in the open market. The investor [our client] retains the stock and is now free to sell another covered call on the same stock and earn another premium. Our client realized an income of $1,740 on his stock and will now receive another premium for the next month.

On the other hand, case b), if the price of XLE is above $77, the holder of the call will purchase the stock at $77. The investor will receive $46,187, net after Schwab's commission [600 X 77 – 13].

Now we start the process all over again. Since the stock was sold, the client has the sale proceeds. We buy another stock and sell another covered call generating income on the new stock purchased. This process can be repeated over and over with different stocks and earning premiums each time, thus generating income on a regular basis.

In both cases the investor [our client] retains the $1,725 premium earned on the call sold. That is why it is called an 'income' strategy. The portfolio generates substantially more cash flow than would be earned from relying on dividends only.

Q: Please talk about dividends. What happens to the dividends if I have sold a covered call on my stock? Do I have to give the dividends to the person who bought the call?

A: No. Ordinary dividends are payable to the investor if he owns the stock on the as of dividend date. They do not accrue to the call holder. Extraordinary dividends and distributions of principal accrue to the call holder if the call is exercised, i.e., it the call holder buys the stock or ETF on or before the call expiration date.

Q: Why did you choose August 15 as the Covered Call expiration date? Why not August 18, one month after selling it, or August 31, at month-end?

A: Stock Options, including Covered Calls are standardized contracts that trade in an exchange. Each stock option contract represents 100 shares of stock. They are offered in many maturities, one, two, three, six months, a year; but they always mature or expire on the third Friday of every month. August 15th is the third Friday in August 2008.

Q: You said that Covered Calls are options. I have always heard that options are dangerous, that dealing in options is speculating and one could lose one's shirt doing that…Is that true? Can that happen?

A: Options do have a bad reputation because one can indeed lose one's shirt when speculating in options. However, the seller of Covered Calls is not a speculator as the seller of 'naked' calls would be. The seller of a 'covered' call owns the stock subject of the option.

In the example above, were the price of the XLE to rise precipitously over the call strike price in that one month, let's say to $100 a share, the seller of the call must give up the stock at $77. Our client owns the stock; he bought it beforehand at $76.90, so he still earns his premium. His only 'loss' is the 'opportunity loss' because he gave up the potential to make a bigger profit; had he owned the stock without a Covered Call, he could sell it at $100.

On the other hand, the 'naked' call seller, since he doesn't own the stock, must first purchase it at $100 a share in order to sell it at $77. He would incur a loss of $13,800 minus the premium received, for a net loss of $12,075.

Q: Do you ever do naked options in a client's portfolio?

A: When a client requests it and after satisfying ourselves that the client understands the risk, for aggressive accounts, we may engage in other option strategies.

Q: In the video Mr. Stein said that Covered Calls are the only option strategy allowed in IRAs. Why? Can you expand on that?

A: ERISA regulations, which are designed to protect pension plans and retirement accounts from risky investments, recognize that Covered Call writing is an income enhancing strategy and provides some protection when the markets go down. ERISA not only permits the selling of Covered Calls to enhance income but they also allow the purchase of Protective Puts which reimburse the investor in the case a stock goes sharply down. Both strategies are considered a 'conservative' way to manage investments. Protective Puts are a form of insurance; buying puts does not generate income like Covered Calls do, they are an expense. Our firm does not generally engage in this practice unless a client specifically requests it, thus we will not address it here.

Q: OK, I accept that selling Covered Calls generate income. Now you added the word 'conservative'. Does that mean that my account cannot lose, that it will not go down?

A: Absolutely Not. You are still invested in the stock market. The stock market goes up and it goes down. If the stocks you are holding have a severe decline, the total account balance will still decline. What I can tell you is that your account will decline less than a similar portfolio that holds the same stocks but does not sell Covered Calls.

In the example above, the investor purchased the XLE shares at $76.90 and received $2.90 per share in option premium when he sold the Covered Call. The price of XLE can fall to $74 and the client would not have a loss. On the other hand, the traditional 'buy and hold' investor, the person who does not sell covered calls, would have a loss of $1,740 in the XLE.

A decline in the market price of XLE below $74 would generate losses for both investors, but the loss of our Covered Call writing client will always be smaller.

Q: Can you address what we give up when we sell Covered Calls? We must be giving up something to earn that premium!

A: Of course. What you are sacrificing is the upward potential of the stock beyond the strike price plus the premium received. You are limiting your profit but taking it up front. In the XLE example above, if the price goes to $78, you will only receive $77. However, you should remember that you are still ahead; you will do better than the regular 'buy and hold' investor, because you will have in essence received $79.90 ($77 at sale plus the $2.90 in premium received when the call was sold) while the buy and hold investor would only receive $78, the market price. In effect, when selling the call, we have limited the profit potential. If the stock goes up beyond $79.90, you are willing to give the excess in order to receive the premium and protection up front.

Q: Why do you say that one of the benefits of the Covered Call Strategy is to achieve an organized sell discipline?

A: How many times have you bought a stock at $43, watch it go all the way up to $67 and then watch it go down to $60? You say to yourself, I should have sold at $67, I will not sell at $60; then it goes down to $54, and so on until it is back at $43. Selling covered calls will force you to sell and realize part of your gain. When you are back in cash you decide whether or not to buy that same stock again or invest in something else.

Q: What does the selling Covered Calls do to my tax return? It looks like we would be generating mostly short term gains. Is that correct?

A: When addressing tax issues, one must differentiate on whether the Covered Call writing is being done in an IRA or any other tax advantaged account as compared to a regular brokerage account.

In an IRA, there is absolutely no difference. The covered call account is treated exactly the same as any other investment account. No taxes are paid as the covered call premiums are received, stocks are sold, etc. Long term or short term transactions are treated the same. When funds are withdrawn taxes are paid at ordinary income rate.

In a regular brokerage account, taxes are owed when the transactions are completed: In the case of the stock itself, when it is sold; in the case of the covered call, the gain is considered realized and subject to taxation when the call expires. And yes, the transactions are mostly short term, so they would be taxed as short term capital gains.

There is nonetheless one caveat. It is the opinion of this firm that Covered Call premiums on ETF's qualify for beneficial tax treatment under section 1256 of the IRS code. The rule applies to gains on options and futures on baskets of securities. We believe that ETF's are 'baskets of securities' and therefore option gains qualify for the 60% long term and 40% short term tax treatment. We are not tax experts and we always advise our clients to consult with their CPA or tax professional.

We have a client retired who sold his business and the proceeds of the sale are his income source for retirement. I tell him, yes, you will pay taxes on the income from your portfolio. It is your money going to work and generating a monthly check for you, except you save the payroll taxes.

Q: What is your relationship with Schwab? Are you associated with Schwab? Are all your clients with Schwab?

A: The majority of the independent advisors employ Charles Schwab and Co. as custodian for their clients' accounts. Schwab has, in our opinion, the most advanced technological platform for the independent investment advisor.

Our clients are also clients of Schwab. Schwab is the custodian responsible for maintaining your account, issuing trade confirmations, monthly statements and forms 1099 at year end. We only have Limited Power of Attorney over your account. You can sever the advisory relationship with our firm at any time by advising Schwab that you wish to rescind the Limited Power of Attorney. You can continue to maintain your account at Schwab or not at your discretion. You can establish a log in ID and password with Schwab and see your account online in real time at any time and follow what we do as we manage the portfolio.

We are not part of or associated with Schwab. Our relationship with Charles Schwab and Co. is arms-length. Because we do bring our clients to Schwab, they do provide some services to us. They have a specialized team that helps us with account opening and the transferring of assets and they provide us with free research sources.

Q: Did you say that when we open an account with your Company Schwab handles all the transfers. Did I understand that correctly?

A: That is correct. Once you decide to place an account under our management Schwab has standard forms they use to create the account and a special form to transfer the assets from your former custodian. The process takes about 2 – 3 weeks, and it is relatively painless.

Q: What is the minimum account size for your firm?

A: The minimum account size is $500,000. Covered Call Writing requires larger positions to be effective and this is the minimum amount where we can adequately diversify the account.

Q: Can you talk about your fees?

A: We are fee only portfolio managers. We do not sell annuities, insurance or mutual funds. We receive no payment or commissions from any other person or entity other than the clients whom we serve. It is the Company's opinion that this is the only way for a client to be certain that all investment decisions are made in his or her own best interest.

Our fees are very competitive and match that of most active portfolio managers. Clients selecting to do Covered Call Writing pay fees based on a percent of assets under management, calculated quarterly in arrears. And they are as follows:

- The first $500,000 – 1.5% per annum
- The next $500,000 – 1.25% per annum
- Assets over $1,000,000 – 1% per annum

Q: How are you different from the other investment advisors or brokers we hear from? What makes you different?

A: We are a boutique firm. We give very personalized service. When you visit our office you talk to one of the principals who will be managing your portfolio. You will visit either with me, Cristina Deniel, or with Rick Stein, the other principal. Both of us make it a point of knowing all of our clients; we are knowledgeable of what each client needs or wants and how each account is to be managed.

When you first visit our offices you do not talk to a 'client contact person' who takes your information, fits you into a standard model and then another person, whom you have never met, handles the account. We structure each account with the personalization that you desire based on your own goals and objectives. After your visit to our office we write a personalized Investment Policy Statement that outlines how the account will be manage. We encourage you to visit us as often as you wish and to review the Investment Policy Statement at least annually.

This concludes our comments. If you have any other questions or suggestions for other topics to be added, please feel free to e-mail me at: Cristina@SWDInvestments.com.

We will also be glad to have a no-obligation, in-office consultation. Just call us to set up an appointment and Rick or I will be glad to meet with you at your convenience.

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