The #1 Fundamentals Trade You Should Make Today

by Andy Crowder

Cabot Options Institute
One of my favorite options strategies is the covered call. Simple, straightforward and easy to manage. Covered calls allow you to lower the cost basis on stocks you already own or, alternatively, give you the opportunity to generate a steady stream of income. But today, I don't want to discuss covered calls. I want to discuss what is, in my opinion, a much better alternative to a basic covered call strategy … a poor man's covered call.

It doesn’t require buying 100 shares of stock. It allows you to use far less capital, while still receiving the same benefits of a covered call strategy. And it’s an alternative that gives you a far greater return on your capital.

Again, the strategy is known as a “poor man's covered call” or, in options mumbo jumbo, a long call diagonal debit spread. The name poor man's covered call comes from the lower capital requirement needed to establish a position compared to a standard covered call.

In fact, in most cases, it costs 65% to 85% less to use a poor man's covered call strategy. The savings in capital required should be reason enough to at least consider using the strategy. And I’m certain after reading this you will indeed find the strategy appealing enough to consider.

A poor man's covered call is an inherently bullish strategy that is the same in every way to that of a covered call strategy, with one exception. Rather than spend an inordinate amount of money to purchase at least 100 shares of stock, you have the ability to buy what is essentially a stock replacement. The replacement? An in-the-money LEAPS call contract.

LEAPS, or long-term equity anticipation securities, are options with at least one year left until they are due to expire. The reason we choose to use LEAPS as our stock replacement is because LEAPS don't suffer from accelerated time decay like shorter-dated options.

The initial barrier to entry when it comes to selling poor man's covered calls comes is security selection. Simply stated, implied volatility (IV) is one of the main keys to security selection. Implied volatility tells us how much risk and return we should expect to see over a 20-to-45-day time frame, so that we can form a realistic plan for creating monthly income.

Next is the price of the security. Just because the IV of a stock fits within our range doesn’t mean that the stock works. We must be able to establish a position while maintaining proper position size in our overall portfolio.

I’m a big proponent of taking a diversified portfolio strategy approach through the use of poor man's covered calls. And again, by using poor man's covered calls, I'm able to reduce my capital outlay by 65% to 85%. And with this reduction in capital, I’m able to realistically diversify my income approach over a wide range of strategies such as Ray Dalio’s All-Weather Portfolio, James O’Shaughnessy’s Growth/Value Portfolio, Warren Buffett’s Patient Investor Portfolio, Dogs of the Dow and several other tried and true investment strategies.
My Approach to Poor Man’s Covered Calls

Given the current state of the market I wanted to include an example from one of my favorite portfolios, Ray Dalio’s All-Weather Portfolio.

The All-Weather portfolio is designed to survive all economic environments, using different types of assets that perform differently during various market environments (bullish, bearish or neutral).

Dalio admits time and time again that he can’t predict the future, which is why he created the All-Weather Portfolio. He needed for a portfolio that mitigates the financial impact of unexpected economic events, even black swan events. And the All-Weather Portfolio becomes especially appealing during periods of market turmoil, particularly for investors who have a low risk tolerance.

One of the constant holdings in the All-Weather is gold. As a result, gold, as seen through SPDR Gold trust ETF (GLD), is going to be my focus for the following example.

GLD is currently trading for 173.9 with an implied volatility of around 20%.

If we followed the route of the traditional covered call, we would need to buy at least 100 shares of the GLD. At the current share price, 100 shares would cost $17,391.

Just think if you wanted to use a covered call strategy on, say, higher-priced stocks like Apple (AAPL), Microsoft (MSFT) or even an index ETF like SPDR S&P 500 ETF (SPY). For some investors, the cost of 100 shares can be prohibitive, especially if diversification amongst a basket of stocks is a priority. Therefore, a covered call strategy just isn’t in the cards.

But, as I said before, with a poor man’s covered call strategy you can typically save 65% to 85% of the cost of a covered call strategy, making the benefits of a covered call strategy far more affordable.

So again, rather than purchase 100 shares or more of stock, we only have to buy one LEAPS call contract for every 100 shares we wish to control.
If we go with the longest-dated expiration cycle in GLD we are left with the January 19, 2024, expiration cycle with 620 days until expiration.

You can see the expiration cycles currently offered for GLD below.

<table>
<thead>
<tr>
<th>Date</th>
<th>Days</th>
<th>Strike</th>
<th>Type</th>
</tr>
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<td>100</td>
<td>Weekly</td>
</tr>
<tr>
<td>20 MAY 22</td>
<td>(11)</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>27 MAY 22</td>
<td>(18)</td>
<td>100</td>
<td>Weekly</td>
</tr>
<tr>
<td>3 JUN 22</td>
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<tr>
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<td>(52)</td>
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<tr>
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<td>(67)</td>
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<td>16 SEP 22</td>
<td>(130)</td>
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<tr>
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<tr>
<td>16 DEC 22</td>
<td>(221)</td>
<td>100</td>
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<tr>
<td>30 DEC 22</td>
<td>(235)</td>
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<tr>
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<tr>
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<td>(403)</td>
<td>100</td>
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</tr>
<tr>
<td>19 JAN 24</td>
<td>(620)</td>
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Once I have chosen my expiration cycle, in this case the January 19, 2024, I then look for an in-the-money call strike with a delta of around 0.80.
When looking at GLD’s option chain, I quickly noticed that the 145 call strike has a delta of 0.78. The 145 call is currently trading for approximately $38.30. Remember, always use a limit order. Never buy an option at the ask price, which in this case is $38.65.

So, rather than spend $17,391 for 100 shares of GLD, we only need to spend $3,830. As a result, we are saving $13,561, or 78.0%. Now we have the ability to use the capital saved to diversify our premium or income stream amongst other securities, if we so choose.

After we purchase our LEAPS call option at the 145 call strike, we then begin the process of selling calls against our LEAPS.

My preference is to look for an expiration cycle with around 30-60 days left until expiration and then aim for selling a strike with a delta ranging from 0.20 to 0.40, or a probability of success between 60% to 85%.

As you can see in the options chain below, the 181 call strike with a delta of 0.26 falls within my preferred range.
We can sell the 181 call option for roughly $1.59.

Our total outlay for the entire position now stands at $3,671 ($3,830 – $159). The premium collected is 4.2% over 39 days. And we can sell calls against our 145 LEAPS 9 to 10 times over the course of a year for roughly 38%, in just options premium.

But, if we were to use a traditional covered call our potential return on capital would be less than half, or 0.9% over 39 days.

And remember, the 4.2% is just the premium return, it does not include any increases in the LEAPS contract if the stock pushes higher. And again, we can continue to sell calls against our LEAPS position until there are roughly 10 to 12 months of life left in the LEAPS, thereby generating additional income or lowering our cost basis even further.

As an aside, an alternative way to approach a poor man’s covered call, if you are a bit more bullish on the stock, is to buy two LEAPS for every call sold. This way you can benefit from the additional upside past your chosen short strike, yet still participate in the benefits of selling premium.

Regardless of your approach, you can continue to sell calls against your LEAPS as long as you wish. Whether you hold a position for one expiration cycle or 12, poor man’s

I like to take a diversified approach, using various portfolios with a proven, long-term track record of success and that take advantage of different market scenarios that fall into different levels of IV.

With the significant reduction in capital that using poor man’s covered calls provide, I’m again able to realistically diversify my income approach over a wide range of strategies such as Ray Dalio’s All-Weather Portfolio, James O’Shaughnessy’s Growth/Value Portfolio, Warren Buffett’s Patient Investor Portfolio, Dogs of the Dow and several other tried and true investment strategies.

As always, if you have any questions, please feel free to email me at andy@cabotwealth.com.
About the Expert

Andy Crowder is a professional options trader, researcher and chief options strategist of Cabot Options Institute Earnings Trader. Formerly with Oppenheimer & Co. in New York, Andy has leveraged his investment experience to develop his statistically based options trading strategy which applies probability theory to option valuations in order to execute risk-controlled trades.

His proprietary strategies have been refined through two decades of research and real-world experience and has been featured in the Wall Street Journal, Seeking Alpha, and numerous other financial publications.

As a professional options trader, Andy has helped thousands of option traders learn and implement his meticulous rules-driven options trading strategies through highly attended conferences, one-on-one coaching, webinars, and his work as a financial columnist.

He currently resides in Bolton Valley, Vermont and when he’s not trading, teaching and writing about options, he enjoys spending time with his wife and two daughters, backcountry skiing, biking, running and enjoying all things outdoors.

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