

Profit Watch Investment Group, Inc.

Terms and Definitions Used in Our Investment Approach

Profit Watch Investment Group (PWIG) has a very narrow investment approach which may not be fully understood by many investors. In addition to purchasing *common stocks* and ETFs (*Exchange Traded Funds*) as most investors are accustomed to, PWIG employs selling options as a major part of its investment strategy. This short paper is designed to explain the investment approach and the terms used in our monthly, quarterly, and annual reports.

We will begin by defining some of the terms we use (these terms are shown in italics throughout the text) and then explain the various investment approaches including fallback approaches we have used to counter undesirable consequences of potentially losing positions.

Definitions

Common Stock:

Common stock is a security that represents ownership in a corporation. Holders of common stock exercise control by electing a board of directors and voting on corporate policy. Our only stock position is in American Capital Agency Corporation (AGNC). AGNC is a Real Estate Investment Trust (REIT) and as such is required to pay at least 90 percent on its earnings as dividends to its common stock holders. The dividends are often (depending on the price of the stock) 20 percent or more.

Exchange Traded Fund:

These funds (called ETFs) are listed and trade on stock exchanges, so they can be bought and sold during the trading day. They usually track an index, either holding the underlying stocks of the index or using derivatives to achieve the same returns as the index. They often trade at a premium to or below the true value of the underlying security or index. Currently, our only ETFs are ERX and TNA, which are the Daily Energy Bull 3x ETF (ERX) and the Daily Small Cap Bull 3x ETF (TNA). They seek daily investment results, before fees and expenses, of 300% of the performance of Standard and Poor's associated index. They seldom meet their stated investment objective; however, they have yielded significant positive results during our investment history.

Option (Stock or ETF):

An option is a privilege, sold by one party to another that gives the buyer the right, but not the obligation, to buy (CALL) or sell (PUT) a stock at an agreed-upon price (*Strike Price*) by a specific date (*Expiration Date*). For every option buyer, there is a seller and the seller has the obligation but not the right to sell (CALL) or buy (PUT) a stock at an agreed-upon price by a specific date. We transact option trades as sellers so we always have obligations not rights with respect to our option transactions. The price of an option has two components, **intrinsic value** and **time value**. Time value is the cash value of the time from now until the option's *expiration date* and will vary widely based on the volatility of the underlying security. Intrinsic value is the difference between the current price of the stock and the *strike*

price for *in-the-money* options, for *out-of-the-money* options, the intrinsic value is \$0.00. That is, there is intrinsic value for *CALL options* when the current stock price is greater than the *strike price*. There is intrinsic value for *PUT options* when the current stock price is lower than the *strike price*. For example: XYZ's current price is \$50 a share, a *CALL option* with a *strike price* of \$45 has an intrinsic value of \$5 and a *PUT option* with a *strike price* of \$60 has an intrinsic value of \$10.

Option Symbol:

All stock and ETF option have trading symbols and these symbols have a rigid format. It is very important that you understand what the various parts of the option symbol represents. The format is:

stkYYMMDDtSTRK

stk is the trading symbol of the underlying security, this will one to four characters in length.

YY is the YEAR of the *expiration date*.

MM is the MONTH of the *expiration date*.

DD is the DAY of the *expiration date*.

t is the option TYPE - C for *CALL options* and P for *PUT options*.

STRK is the *strike price* of the option – with decimal but only if necessary

For example -TNA140222C83.61 is a **CALL** option for TNA with an *expiration date* of **February 22nd 2014** with a *strike price* of **\$83.61**. Our broker, Fidelity, also places a “-“ in front of the option symbol to designate that the symbol is an option.

Strike Price:

All stock and ETF *options* have a strike price. It is the price that one party to the *option* trade agrees to sell the security to the other party.

Expiration Date:

All stock and ETF *options* have an expiration date. It is the date that the *option* contract expires and can no longer be exercised. The purchasing party has the right to exercise the *option* up to the options expiration date. All American *options* expire at noon on the Saturday after the third Friday of each month. Since the *options* market is not open on Saturday, the expiration really occurs at 4:00 PM on the third Friday of each month.

CALL Option:

The purchaser of a CALL option has the RIGHT to BUY 100 shares the underlying security (stock or EFT) at a fixed price on or before the *expiration date*. The seller of a CALL option has the OBLIGATION to SELL the underlying security (stock or EFT) at a fixed price on or before the *expiration date* if the buyer chooses to exercise the option. We are only sellers of CALLs when we own sufficient quantities of the underlying security to cover the potential CALLs

PUT Option:

The purchaser of a PUT option has the RIGHT to SELL the underlying security at a fixed price on or before the *expiration date*. The seller of the PUT option has the OBLIGATION to BUY the underlying security at a fixed price on or before the *expiration date* if the buyer chooses to exercise the option. We often sell *out-of-the-money* PUTs but we always maintain sufficient cash to cover any PUT that is exercised which would force us to purchase the underlying security.

Margin:

Buying on margin is borrowing money from our broker (Fidelity) to purchase stock, ETFs and *options*. You can think of it as a loan from Fidelity. Margin trading allows us to buy more stock than we'd be able to with only our cash. Our Fidelity account is a margin account. Normally, a margin account can borrow up to 50% of the purchase price of a stock; however, some of our securities are high risk and as such only allow 25% borrowing. When you sell stock in a margin account, the proceeds go first to the broker to repay the loan until it is fully paid then the remainder goes to the cash account. There is also a restriction called the maintenance margin, which is the minimum account balance you must maintain before your broker will force you to deposit more funds or sell stock to pay down your loan. When this happens, it's known as a margin call. Borrowing money isn't without its costs. If we use margin, we will also have to pay the interest on the loan. Therefore, our use of margin is mainly for short-term investments. Since we sell *cash covered PUT options* and maintain the cash to cover the exercise of any of our PUTs, we are never really in a margin position, however, there are occasions that if our cash covered PUTs were ALL exercised at the same time, we MIGHT use a small portion of our margin. Although it is theoretically possible, because our investment strategy, it is highly unlikely that we would ever have a true margin call.

Covered CALL Option:

PWIG only **sells** *CALL options* on securities we already own. That's called selling a COVERED CALL, so if the CALL is exercised we have the underlying security to honor the call. PWIG has a strategy to avoid losing a stock (to an exercised Covered CALL) that we really want to keep (see *Rolling Options* below).

Cash Covered PUT Option:

PWIG only **sells** *PUT options* on securities we would want to own AND have cash to cover the cost of the underlying security if the *option* is exercised (is PUT to us). Our PUT trades are called selling an *out-of-the-money* (see definition below) CASH COVERED PUT, so if the PUT is exercised, we have the required cash to cover the cost of the stock that is being PUT to us without borrowing cash from the broker. PWIG has a strategy to avoid getting a stock put to us when we don't want it (see *Rolling Options* below).

Rolling Options:

Rolling an *option* is a single transaction that buys back an existing *option* and sells the same number of contracts of an *option* with a later strike date. From time to time our *Covered CALLs* and *Cash covered PUTs* are in danger of being exercised when we do not want that to happen. When this occurs, as we approach the *options expiration date*, we try to buy back the exposed *option* and sell a new *option* on the underlying security with a more favorable *strike price* and a future *expiration date*. For example, let's say we own 300 shares of XYZ that we bought for \$50 a share and sold 3 covered \$55 CALLs with an *expiration date* that is now less than one week away and we really do not want to sell XYZ at this time. However, the current price of XYZ is \$60 a share. We may be able to buy back the \$55 Calls for \$6.00 each and sell 3 *covered CALLs* with a *strike price* of \$59 and an *expiration date* one month from now at a price of \$7.00. Our net income is only \$300 (\$7.00 minus \$6.00 times 300 shares) on stock that cost us \$15,000 and after commissions, our *premium profit* is less than 2% for about 30 day, however, the increase in the *strike price* of \$4.00 per share will produce a *potential profit* of \$1,500.00 (\$1,200 plus

\$300.00) if the price of XYZ stays where it is at the time of the “roll” transaction. This is about 10% profit in about 30 days, that’s over 120% annualized!). We use a similar technique for our PUTs that are exposed to exercise.

In-The-Money Option:

Any *option* that is in danger of being exercised is an “in-the-money-option”. That is, a *CALL option* that has a *strike price less* than the current price of the underlying security or a *PUT option* that has a *strike price greater* than the current price of underlying security. In the past we have, on rare occasion, used in-the-money *cash covered PUTs* to **buy** stock.

Out-Of-The-Money Option:

Any *option* that is NOT in danger of being exercised is an “out-of-the-money-option”. That is, a *CALL option* that has a *strike price greater* than the current price of the underlying security or a *PUT option* that has a *strike price less* than the current price of underlying security. We generally sell out-of-the-money *covered CALLs* with the hope that they are *in-the-money* at the *expiration date*. We generally sell out-of-the-money *cash covered PUTs* and hope they will still be out-of-the-money at the *expiration date*.

LEAPs:

LEAPs are *options* with a longer time horizon (normally one year or more) with a January *expiration date*. Most optional securities have *options* with one or more LEAPs available. We normally hold one of more *cash covered PUT* LEAPs in our account at all times.

Premium Profit:

In our monthly report, we list all transaction that occurred in the prior month and we use the term “Premium Profit” that is calculated differently for *CALL options* than *PUT options*. For *CALL options*, the premium profit percent is calculated by dividing the *CALL option* premium by the actual cost of the underlying security. For example, if an option with a *strike price* of \$50 is sold for \$2.50 and the price we paid for the underlying stock was \$40 then the premium profit is $2.50/40$ which is 6.25%. For *PUT options*, the premium profit percent is calculated by dividing the *PUT option* premium by the strike price. For example, if a *PUT option* with a *strike price* of \$50 is sold for \$2.50 then the premium profit is $2.50/50$ which is 5%.

Potential Profit:

Potential profit is based on the best possible outcome which again is calculated differently for CALLs and PUTs. For *CALL options*, the potential profit is calculated by adding the *option* premium to possible profit (or loss) on the underlying security if the *option* is exercised (*strike price* minus the original stock purchase price) divided by the original stock purchase price minus the *option* premium. For example, for a stock that was originally purchased for \$40 with a *covered CALL* with a *strike price* of \$50 and a premium of \$2.5, the potential profit would be $(2.5 + 50 - 40) / (40 - 2.5)$ which is 33.3%! For *PUT options*, the potential profit is calculated by dividing the option premium by the *strike price* minus the *option* premium. For example, if a *PUT option* with a *strike price* of \$50 is sold for \$2.50 then the potential profit is $2.50 / (50 - 2.5)$ which is 6.67%.

Annualized Profits:

Annualized profit is calculated the same way for both *CALL* and *PUT options*; we multiply the *potential profit* by 365 and divide the result by the number of days to the *expiration date*. For example, if the *potential profit* is 2.5% and the *expiration date* is 31 days away from when the *option* was sold, then the annualized profit is $2.5 * 365 / 31$ which is 29.4%. We use this calculation to help determine whether or not a transaction will meet our goal of 20% per year return on investment. For roll transactions where we pay more to buy back the purchased option than we get from the sale option, we combine both option transactions and use the transaction date of the original option sale to compute the annualized profits.

Roll Profit Percent:

When we roll options and we are able to buy back the original option for a price less than we sold it for, we calculate the profit for both the buy-back options and the sale options as separate transactions. For the buy-back option we calculate the percent profit by subtracting the original option premium from the sale premium then divide that by the original option premium. For example, if we bought back an option for 0.10 that we originally sold for \$1.00 then the profit for this option is $(1.00 - .10) / 1.00$ which is 90%. For the sale side of the roll transaction, we calculate profits the way we normally would for either the *CALL* or *PUT options*. When we roll options and we are not able to buy back the original option for a price less than we sold it for, we calculate the profit for both the buy-back options and the sale options as a single net profit. For *CALL options*, this is a more complex calculation; we compute the numerator of the percent calculation by subtracting the *strike price* of the original *CALL option* from the *strike price* of the sale *CALL option* then add the option premium from the original option sale to the option premium from the sale of the rolled option and subtract the premium that we paid for the buy-back of the original option. The denominator is the original price we paid for the underlying security.

PWIG Investment Strategies

Using Cash Covered PUTs to Purchase Stock:

It is possible to purchase stock by selling PUTs. When we want to buy stock, it is often better to sell an *in-the-money* PUT at a *strike price* above the current selling price. We only do this for stock we **want** to purchase at today's market price but would like to pay less than the current market asking price. We do this by selling the nearest term *PUT option* at a *strike price* slightly higher than the current price. Since the *option* is *in-the-money*, the intrinsic value will make the premium greater than the *strike price* minus the current price, which means the buyer is paying us more than the difference between the *strike price* and the current market price. For example: let say we want to buy 300 shares of XYZ at the current market price of 50. So we sell 3 *PUT options* with a *strike price* of 53 and the nearest *expiration date* for \$4.00. We receive \$1,200 for the **obligation** of buying XYZ at \$53.00 per share by the *expiration date*. If the price of XYZ is greater than 53 on expiration day, we just keep the \$1,200 that the buyer paid us but we do not get the stock. However, if the price of XYZ is less than 53 on expiration day, we will be forced to buy the stock for \$53.00 at a total cost of \$15,900 and a net cost of \$14,700 (\$15,900 minus the \$1,200 we received for selling the PUTs). That is \$300 less than we would have paid for XYZ on the day we sold the PUTs! We have used this approach on several occasions.

Using In-The-Money Covered CALLs to Sell Stock:

There are times when we may want to sell stock we hold but do not need all the cash immediately. We can sell an *in-the-money* CALL with a *strike price* lower than the current market price and receive more money than if we just sell the stock today at the current market price. We pick a *strike price* that we feel will be lower than the market price on expiration day, otherwise we will keep the stock (but we also keep the money we received for selling the *option*) and that was not our original intention. So we really need to pick a *strike price* below the price we expect the stock to be selling at expiration day – the best price is a price where we would like to buy back the stock if it fell to that price. For example, you own 500 shares of XYZ that you paid \$50 a share. XYZ is now at \$60 (it's all time high price), it is January 25th and you think the stock price will decline to \$57 before mid-February. You need \$2,000 to buy some other stock so you sell the February \$56 CALL for \$4.50 (\$4.00 intrinsic value and \$0.50 time value). You receive \$2,250 for the transaction and now have the cash needed to pay for your stock purchase – you also still have the 500 shares of XYZ but you expect to lose them at the February options *expiration date* if the price of XYZ is above \$56, however, you will keep the stock if XYZ closes below \$56. If you really don't want the stock at all, instead of selling a February \$56, sell a February \$50 for about \$10.25. This is a much deeper *in-the-money* CALL and will almost certainly be exercised on or before the *expiration date*. If the options are not exercised, you will still keep the shares.

When and Why we Roll Covered CALLs:

When we own a security that is exposed to a *covered CALL* and the security is rising in price we may want to keep the security. We originally sold the *covered CALL* expecting the price of the security to be slightly lower than the *strike price* at the *expiration date*. Often we underestimate the increase in the price of the security and we are about to have the *covered CALL option* exercised. We really don't want it exercised because we will just have to buy back the underlying security at a higher price. When this is about to happen, we roll the original *covered CALL* one or more months forward and increase the *strike price* if possible. We do this by buying back the original *covered CALL* (sometimes at a loss from what we sold it for) and selling a new *covered CALL* with a future *expiration date* and a higher *strike price* (if possible). Keep in mind, a portion of both *option* premiums are intrinsic value which is the same for both the buying and selling *option* – so a portion of the *option* premiums is a wash. We normally get a very small net premium for the roll transaction but when we add in the additional *strike price*, the total profit can meet our target of 20+% annually. This approach allows us to keep the underlying security while maintaining our profit goals.

When and Why we Roll Cash Covered PUTs:

When we have sold an *out-of-the-money cash covered PUT* on a security that has dropped in price below our *strike price*, we are exposed to being forced to buy the underlying security at a price that is higher than the current selling price of the underlying security. This is a *cash covered PUT* that is going against us. When this occurs, we roll the PUT forward and down if possible. That is, we buy back the exposed PUT (sometimes at a loss) and sell a new *cash covered PUT* with a future *expiration date* and a lower *strike price* (if possible). A portion of the *option* premiums is the intrinsic value which may be the same for both the buying and selling *option* – so all or a portion of the *option* premiums may be a wash. We normally get a very small net premium for the roll transaction but with the lower *strike price*, we reduce our exposure to loss. This approach also lowers the cash required to cover any potential PUTs.

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