

The Farmer's Story:

A strategy to reduce risk and increase cash flow



You worked hard for your assets;
now make your assets work hard for you!

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Foreword

More than 25 years ago, I was in San Francisco at a meeting of 300 or so financial planners, and because in their eyes I was an expert in the beginning of what has become A Farmer's Story, I was asked to address the crowd and discuss how it works.

My little talk was well received and I got a lot of compliments on it, but back then this strategy was hindered by high trading costs, as well as legal hassles.

Wow, have times changed! Not only have the hurdles to this concept disappeared, but at the same time it's being used and bragged about by some of the biggest names in the investment world, including none other than Warren Buffett himself.

This strategy provides a stream of cash. This cash flow is based on assets which you already own but perhaps, aren't using to their maximum capacity

I will show you how to use call options to generate cash flow and hedge the values of your stocks, mutual funds, variable insurance contracts, businesses and commercial real estate.

I made this incredibly short, so that you can get to the bottom of it very quickly. You can find a lot more information at www.your401kashmachine.com

Chapter 1

The Farmer

A farmer in the Midwest inherits a 10 acre piece of land from his uncle. He already has a farm, and this property is a little far from his farm, to be worth farming himself. He has no particular attachment to the property, but neither is he in any hurry to sell it.

He knows for certain that the value of the property today is \$1,000,000. This value is based on the appraisal needed when his uncle died, as well as on his own research. Due to the property's location, it seems likely that it may one day be suitable for a shopping center, apartment building, or some other commercial use.

Sure enough, soon after the farmer inherits the land, a shopping center developer approaches him and offers him the following deal:

The developer wants an option to buy the property at a later date. He will give the farmer \$20,000 today for the option to buy the land at any point over the following 2 years. The farmer will get to keep the \$20,000 even if the developer ultimately decides not to buy the land. If the developer does decide to buy the land, he will pay the farmer a set price, plus the farmer will keep the initial \$20,000 that he received up front. The set price the developer will pay for the property is \$1,250,000, or 25% more than our farmer knows the land is worth today.

The developer prefers an option to buy because he doesn't know for sure if he will be able to get the necessary zoning changes and financing that are would be necessary in order to build the shopping center. Maybe he will be able to get these things lined up, thus adding tremendous value to the property, but it's also possible that none of this will come through. He doesn't want to risk buying the land outright today for \$1,000,000 and get stuck holding a piece of land that he can't develop; if he can't develop it, the land is worthless to him. He would rather risk \$20,000 on the chance that he can get things to work in his favor. *Buying the option for \$20,000 is a gamble, but not as big of a gamble as buying the land outright today for \$1,000,000.*

So, if the developer ultimately buys the land, the farmer will end up with \$1,270,000. If the developer decides against the purchase, the farmer will end up with \$20,000, and still retains the million dollar property. Either way, farmer comes out ahead!

The question I ask you now is, "If you were the farmer, would you take this deal?"

Most people would jump on the opportunity to get that \$20,000 in hand today!

You probably don't have a million-dollar piece of land sitting around, but I'll bet you have assets such as commercial real estate, a 401(k), mutual funds, IRA's, variable insurance contracts, stock options or businesses. I'm going to show you how you can use these "assets" to produce a stream of cash, without actually touching the assets themselves!



Chapter 2

Using Your Assets as a Cash Machine

If you have assets such as those described in Chapter 1, there are “developers” looking for you, and they want to give you about \$20,000 for each \$1,000,000 worth of exposure to the S&P 500® index¹ that you have in those assets. Your assets are the “land,” and the “developers” will gladly pay you for the growth in that asset above 25%.

It’s a little different from the farmer’s deal, because these “developers” won’t actually buy the land (your assets) itself; rather, they just want a chance to get some of the value increase from it if the markets go up significantly. They will pay you money today in exchange for that chance. This type of transaction is referred to as “selling call options”

What does this mean exactly? While the numbers are estimates and can change with the markets, here’s an example:

Assume, you have assets that are worth \$1,000,000 today and they’re invested in the S&P 500®.

You can sell a call option (i.e. accept the developer’s deal) for about \$20,000². If the S&P 500® index rises more than, say, 25% during a specified time period, let’s say 2 years, you will have to give the buyer (“developer”) an amount equal to the increase in value above that 25%.

Note: It doesn’t have to be 25%, and the time frame doesn’t have to be 2 years. Each of these variables can be set higher or lower, but 25% and 2 years match with our farmer’s story.

¹ The S&P500® is used as a common example of exposure to the stock market; however, other indexes can be used too.

² The exact amount of money you will receive will vary, of course. To verify, call up your investment pro and ask them to quote the SPY call options 2 years out and 25% out of the money. The money you would get if you sold the calls at that quote should come pretty close to the \$20,000. You will need a brokerage account to do this, which will need proper collateral and approvals. The SPY is one of those new fangled things called an ETF or Exchange Traded Fund. The SPY changes in price with the S&P500®. You sell the call options against that, which represents assets you own and your exposure to the S&P500®. Don’t be greedy; use a pro to help you.

To put this example in some actual numbers let's say, the S&P 500® has risen 30%. Your assets are worth 30% more or \$1,300,000!

Because you sold the option, and unless we use a technique to stop it you will owe the buyer of the option an amount equal to the increase in value over 25%. Since $30\% - 25\% = 5\%$, this means you will owe an amount equal to 5% of \$1,000,000, or \$50,000.

"Now wait a minute, Charlie," I can hear you saying, "Why in the world would I sell an option like this if it means I might have to pay out thousands of dollars?" First, let me show you a couple of possible scenarios:

1. The S&P 500®, and the value of your assets, might not go up at all within the 2 years. In fact, they might go down. Guess what? You'll still have the \$20,000.
2. The S&P 500®, and the value of your assets, might stay roughly the same within the 2 years. Again, you'll still have the \$20,000.
3. The S&P 500®, and the value of your assets, might increase 3%, 5%, 10%, 18% or even 25%. You'll still have the \$20,000, AND the value of your assets will have grown with the market!

Go back for a minute, to the initial example in which the value increased 30%, and you thus owe \$50,000. Guess what? You're still way ahead:

- Your value of your assets increased approximately 30%, from \$1,000,000 to \$1,300,000.
- You also have the \$20,000 you received when you sold the call option.
- Combined, that means you have assets worth around \$1,320,000. So you pay the \$50,000 and are left with \$1,270,000, an overall gain of 27%, or \$270,000. I don't know what that conjures up in your mind, but I can't help but think of the infamous Charlie Sheen quote, "WINNING!!"

"Ok, Charlie, I see that, but I'd really just rather have the value of my assets go up to the \$1,300,000, and keep ALL of that gain, and forget about the \$20,000," you say.

My answer to that is this: Sure, that sounds good. Forget about selling these calls, and just wait for the market to rise more than 25% and come out ahead. But remember the first two scenarios? The ones in which the market goes down in value, or remains static? In cases like that, the \$20,000 is free money! And what about the third scenario? The one in which the market goes up, but to a level less than or equal to the strike price? You'd still be up \$20,000 (plus the increase in the value of your assets), without having to pay anything out.

The only time you potentially have to pay anything out is if the market goes up more than the 25%, but we have some really cool ways we can avoid paying out even then. I'm going to talk about that in the latter half of Chapter 3.

So right now, this may be sounding too good to be true. You're probably thinking, "Who in the world would pay \$20,000 when I sell a option like this, when the likelihood that they will ever receive a payout is very low? They'd just be throwing their money away and that's stupid!"

Good point! But let me tell you about a little town out west. You may have heard of it. It's called Las Vegas.

Chapter 3

You own a casino!

Las Vegas. “Sin City.” It’s the city made famous for its neon-lighted strip, feathered showgirls, and all-you-can-eat buffets. Oh, and don’t forget the gambling. From penny slots to high stakes poker, and blackjack tables by the thousands, in 2010 alone, the casinos on the Las Vegas Strip won \$5.7 billion³.



Intuitively, every gambler who heads to Las Vegas -whether it's a blue-haired grandma with a roll of quarters for the slots, or a celebrity with a million dollar a year poker addiction- knows the odds are stacked against them. They know the odds favor the house. They know at the end of the night, the casino will be the big winner. They know that despite winning a couple of hundred bucks occasionally, their lifetime total has them way down in the hole. In short, they know they will lose.

And yet.....they continue to play the game. Why? Because hope springs eternal. They think, maybe, just maybe, THIS will be the trip when they come home a big winner. It happens, right? Everyone knows someone whose neighbor's brother's mother-in-law dropped a quarter in a slot machine and came home with \$10,000! Wait. Stop right now, and re-read the first paragraph at the top of this page; the one that says in 2010 the casinos on the Las Vegas Strip took in \$5.7 billion in gambling revenue.

³ Check out the “net wins,” that’s how much the Casinos take in after they pay the gamblers
<http://www.americangaming.org/industry-resources/research/fact-sheets/top-20-us-casino-markets-annual-revenue>

The fact is, people throw away **billions** of dollars every year in exchange for a chance that they might get lucky and be one of the few who comes home with a little more in their pocket than they started with.

Much like the gamblers who go to Las Vegas or Atlantic City, there are gamblers who buy the calls I described in chapter 2. They know the odds are stacked against them, but as long as they have a theoretical *chance*, they will play the game. Maybe they crave the thrill of it all, and the adrenalin rush. Maybe they are know-it-alls, convinced that they KNOW what the market is going to do. But really, who cares why they do it?!

The point is that they are out there, they have money, and they want to visit *your casino* and put their money on the table! (Yes, you have a casino! Stay with me and I'll explain)

Now, let me back up a minute and clarify something. Las Vegas is all about gambling, but I need to make sure you understand just who it is that is doing the gambling. The owner of the casino is not the gambler. The odds are in his favor, and history has proven that over time, the casino will take in far more than it ever pays out. And on the off chance that someone gets on a really hot streak and continues to win BIG, the casino can opt to end the game, and send him on his way. They have the right to do that, and they exercise that right when necessary.

You are an investor, not a gambler. You are the owner of your casino. Your assets are the casino, and you sell call options to the gamblers. They give you money, and most of the time they lose, flat out. They pay you for the call, and the market drops or remains static, or goes up but doesn't reach the strike price. You win, they lose, plain and simple. As the holder of the assets, you own the casino, and when the call expires worthless, you are counting your money, and the gamblers are looking for the next opportunity to throw some money at a chance of gaining something.

Kicking the Gambler Out of the Casino

So what happens when the market is rising and it looks like it might just rise above the strike price? In our earlier example, that would mean an overall rise in the S&P 500® of 26% or more. You've sold to someone else your growth above 25%, and while you'll keep the \$20,000 you sold the call for, it looks like the gambler might win here. Let's take action and make sure we don't actually have to pay out any of our profit to them.

As mentioned earlier, if you own Caesar's Palace in Las Vegas and some gambler starts winning all the time, your pit boss is going to summon some really big guys from your security team and ask that gambler to leave. (Although they really aren't asking him, they're telling him!)



Likewise, we don't want winning gamblers in your casino; after all, you're an investor and the whole point is to make money. If 75%⁴ of the options expire worthless, that means 25% don't, and some of those might cost you money. We want to avoid losses if we can, and here is how we do that:

When it looks like a gambler's bet (the call option he bought from you) is going to pay off, it's your job (actually it's our job, if we are in charge!) to cancel that bet. You are not running your casino to lose money. This is not a charity.

So the markets are going up, the mutual funds and stocks you own are moving higher, and perhaps the overall value of your assets has never been higher. Keep in mind that in the grand scheme of things, this is what you want!! You want the value of your assets to rise higher and higher and higher, so that you can ultimately fulfill

⁴ For a study that confirms this 75% figure go to:

Do Option Sellers Have a Trading Edge?

by John Summa, CTA, PhD, Founder of OptionsNerd.com and HedgeMyOptions.com

<http://www.investopedia.com/articles/optioninvestor/03/100103.asp>

your retirement dream of living on a sailboat in the Bahamas, sipping drinks out of a coconut!

So let's cancel the bet. It's pretty simple, really. These calls are not actually person-to-person transactions; they're all sold electronically to anonymous buyers. To buy one back, get on the computer and buy it back. The transaction is over. The gambler can go play in someone else's casino.

Yes, I know, you have a big question: "What will I have to pay to buy back the option? And where will I get the money, because I already spent the \$20,000 on a down payment for my sailboat."

First of all, it's likely that you will not need to give the \$20,000 back; that's why this is so powerful. 75% of these options expire worthless. Those are better odds than the casino gets and they are pulling in billions.

There are three possibilities:

1. You can buy the option back for less than you sold it for.
2. You can buy it back for the same amount that you sold it for.
3. You have to pay more than you originally sold it for.

Obviously, we like the first option best, right? Because we still come out ahead. WRONG! I like option #3 best, because generally speaking, it means the value of your assets has gone up in value a lot, and quickly too, and that means your financial future is on the right path!⁵



⁵ Buying a call back for more than you sold it for means you will have a tax loss on that transaction. The CPA in me tingles at this!

So maybe you really didn't spend the \$20,000, but it's tied up in another investment, and you need to figure out where to get the money to pay for the options that we are buying back. What's important to understand is that the value of these options is all about the time that is left on them. The less time remaining, the less they are worth. If the market goes up a lot, sure, they will be worth more than what we sold them for. After all, the index may be up 20% or 25% since then! But with every day that goes by, they become a little less costly to buy back. That's the nature of a wasting asset. Like lettuce in the refrigerator, these options have a limited shelf life.

And as time passes in this story of success, new options are being created at the new higher strike prices as the S&P 500® goes higher. So we buy back the ones that represent the 25% growth, and then sell more of them, with more time on them, going up another 25% or whatever strike price we can get. Each market is different here, so there are no promises that you can always sell more options to pay for the ones you are buying back, but it usually works that way.

We have even more choices on how to deal with an up market. That growth gives you the ability to sell more options, and hence gives you more money to use to buy back the call options owned by the gambler you kicked out. Or maybe you now have other items against which you can sell options. You are running a casino and just kicked out a player that was about to cost you money, so you can now let in another player, or several players, to make up what that winner may have taken with him. Just like in a real casino where the gamblers are all playing different games, your gamblers don't have to play the same games (i.e. buy the same options) either.

In Las Vegas, the casinos just want people to play, because in every game offered there, the odds favor the casino.⁶ The more the gamblers play, the more the casino wins. In our game we win 75% of the time. Those are pretty good odds!

Our farmer back in Chapter 1 would have been very happy to let his farm go at the agreed upon price of \$1,250,000 if the developer executed his option to buy. It's much the same here; your assets have increased in value the same 25% that the farmer's land did.

Important note: The stories are a little different. The farmer would have had no choice; he would have to sell to the developer if the developer decided to buy. You have a choice, and we will use that choice, and do all we can to keep anyone from getting any of the appreciation above 25% from you. Also remember the farmer's deal involved potentially selling his actual land. You are just paying off

⁶ <http://www.insidervlv.com/casinooids.html>

based on the excess appreciation of your assets; you will continue to keep and own your assets no matter what.

So to summarize, even if you have to pay out on a call, or buy a call back for more than you originally sold it for, it means that the value of your assets has risen in value a lot. The market is up, and you are doing well overall, which is really the main goal for you.

But what about when things are not going well? The market is down, or maybe it's up but just a little, and the value of your assets is down or relatively static... what then? You still have the \$20,000, from selling calls, which you get to keep! And when those calls expire worthless, you get to start over, and sell another batch of call options...and get more money!

Chapter 4

Let's take it up a notch!

Let's review what we've covered so far, and then I'll show you how to take this concept even further.

- A farmer owned an asset- a piece of land. There was a chance the land would go up in value in the future, if various zoning changes and financing could be secured. A developer gave him \$20,000 to secure rights to buy the property for a set price for a period of time.
- You have assets. Again, this could include commercial real estate, a 401(k), mutual funds, IRA's, variable insurance contracts, stock options or businesses. These assets have exposure to the rise and fall of the S&P 500®. Assuming your exposure is \$1 million, a "developer" is willing to give you the same \$20,000 for the increase beyond a set point for a period of time.
- Your "developer" is essentially a gambler, and your assets are the casino. As the owner of the casino, the odds are heavily in your favor. As with a real casino, if it looks like the odds are turning in favor of the gambler, you can kick the gambler out of your casino.
- If the markets go down, stay the same, or go up but just a little, you are \$20,000 ahead. If they go up a lot, there may be a small price to pay to kick the winning gambler out of your casino, but you will still be ahead, due to the largely increased value of your assets. To recover the cost (and perhaps raise more cash) of kicking the gambler out, you can sell more call options to new gamblers.

Let's talk about how to take it up a notch. There's a different way of doing this that most likely increases your rate of return and lowers the risk even more.

The people buying the options (i.e. giving you money!) are gamblers and speculators, right? These people like quick action. They want things to move in a hurry. The markets in which we sell the options are based on supply and demand, so when there are more gamblers at the table, and they are all buying the same options, they tend to pay more for them. That's 'Economics 101' and it makes perfect sense.

Shorter Time Periods Yield Higher Annual Returns

It follows that options that are shorter in time and closer to the point where you might have to give up some profits (in industry lingo, we call that being "closer to the money") will likely be better for you. These options yield a greater expected annual profit, but expire in 30 days or so.

Here's an example:

Our farmer in Chapter 1 got \$20,000 for promising to sell his land for \$1,250,000 within 2 years. That's \$10,000/year, or a 1% extra return on the farm per year. Not bad, if you know anything about farms!

You can do the same plus or minus with your "farm" and get that extra 1% return. But if you let the gamblers place their bets on the short end you may get a much higher return. Instead of selling options that expire in 2 years with a strike price at 25% or higher, you can sell options that expire in 30 days with a strike price only 5% higher. You may get a much higher return this way, plus you are out of the game after only 30 days, meaning you can start over and collect new money every 30 days.

The downside to this is that because of the short time frame, we have to spend more time monitoring things that much more closely, *but that's all part of what we do for you!*

This is what the big boys do!

This whole concept might be a new idea for some people. Others may be happy to learn about recent changes that now allow us to separate the options from the stock or mutual funds that they represent, or the ability to sell the options against old-fashioned mutual funds. Either way, it's exciting stuff!

But the big guys know all about this. Case in point, let's look at the most famous investor of all time, the "Oracle of Omaha," Warren Buffett. He is probably the biggest player of all in this market.



Warren can do things that ordinary people can't. He can make very long-term transactions, and do so with huge amounts of money. For example, in 2007 he sold

options to a group of foreign banks and institutions and collected \$4.5 billion⁷. That's \$4,500,000,000. That's what he took in the door, and it's akin to the \$20,000 we will take in for you.

Now technically, what Warren does is a little different, because he is actually selling "puts" and that means he is "unhedged." When you sell calls, you are "hedged" (because you own the index via your ownership of your assets), and that means we are more conservative. It's not really necessary to get into the nitty gritty of the differences here, but suffice to say that Warren is doing what I'm talking about here. He is raking in the money up front in anticipation of the markets going higher.

He gets to use the \$4.5 billion anyway he wants, just like you do with the cash we take in for you.

Conclusion

This is a new way of getting a stream of cash from your assets without touching them.

We have showed you how to open you own casino and rake in the profits from losing bets from the gamblers out there. This can be done from home on your computer.

Of course, like any business you need rules and guidelines to tell you what to do when various things happen.

At my Investment advisory firm, Winning Points Advisors, LLC we offer a turn key solution to these issues and take on the management of your "casino" for you.

For more information please go to www.your401kcashmachine.com and click on: "More Information."

Should you choose to do it on your own, please do so with a slow start and after more reading on the subject .⁸

⁷ <http://news.morningstar.com/articlenet/article.aspx?id=285699>

⁸ <http://www.optionsclearing.com/about/publications/publication-listing.jsp>

Epilogue

What Will You Do with Your Cash?

Most people will take the money they get from selling call options and simply spend it; that's human nature. As with almost any source of "found" money, most people will adjust their lifestyle and spending to the increased level of income, or cash. They'll buy a bigger house or a newer car, or take a trip around the world. And if that's always been your dream, go for it. As the saying goes, "You can't take it with you," so spend it on something you've always dreamed of and don't look back.

Other people won't spend the option money, but will invest it. Ideally these will be investments intended to contribute toward their future. They might buy more stocks or use it to increase their retirement contributions. That's fine too.

Turning your Cash Flow into a Thing of Beauty

But if you want to do something truly powerful, something of significance, something beautiful, I suggest that you take this new stream of found money and use it as follows:

Take 10% of it, and give it away. Give it to your place of worship, give it to a bum on the street or leave \$100 tips at Denny's. Set up a 529 plan for a disadvantaged kid, or make anonymous gifts to a family or friend in need. In short, get it out there working again. In this wonderful country a small amount of money at the right time can change a person's life.

Take the rest of it (after you pay your taxes on it) and buy a life insurance policy on your life; buy a policy that has a lot of cash value in it, and that doesn't drop in value when the markets do. This will build a sizable cash stockpile that you can use when either good opportunities or challenges come your way.

The call options are the result of other people gambling, gambling that you are likely to profit from. Take the profits and put it in a place that is safe, a place where the earnings on it are tax-deferred, and a place where, when you die, your family will get a big slug of cash!

You may have learned in these few pages that the cost is virtually nothing, the process removes some market risk, and the rewards (of the life policy) are tax free, compounded and make you and your family stronger everyday. This is quite the exact opposite of what the gambler is doing to his family nearly every time he loses money wagering in Las Vegas or buying the options from you!

Statistically, you win, up front, and continue to win all through the process. You give back a 10% slice to someone in need or just randomly, then when the end comes for

you, you leave a big win behind for your family, all with virtually no cost and LESS risk.

That's why I call this a **beautiful** transaction! What do you think? If you have a better idea, one that's as opposite in risk, rewards and in the odds of winning as this one when compared to the gamblers, I would love to hear about it.

Drop me a line at: cstoll@thewinningpoints.com or call at (800) 950-9112

Disclaimers and Wisdom

All investing involves risks. The strategies described herein are crafted to increase your cash flow in all market conditions, including cash flow that is the result of but not directly from, the assets we speak of. While this strategy is crafted to outperform in most market conditions, it can underperform, in those markets that go up too far and too fast or when the strategy is halted before it can run its course, or the markets it takes to execute the transaction are inefficient or closed. All herein is based on normal times and conditions, although this strategy usually does some of its best work in lousy (down) markets.

No promises, warranties or guarantees of safety or of not losing money are expressed or should be implied. In fact the major premise of our description is that the investor has \$1 million at risk in the S&P 500®, and that is not without risk. This strategy will not offset the risk of principal loss on such an investment in the stock markets; rather it's an "add-on" to increase cash flow because of that risk.

In order to explain the concept simply, I have used analogies that in my opinion are accurate and fairly represent the transactions. If you take this strategy and amplify it, or set it up and ignore it, you will become the gamblers that we speak so poorly of. So don't do that. Use as directed. No overdoses. It's highly recommended that you have Professionals, like us, on your side for these transactions.

This strategy is not a portfolio management tool, but is intended to be a way of getting a little more out of our investment dollars without taking any more downside risk. Who doesn't want that?

This strategy requires a non-retirement account to execute the trades in. This account must have collateral of a certain size relative to the assets you own.

While we speak of the assets that you have as necessary for this strategy, a variable annuity or variable life contracts, stocks, mutual funds and any investment that you own, and benefit from the appreciation on, may qualify.

None of this is really new, the smart and big money have been doing this for a long time. However the low cost trades, and the higher volumes of the exchanges make it attractive for smaller investors.

Please read Characteristics and Risks of Standardized Options. Please check it out at <http://www.cboe.com/Resources/Intro.aspx> this material and supplements thereto are incorporated herein by reference.