

The "up" scenario

In the "up" scenario, the maximum gain that can be attained is the stock finishing at \$10.00 or higher.

At \$10.00, you would profit from the full value of the extrinsic value of the option which is \$.50 and you would also have \$.50 of capital appreciation from the stock for a total of \$1.00. This represents a 10.52% one-month return or an annualized return of 126.32%.

It is not realistic to expect this type of return every month but remember, recent studies show that premium selling works approximately 80% of the time, which is still very good.

We stated earlier that the maximum return of this buy-write will be actualized when the stock reaches \$10.00 or above and the maximum return will be \$1.00, and no more than \$1.00. As the stock goes higher, the option will earn less in direct proportion with the increase in capital appreciation.

For example, if the stock closes at \$10.30 you would receive only \$.20 from the option. The option would now be worth \$.30 because with the stock at \$10.30, the 10 strike call would have \$.30 of intrinsic value.

Since you sold the option at \$.50, you would see a \$.20 profit ($$.50 - $.30 = $.20$). Since you bought the stock at \$9.50 and it is now \$10.30 you have \$.80 of capital appreciation. Combine the two and you have a \$1.00 profit.

Let's look at what happens when the stock trades up to \$12.00 and see if you again have a \$1.00 return on the position. At \$12.00, the option will have \$2.00 of intrinsic value (stock price - strike price) because it is in the money.

You sold the option at \$.50 so you have a \$1.50 loss. However, you bought the stock for \$9.50 therefore you have a \$2.50 capital gain. Combined, you have a \$1.00 profit.

In a third example, if the stock trades up as little as \$.10 you still have a \$.60 gain. You will receive \$.50 from the sale of the call which would expire out of the money thus worthless plus \$.10 of capital appreciation. \$.60 represents a 6.3% one month return.



Please refer to the chart below for examples of total dollar profits per number of contracts, remembering that each contract controls 100 shares of stock.

Number of Contracts	Capital Appreciation	Profit Per Contract	Total Dollar Profit
1	.10	.50	\$60.00
5	.10	.50	\$300.00
10	.10	.50	\$600.00
20	.10	.50	\$1,200.00
50	.10	.50	\$3,000.00
100	.10	.50	\$6,000.00

Observe that if the stock closes over \$10.00, then your stock will be called away because your short calls will be exercised. This is correct but we will talk about position management later. For now, let's get back to our three scenarios.

In the "up" scenario, you would profit with the buy-write when the stock is up as little as a penny, but you are also limited on our maximum profit.

You are limited on your maximum profit as defined by the formula below:

$$\text{Maximum Profit} = \text{Strike Price} + \text{Option Price} - \text{Stock Price.}$$

This method of calculation will work every time. As you see, the buy-write has a positive but limited upside potential.

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