Winning Points Advisors, LLC

Working for Our Clients, and Only Our Clients!

May the wind be always at your back….

--Irish blessing

This paper describes the design, psychological, structural and economic advantages that allow our index trading program to help the wind stay at your back.

Who doesn't want the wind at their back?

Ever been for a walk on a windy day and felt that wind push you a littler faster down the road, perhaps as you turned to return home and felt it in your face you realized how just a little wind, going your way, or against you, can help or hinder your progress.

In this article I want to describe that wind and the reasons why our options program by it's nature puts it on your back, making it that much easier to be successful.

Sure, we will still lose money in option trades from time to time, everyone does. But it's nice knowing that there are a few fundamental things making this the right place to be. Just because the wind is at your back does not mean that your journey is guaranteed to be safe, but, if we get nature blowing you in the right direction, the rest of the details just got that much easier- that's our intent!

We believe each of the items discussed here work separately and together to change the odds, or take advantage of structures that are out there to change the odds into your favor.

Dividends

When you own a stock you get paid the dividends. They are paid by a lot of the company's that we own, and that process works like this.

The board of directors declares a dividend to the owners of the company as of a certain date, lets say it's going to be a 50 cent dividend to owners of the company June 1st, . To be paid on June 15th.

The company transfer agent will sort out who owns all the stock on June 1st and cut them a check on June 15th. Sounds simple enough.

To do this, the company sets an ex-dividend date, it's this date that allows you to be on the company book on the record date. In today's system, for 2011 if you bought the stock on May 27th, the trade would settle and you would show as the owner on June 1st and get the dividend. But if you bought it on May 28th, the trade would not settle in time, and you

would not get on the books in time to be the owner, and so that date, May 28th would be the ex-dividend date. If you buy it on May 28th you will buy it "without" or "ex" the dividend hence the term.

So if you bought it on May 28th and didn't get the dividend it's not fair that you pay the same price as it closed at the night before, when if you have bought it then you would have gotten the 50 cent dividend. So when the stock opens for trading on the morning of 5/28 it will open 50 cents lower than the night before. This is to try to keep it all fair. For the people that own the stock before the ex-dividend their share price goes down, but they will get a check in the mail in a couple of week for that dividend, for the new buyers, they paid 50 cents less and get no check. That's how that works.

What then, does a stock paying a dividend mean to a guy that owns options on it, betting that the price is going up? The answer is it means that the stock opens lower by the 50 cents on the ex-dividend date and he needs that stock to move that much more, to make his options have any value. This is a real headwind to this person and as such is a automatic wind at our back, as the owner of the shares and being short the calls.

Suppose we sell calls expiring in one year at a price that's 10% higher than the stock is today (Say the stock is $100, we in this example sell the $110 calls, getting cash in today, and in exchange giving someone else the right but not the obligation to buy that stock from us at $110 for the year). If the stock also has a 2% dividend, which we collect, the stock then would have to go up more than 12% over the net year to make those option we sold worth anything to the gambler, which is how we refer to the buyer of the options.

This is one reason why of course, stocks with high dividends usually have lower option premiums.

The same holds true for the indexes as well. The dividend is a drag on the owner of the options and a breeze helping us.

We can sell calls on Indexes- Big News here: "Indexes don't get taken over"

Yes, one of the great days in a option buyers (gamblers) life is when a stock he owns calls on, gets taken over. His rate of return is huge, likewise for people like us who sell these calls , this means that we may have left some profit on the table. Sure we will still likely make money on the stock but not a much as if we had not sold the calls.

By trading options on indexes we miss most if not all of this. Indexes don't get taken over! Those traders just won't have that kind of huge win on their index calls, because no one can afford to take over the entire S&P500™ index or the other indexes we trade. There just isn't that much money out there. This is a huge wind at our back as for the index calls, as this isolated "take over" event can't happen here.

We get paid up front

One beautiful thing that a lot of people overlook in these transactions is that we get paid up front. That means when the transaction starts, meaning we sell calls in the clients account, the maximum profit for the transaction is sitting there earning interest or being otherwise put to work.

Perhaps it's only earning interest in a money market account, but it could be used to buy an insurance policy, pay off credit cards, go into a 529 plan or any number of other transactions which can take a relatively small sum today and leverage it , to accomplish some big dream later. Don't underestimate the power of compounding this cash flow. Albert Einstein defined compound interest as one of the most powerful forces in the universe. That's a heck of a wind at your back.

Options on indexes usually pay a lot more than on individual Stocks

When we sell option on the indexes we usually collect a lot more cash that we would if we sold them on the individual stocks that comprise the index. This is because of our gambling buddies out there, because the gamblers are usually playing the markets over all (and there is a 800 lb Gorilla in this market I will describe in a moment) the money they will pay us is much greater. Hence this is a nice wind at our back!

We get paid a premium above what the option is worth intrinsically.

This one sounds easy, but I see a second level to the issue. If we have this $100 stock and sell a call against it and collect $4 for the $110 call, we have protected ourselves against loss on the transaction not up to $110 but up to $114. That extra $4 we collect is in reality additional strike price that the gambler is giving us. They have paid it to us up front, this is money that offsets the downside, or we get to keep if the stock only goes up a little. It's a hedge against the down or sideways days months or years.

We are the beneficiaries of variable bet pricing.

This is a fun concept so stick with me on this. Basically what I trying to explain here is that, especially when it comes to index options we are using the very nature of humanity to our benefit.

A wager (a bet) can be placed in a variety of ways:

<u>Fixed Pricing/Fixed Return- Las Vegas Casinos Style-</u>

The odds appear to be consistent and the price of the bet stays the same. Ignoring card counting and your skill in the fine points of the game, when you play blackjack, you place the bet in the same dollar amount and the odds don't change. When the cards are going your way, the house can't reduce your payout, nor can someone else come in and

increase you wager against a fixed payout. In short no one has the opportunity of buying your seat from you and playing your hand when you get a "heater" going- the bets always cost the same. You bet in dollars and when you win you know how much the win will be, based upon the size of your bet. If you bet $10 and you win, you get back $20, not $30 not $300 and not $10.

Fixed Pricing/Variable payout- Horse Track Gambling

If you play the horses the size of the bet is fixed-- it's in increments of $1. But your winning payout changes based upon what amount of bets are placed over all, and on your particular winning "pony". If you win you may get paid 50 to 1 or only 3 to 2, this is called a variable payout. The more people think they know what the result will be, which is which horse will win, the more they are willing to bet on it and the less profit the winners will get. A sure thing, pays a lot less that a long shot. The horse track has their percentage built into totals they are taking no risk at all.

Variable Pricing/ Variable Payout

In our options "Casino" we have variable pricing and variable payout

When the gambler wants in he was to go to buy his bet at the market, which can vary greatly depending on the perception of the markets over a host of details, like interest rates volatility, what disaster is cooking that day in the media, but in the end it's supply and demand- the gambler is the demand and the more of these contracts he wants, and the more other gamblers are out there that want them too, as well as the number of sellers (us) that will determine the price. When the markets are going up and everyone is euphoric the cost of the bets expand greatly.

This is different than a $10 black jack bet that will either return $20 or $0, and its different that an bet at a racetrack where some computer somewhere determine the payout, this is supply and demand.

Because it's like that, distortions can and do take place which we are ready to take advantage of by selling calls into them.

One day a call on a index which that has 30 days to run, with a strike 5% out of the money might cost 50 cents, the next day, if just the tone of the markets change, it might cost $1. It's all about supply and demand. The gamblers and the house (that's us) making trades with no set price on anything, the aggressive gamblers out there put that price and hence our return up by competing with each other.

Likewise to the gambler, the payoff is completely unknown, the gambler does not have a clue as to how much he or she will make on the trade, and while they have a maximum loss which is equal to their investment, otherwise their results are unknown. In Vegas they win at Black Jack they double their money, in the option market they could make 10

times their money or only $1, or lose it all, it depends on when they sell those options they bought.

This means, that the enthusiasm confidence excitement of a bunch of gamblers who don't know the result can play into our hands. Unlike the casino, we can take the gamblers bets when he is in a state of euphoria and is paying up for the trade. A Las Vegas casino, will always sell the gambler his bet, deal him another hand of blackjack with the same published odds even when, if the game were structured differently he might be willing to "pay up" to play. For the blackjack players out there, the game could be priced better if the casino changed the payout based upon the number of face cards left in the deck, of course if they did a lot fewer people would play, as that knowledge might give certain gamblers an edge.

In our casino, that gambler can, and the market will force him to pay up to play when the game is "on". If he wants to buy these calls the market will tell him what they will cost.

As an example, in relatively quiet time earlier this year, our internal measurement of the profitably of options trades which we refer to as RoRE (return on risk exposure) which is simply a measurement of the cash we get in based on exposure we are writing calls against was at 2.5%. This means that we were taking in 2.5% (annualized) cash flow based upon the exposure we are writing against. That's pretty good and a solid reason to be doing this. Today however as I write this it's about 8%. This dramatic difference caused by gamblers bidding up these prices because of higher volatility. That is a huge difference, and illustrates the variable pricing. The gamblers are having to pay a lot more for the same bet as they did some months ago, this translates into use getting more cash in the door from the sales.

In Las Vegas regardless of the volatility (measured there by the number of face cards left in the deck) the bet would still cost the same, so if you can successfully count the cards in blackjack you are able to make bets that are way off the normal odds, that's why the casino doesn't like that!

In our business the bets often change in price a lot and we get the benefit.

If it's important and if we have the size we can get special income tax rates on these trades

Taxes, they one of the two things you can't avoid. Should the account be large enough and or the spread drag us there, by using a commodity index to write against, we can get 40% of the gain we generate taxed at long term capital gain rates. It's not a lot, but can help out.

We can select the taxpayer

This is a unique advantage to a program like our 401(k) Cash machine, as it seperates the seller of the option- being say our client in a joint account with his wife- from the literal owner of the underlying exposure – being the Clients 401(k) held at a NY trust company. Once the separation is done it's not a big deal to make the seller of the calls someone or something else that – might be in a lower tax bracket- might have a different sized estate- might be the recipient of the funds anyway, this way this cash flow might be sheltered from high income taxes, and high estate taxes. While this can get a little fancy, the wind at your back nature of it is dramatic as you might avoid income taxes altogether- A parent who is being supported by a wealthy child, a trust which gathers the money to buy a life insurance policy that pays the entire estate tax bill for the family… pretty powerful stuff, this wind can be a little strong.

Time-

Time destroys all things, especially option values.

When we sell an option, it has affixed finite life; there is a date at which time it doesn't exist anymore. The deal ends. There are only a few things in life where time is on your side, this is one of time. The buyer has to have that stock or index move in his direction in the described period of time, all we have to do is wait, and if the option gets to a danger point for us, react to it, if not then we just let time run out.

Alphas and Beta's

The term Alpha refers to the valued add that a manger has brought to a mutual fund. In short did he beat the indexes and by how much.

The term Beta refers to the volatility of a fund or stock, if the index goes up 1%, is this fund likely to go up 1% if it does it ahs a beta of 1 perhaps only ½ of 1% then a Beta of .5 or perhaps when the index goes up 1% this fund or stock will tend to go up 2%, it's beta would be 2.

As a reminder, we are selling calls against the index but own different funds/stocks which generally track the index but have more promise (we think) than the index does.

Many time the betas on our funds are over 1, meaning that they are more volatile that the underlying index. So if we determine that we have $1000 of expose to the S&P500™ and sell calls against that, and the fund we own that gives us that exposure has a beta of 1.5. Then if the index goes up 10% then our fund should go up 15%.

This means that while we have written calls on a $1000 exposure to the index we really have mathematically and all things staying equal a $1,500 exposure. This means that if the markets go up, we have yet another wind at our back- when you are selling short term options-as we commonly do and the stock /mutual funds we hold outperform the markets the portfolio comes out a winner as any upside taken away by the options should be

replaced by the amplifying beta. Of course, we do a great deal of work to try not go have the options cost us anything, cash wise, but the portfolio is still priced every month and when the market starts to get strong, those options will go up in value, it's nice to know that a high beta portfolio will help out.

Alpha are the key to life however, who really cares about the beta in investing, we want to beat the markets long term and that's what the Alpha measures. But like the beta the alpha says that over time, market ups and downs, that if our portfolio beats the indexes AND we have written calls against the indexes, that alpha is profit that is in the portfolio.

Most option writing funds, go out and by the index and then write the calls against it to generate extra return. This has two flaws from our perspective. First the upside of the assets is limited by two things- the assts will track the index, they are unlikely to beat it if the manager it trying for a match between what he is selling and what he owns. This means that the portfolio will have trouble doing any better than the index in the up years, because it is the index. More, if there are really big up years the portfolio will run up against the strikes on the calls he sold and stop going up from there.

We attack this challenge on two different levels. First we build our portfolios first, without regard to the option ability of the holding or a perfect match to an index. So hopefully, our portfolios do better than the indexes, or at least they can be designed to try to do better. Next we sell short term options against the exposure, not a covered write. We believe that this combination is great, giving us the highest RoRE but also the best portfolios. Time will tell.

Don't miss out on Alpha!

Expenses in the ETF's work in our FAVOR!

The Exchange Traded funds (ETF's) we write the calls against (we don't own them) and against the prices of which the call prices and value are being valued have expenses that the indexes don't.

I bet you never thought you would hear us say the fund expenses are a good thing. These expenses, like the dividends, reduce the ETF's performance, which keep it, just a little more out of the money. The gamblers don't care much about this as they are often in an out of the these trades on a day to day or even minute to minute basis. We care because we are usually in there. Over time, this can help out, a little. This is probably the smallest wind at our back, but let's not ignore it.

If the S&P500™ goes up 20% in a year and the index we are selling calls against goes us 19.75% that means that the calls we have sold should underperform the index calls by the .25%, that profit over time, should be ours, in higher capital gains.

There's a RICH and hungry 800 pound gorilla in the room and you have his banana's! What will you charge him for the food he must have?

This perspective it turns out, is news to some.

We have been watching it for a couple of years now and think it's a big part of the future and a big reason why we must execute on this type of strategy. This one may not be a wind at your back but a rising tide that wants to lift your income and cannot be denied.

I need to tell you a little history-

Way back in 1995 some really brave and smart guys in Iowa came out with a new product class. It's called a fixed index annuity, and basically it's an insurance contract for conservative money-

You put you money in a insurance policy and they pay you interest based upon how the stock market does. But they don't pay you negative interest. So you can't lose money during market declines. But they don't pay you interest on all of the profits either. Pretty cool, you can get some of the upside and none of the downside. Popular as you can imagine these days.

The insurance companies do this by using options. They take the money the buyer gives them, and buy bonds with it. They use the interest off the bonds to buy options to provide the upside to the contracts. They couldn't take the money and invest it in the market, as that would leave them holding all the losses and having to give away some of the profits. That's not how insurance companies operate.

Since 1995, the total amount invested in this type of contract (now joined by Indexed Life insurance) is approaching $1 Trillion.

The interest on that is close to 5% a year. This means, in round and perhaps slightly high numbers, but more money flows into these thing every day, that perhaps $50 Billion a year of money is flowing into the options markets to let these fixed index annuities do their thing.

That interest or a large part of it, must flow into the options market is one way or another to give the insurance companies the profits they need to pay the gains to the policyholders. The insurance companies can't gamble with this, this is an ongoing thing. that as long as there contract stay in force will continue.

The insurance companies don't really care if the options make money or not, as low as if when the market goes up there is enough money there to credit the interest to the policyholders. If the market goes down and all the options expire worthless, that's ok,

they will buy more next year with the new interest money they have collected off the bonds.

Bottom line: for the foreseeable future, we have a huge buyer of options that is not so concerned about the price of the options. Hence it's logical to believe, given this new player in the options markets that the prices and premiums we will enjoy on sell those calls will be high for a good period of time.

We will help feed that 800 lb gorilla by selling him expensive options all day long.

In Summary

We find a number of winds at your backs when we sell these calls.

Dividends- they automatically make it harder for the option buyer to win and hence increase the odds that we will win.

Indexes don't get taken over- by selling the options on indexes we can avoid the possible takeover a stock we sold calls against- this means a smoother ride

We get paid up front-by generating that cash up front we hedge the portfolio and open the door to other good things-

Options on indexes usually pay a lot more than on individual Stocks- there a bunch fo reasons why but not of them are bad, this is where the action is.

We get paid a premium above what the option is worth intrinsically. This offsets risk.

The options we are selling are variable priced and variable return gambles for the other side, this means that we can profit when the unbridled enthusiasm on the other side of the trade pushes the price up on these transactions.

We might be able to get some of the profits on the transaction by using commodity indexes which are taxed in part as long term capital gains.

We can select the taxpayer with a little planning we can send the profits to someone in a lower estate, lower tax bracket, or some other strategic structure.

Time is on our side- the option has a finite life, the risk belong to someone else- each day that goes by is generally good for us.

Alphas and Betas- the flexibility of our process all the portfolio to be built any way that's best and then hedge it, instead of the other way around.

There is a rich and hungry gorilla in the room who is likely to push option pricing higher (and hence our returns) regardless of the dynamics of the marketplace- the gorilla is huge now and growing every day.

All this adds up to a lot of tailwinds, some can be quantified others not, but in looking at the list it's easier to see why we are excited about this process and what it can offer in the way of cash flow, hedging, other strategic alternatives, and just general risk aversion, but without interfering with our basic portfolio design.

None of this eliminates risk, or provides any guarantees or promises of success, either in option trading, hedging or your general portfolio.

Thanks for wading though all the logic, next time you feel a breeze at your back, think of all this and enjoy it! (And be glad you don't have to read it again and there is no TEST!)

Questions? Comments? Suggestions?

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