

TRANSCRIPT

## Managing option positions and post trade evaluation

*Presenters: Konstatin Vrandropulo & Edward Modla*

Konstatin Vrandropulo: Hello. Big welcome to everyone in the audience here today. I know that there are thousands of you signed up for this event. Ed and I very much appreciate you, of course, taking your time to join us. We're excited for the next effectively three hours that we're going to be spending with you.

[00:00:20.50] This is a three part event. Part one just started, of course, Managing Option Positions and Post Trade Evaluation. I want to say this, we have prepared pretty well for this event. We have a few things that we find beneficial as traders and investors ourselves. We want to make sure that we make it as impactful for you as possible. So relating to both education as well as trading decisions and some personal experiences. Stay tuned for those.

[00:00:56.71] Of course, if you've signed up for this event, understand that there are two other parts. There's still time to sign up for the rest. They were dedicated to sort of flow in sync with each other, one after another. We would be glad to have you.

[00:01:13.39] A little bit about myself. My name is Konstantin Vrandropulo. I am a Trading Strategy Desk Specialist here at Fidelity Investments. I have over 10 years of experience with the firm. Very excited to be here.

[00:01:26.18] What I and my colleagues do on the strategy desk is, of course, work with self-directed investors. We provide insights and analysis into markets. Markets of all kinds, by the way, equities, fixed income, derivatives markets, effectively what we're here to discuss today.

[00:01:47.18] So I'm looking forward to sharing my expertise with you, talking to you through the prism of Fidelity tools and resources as our special guest here today Ed Modla is going to be sharing his know how about what we're here-- what we've gathered here today to discuss.

[00:02:06.46] If you're interested in additional work that we do here on the strategy desk, you can always find all the details by going to [fidelity.com/coaching](https://www.fidelity.com/coaching). Ed, I'm very excited to have you back. We've worked together before. Looking forward to what you have in store here for us today. Welcome in. Please take it away. Tell us a little bit about yourself.

**Ed:** Sure. Will do. Thanks, Konstantin and to the Fidelity team. It's great to be here.

Name's Ed Modla. And it's hard to believe but I'm going on 26 years in the options business this year, starting from back in 1997 in the trading pits, on the trading floors in Chicago and New York as a professional options market maker for a number of years.

[00:02:47.81] I also spent some time as a broker in the futures and options on futures business. But now almost nine years working for OCC, that's the Options Clearing Corporation, in their investor education department. What we do is provide free education about exchange listed options to anyone that wants to listen and to learn. That's individual investors, financial advisors, money managers, professionals in the community, and anyone else that would lend their ears to us.

[00:03:15.79] So as Konstantin says, super excited about today. We're going to start with managing positions, post trade evaluation. We're going to discuss strategy also in this first session. And I hope everyone can stick around for all three because we're also going to get into pricing factors, Greek exposures, and then further strategies in session three. So a lot of bases that we're going to cover here today.

[00:03:36.26] Let's get going into session number one here. First, a few disclaimers from our side, and then the outline. We're going to say a few words about entering positions, monitoring them, and then managing them.

[00:03:49.81] And then outline for this first session a couple of strategies that involve a stock position. And talk about not only how they're constructed, but a little bit on the management technique side. What choices are available to investors when they have on a covered call position or a stock repair position.

[00:04:08.86] We'll define those, outline their risk structure, and then talk a bit about how they're monitored moving forward. Before we get into this outline, I do want to spend a minute to reflect on where we're at as an industry. This is annual options volume year by year. Information derived from the Options Clearing Corporation, starting from back in the year 2000. Billions of contracts here on the left side.

[00:04:34.19] And as you can see, the steady increase in volume over the years since 2000, followed by really a consolidation of volume around this 4 billion per contract-- 4 billion contract per year level during a period-- for those of you that remember-- was very low volatility, 2010 to 2017, with a slight exception

of 2011. Extremely low volatility levels. But this industry maintained strong in its historic volume levels.

[00:05:03.78] Then elevated volatility, 2018, '19. We all know what happened in 2020.

The explosion, and by far setting volume records in 2020. And to some people's surprise, that has continued. Another record set in 2021 and yet another one in 2022, eclipsing 10 billion contracts cleared over the course of that year.

[00:05:27.42] A few observations about this. Where we stand we have seen some evolution, particularly last year, with volume being geared more towards short-term options. We're seeing a lot more activity in the short end of the expiration curve versus the longer end.

[00:05:44.70] And also fairly interesting, we've seen in 2022 a decrease in equity options and an increase in ETFs and index options volume. If you're looking at this chart here, OCC has equity in blue. This actually includes ETFs. And that's because both equity and ETF options are physically settled contracts. That's a way to state that they settle into physical shares. So that number is mingled here on the graph.

[00:06:17.98] But if you extract that using other data, it's interesting to note equity volume declined last calendar year, while ETFs and index volume increased. And I just looked up earlier this week to see where we're at.

[00:06:31.17] In January 2023, we had 919 million contracts cleared for the month.

That comes out to an average daily volume just shy of \$46 million contracts per day. 3.1% higher than January of 2022. This industry continues to be resilient. Everyone's wondering when this volume explosion will top it all off. We just haven't seen it yet. And so the industry is in an exciting time. Glad to have you here with us today.

[00:07:02.12] So let's start by taking a look and reflect back at where option strategies come from when you make that decision. What is some of that process that many investors undertake. And here the first thing to note is planning a trade and developing a forecast. I often say that there's not such thing as a best options strategy or one or two strategies that are the best to use. Options work as advertised.

[00:07:30.63] The first step is developing a market forecast, further scrutinizing the confidence level of that forecast and the risk tolerance of the investor. And then from there, selecting what strategy best fits that environment. The more

strategies you know, the deeper your toolbox is to tap into selecting the right strategy to fit your forecast, your confidence level, your risk tolerance, and then managing that position appropriately. That gives people the best chance to be successful.

[00:08:05.13] Options are not set. And forget investments once a position is opened.

You have the forecast, you've selected the strategy, but now you have to monitor. And the market dynamics, of course, are changing for a variety of reasons. It's important to know what is happening with respect to the economic calendar or announcements specific to your firm.

[00:08:25.50] But market dynamics also always changing. Might need-- or trigger the need for opposition management to occur. So, Konstatin, as we think about this element of position management, strategy discussions, that discussion that you're having with clients, and market dynamics changing, what things come to mind for you investors need to within this prospect of before the trade and during the trade?

**Konstatin:** Ed, I think this is the most important question that those of you in the audience could ask yourselves before you hit the trade button to get in or to get out. You need to make sure that you have some bullet points checked off.

[00:09:08.67] And so for us on the strategy team, any time that we are coaching clients in a group setting or having one on one conversations, it's always really geared towards what we call on the strategy desk the three pillar approach.

[00:09:22.35] Those three pillars being, number one, where do you think the underlying is going? So having some sort of a direction view. It could be up, it could be down, it could be sideways. How long do you think it's going to take in order for that view to play out directionally?

[00:09:41.67] So have an aspect of time and have some sort of an approach that you can take, whether it is fundamentally biased or event biased. Or it's technically biased with some sort of a chart pattern and a time that it takes for the underlying or took for the underlying to base out or top out.

[00:10:07.54] But having that idea on time, remember options trades do have finite lives. And this is a very important aspect. Now Ed mentioned that shorter duration, shorter dated expirations are blowing up in popularity. They certainly are.

[00:10:25.78] Time is something that is consistently moving forward regardless of how much we would like to stop it. So it's becoming a much more important



aspect of the trading conversation with clients, especially over the past couple of years.

[00:10:41.80] And then, finally, of course, having an outlook on the underlying securities volatility. So this is a third pillar, which you don't normally think about when you are trading stock or exchange traded product by itself. We'll talk about implied volatility in detail in the second presentation.

[00:10:59.31] But those three things are absolute musts that you have to answer. If you haven't answered them, that means that you're not ready to place a trade. Any time that you've placed the trade and you're in one, you're constantly evaluating through the market conditions and dynamics changing of what your answers are for those three bullet points. That's kind of how we coach or what we coach too on the strategy team.

[00:11:27.05] And there are a couple of things that this helps with to make sure that you're less emotional about decision making. That's identifying those scenarios of how will you be right? How would you be wrong potentially on the strategy, on direction, on time, on volatility.

[00:11:45.84] What this helps me do personally is it helps me prepare for several outcomes that I've already thought through before I click the button. And by doing that, it eliminates my dependency on normal human biases that we're all-- that we can all reflect on.

[00:12:08.79] We are emotional human beings. And when we're making trading decisions, we are trying to be more mechanical and less emotional about things. It's tough, not easy. But this is one of the approaches that possibly could help you.

[00:12:23.88] Now, Ed, I always like to quote some of the influential investors and traders that affected my experience in life. And one of the first ones that I remember learning from or learning about when I was in college just starting out a long time ago at this point, was Mr Paul Tudor Jones.

[00:12:51.04] And one of his go-to comments used to be-- and I'll quote it specifically, "don't be a hero. Don't have an ego. Always question yourself and your ability. Don't ever feel that you're very good. The second that you do, you're dead."

[00:13:10.63] By the way, not having an ego or having or suffering from some sort of hubris doesn't mean that you don't have to be confident. You have to be

confident. And in order to be confident, you need to be knowledgeable. So that's what Ed and I are here to share with you today, but that's the way we approach it here on the strategic desk. Ed, back to you, sir.

**Ed:** Yeah, I love it. And those three pillars that you defined, I wrote it down so I'll be stealing from you at some point here. Direction, timing, and some semblance of volatility is such a key component in the options space. And, yes, we will get to that in great deal with definitions and interpretations in session two today.

[00:13:48.35] So we have this framework of planning the trades, setting the tables, executing the trade and then managing it. Let's get into a few strategies then and dig a little bit deeper, first, with the covered call strategy.

[00:14:00.52] We're going to touch from a few different angles. First of all, for those of you newer to options, we'll outline what this strategy is, its components, the risk profile and such. And then offer some deeper commentary when we talk about managing this position.

[00:14:13.48] A covered call involves two pieces, it's long stock and short a call option. Now often, the stock position comes first. And the investor may have this position for a certain length of time, and then decide at a later date to sell a call or overlay an option's position onto an existing stock position.

[00:14:35.69] This could also be the result of a simultaneous transaction, buying shares and selling a call option. That simultaneous nature is often called the buy-write strategy, drawing a subtle distinction between the two. But either way, you have two pieces, long stock short call. And it's short 1 call option for each 100 shares owned.

[00:15:02.80] Let's remember a little bit of options. Basics being short 1 call option means that this investor who sold the option is paid the option premium that's \$4 per share. They're obligated to deliver 100 shares. A standard contract is written on 100 share as a standard deliverable, so  $\$4 * 100$  is 400 total dollars received by this option seller.

[00:15:28.81] And for that payment in exchange for that credit received, this investor has accepted the obligation to deliver or sell their shares of stock at the strike price, which in our example here is \$60. That's the strike price of the call.

[00:15:45.85] Comparing long stock to covered call now, you can see a couple of major differences. The covered call has lower cost. It involves buying shares and then receiving some of that capital back through the sale of the option.

[00:16:00.46] Not specifying what expiration here, but let's say this investor-- let's put a hypothetical that this investor paid \$59 for stock. At some point, stock's sitting around, hasn't moved much. This investor is starting to feel like, OK, my bullish thesis might be disappearing a bit. It's still there, but maybe I want to bring in some premium and reduce my risk. So they go out a couple of months and they sell the 60 strike call option for \$4.

[00:16:25.72] That now means their net debit is \$55. Their break even point has been lowered to that level. Better break even point, more likelihood of being successful on the trade because of that. And outperforming long stock because of that credit received at various levels until you reach this intersection, which would be \$64 above which long stock starts to outperform.

[00:16:54.76] The reason for that is the obligation that is associated with the short option position. That's how this trade is outlined. Now what's all we're going to transition into position management techniques that Konstantin know maybe we should take a little bit further look and a little further discussion on covered call and its execution and initiation.

**Konstatin:** Absolutely, Ed. Thank you for that. Listen, if you're looking at that profit and loss diagram for the first time, we as traders refer to them as hockey stick

diagrams, profitability of dollars gained, dollars lost. Different strikes across the x-axis versus y-axis.

[00:17:37.27] It might be overwhelming. So what I wanted to do-- and this is going to be a theme through out the next three hours-- is we're going to utilize Fidelity tools and resources to help you simulate some of these things. And show you how these tools work.

[00:17:52.57] So this is a screen share of Active Trader Pro with a wide background. Now, Ed, I know that we had maybe stock XYZ on there. It doesn't have to be any particular symbol. I have my filter stool up in front of me right now. And so what I'm going to do is just go down the list, find maybe the first non-leveraged product that has traded many shares today.

[00:18:19.01] And going down the list, some of you are probably looking at it, some of these names you recognize. But I'm going to stick with SPY. SPY is a State Street corporation's SPDR ETF tracking the S&P 500. Very well known down there. Traded close to 95 million shares today, so it certainly does have liquidity.

[00:18:40.62] Now this underlying exchange traded product has many competitors out there, probably over a dozen. Half of that come to my mind, off the top of my head. So I'm not advocating for the fact that it's the best, it's the cheapest to own XYZ, is just the one that trades a ton of volume.

[00:18:58.80] So let's go ahead and go to our profit and loss calculator that can be found in Active Trader Pro by going to Options, Profit and Loss Calculator, this tool appears. So Ed, what I'm going to do is just simulate a covered call position in a similar maybe light of what was presented on that slide.

[00:19:22.13] Now, as Ed mentioned, can already own the stock or you could put the trade on all in one go. Buy the stock and sell the call against it. If you're doing it an all in one go, you're selecting the buy write here and the strategy piece, let's go ahead and type in 100 shares for every one lot of an option that I am selling. I need to own 100 shares to overwrite that 100 lot.

[00:19:51.01] I'm going to go out to those March expiration, the third Friday of the month. And I'm going to go maybe a little bit or slightly out of the money, I think, in our slide there. Stock was at 59, we're selling a 60. So maybe I'll look at aggressively selling a pretty close to at the money option, maybe a 403, a 404, or 405.

[00:20:19.87] Let's stick with a 405 to keep it round numbers. And you can see right away that your net debit is decreased by the amount of credit that you receive in order to sell that option against the stock that you're having to purchase.

[00:20:36.22] I'm going to go ahead and hit Apply. And, remember, this is a simulated trade. It lets us know that it's simulated because it has the Sim button right over here. And it breaks it down. And Ed, what I love about this tool, in my opinion, one of the most powerful tools that Fidelity offers, is that you can simulate as many strategies as you would like. You can play with them until you're ready to place it.

[00:20:59.71] And to your point earlier, do I have to be overwhelmed by break even points or having to calculate them manually? Or what would happen if the stock goes up versus if the stock goes down? Well, this tool breaks it down for us very visibly right away.

[00:21:18.34] So I know that if I do this right now, I buy the stock at approximately \$400 and I sell the call option against it at 5 and 1/4, my break even is approximately 395.21 at expiration. If the stock is above that level by expiration, I'm standing to make some money. I'm capped on the upside



because I sold my upside away, but I continue to lose if the stock keeps going lower.

[00:21:48.47] So Ed, back to you. From the perspective of this being not a massively bullish strategy, it is neutral to moderately bullish at best, but it doesn't protect us from substantial further downside in the stock. So let's talk about how we would be managing this trade, and the thoughts that go behind that process.

**Ed:** You're absolutely correct. I'm glad you brought that up. While this strategy does buffer that downside, it just takes one bad experience to realize how small sometimes that buffer is. The risk of loss is really pronounced here to the downside, and is consistent with perhaps the stock selling off.

[00:22:28.90] Konstatin, you mentioned something else that brought to mind that strike selection element we stayed close to at the money in our examples. Each investor is going to have their own preference. And from one trade to the next, how close they come to add the money with their strike selection will vary.

[00:22:44.77] The lower strikes, of course, will give you greater premium if that's your priority. Higher strikes give you less premium, but more room for that stock to

run before reaching the strike price and capping your gains. Some of that decision will be based on how far you think that stock will go.

[00:23:03.01] Investors often say the selection of their short strike, whether it's a call strategy or a put strategy, the short strike is the level they think the stock might get to but not actually break through that level. And that starts to be the basis for where they select that strike.

[00:23:18.91] So now we got the position on, we know a lot about it, let's take a look at what some of the choices are as far as managing this position. Like any other strategy, getting out of the position is always considered. For a variety of reasons, things might not be going well. Your risk tolerance has now been breached. You want to get out of this position and move on to something else.

[00:23:40.57] Or, as we'll see in a few slides from now, maybe there's a consideration to get out because you've already reached close to your maximum gain on the trade prior to expiration. If you reach that condition, you might think about closing down the position. I'll elaborate a bit on that in just a second.

[00:23:58.09] Since we're short options, and there equity options that could be assigned on any day, we have to contemplate the possibility of being assigned

early. For call options, generally that would be for in the money calls a day prior to the ex-dividend date, and usually for options that have very little, if not no time value remaining.

[00:24:19.79] It's a lengthy discussion we can get into here. But for our purposes today, just be aware of that when there's an upcoming dividend rolling. We're going to cover on the next slide in a bit of detail, just to define it for you here up front. It's not as complicated as some people might think it is.

[00:24:36.66] But rolling is simply closing an existing contract, and then opening a new one. For our context in this strategy, buying to close the open short call that exists, and then selling to open a new one. And in doing so, adjusting what the net credit or debit might be and adjusting break even points and the risk profile from there as well.

[00:25:01.37] One point of caution, and this often has come up not too often, but over the years I've seen once there's a situations of vast market sell offs and investors panic because their stock and their portfolios are losing a lot of money very quickly. Try to hit the close button, try to sell their stock position.

[00:25:20.54] And just always remember that when closing this position, you likely have to execute the stock and option at the same time or buyback to close the option first. Trying to sell the stock while you have a short call position, even if it has very little or no value left, would mean you'd have an uncovered call with the obligation to deliver shares that you no longer own.

[00:25:47.66] So closing this position usually involves one of those two methods of simultaneous or closing the call option first. Now bets are rolling. We mentioned this was one of the techniques investors can use. It's rather simple, buy to close an existing short.

[00:26:04.22] Write to open or sell to open a new call option. Often this can be done as a singular transaction, as a spread order entered in as such. Buy to close one, sell to open another at a net credit or debit, depending on what it is that you're doing, for one singular price executing both pieces at the same time.

[00:26:26.18] It is also possible to leg into this position. Legging into a role means executing these two sides separately. Buying to close the existing short call, and then subsequently working to sell to open a new call option, perhaps at a higher price than you can get currently.

[00:26:46.67] In between the execution of those two sides, you do take some risk of market movement and not getting executed on both sides. For example, this might occur if the open short call is close to expiration, has very little value left. And you're ready to buy it back to close, and you'd like to sell another call.

[00:27:07.13] But maybe you're a bit more bullish now than you were when you originally established the position. And you might want to work a higher price perhaps even at a higher strike price in premium level and see if you can get filled on that second piece to roll by legging into the position. So different ways to roll. But, effectively, it all comes down to closing the existing position and then opening a new position.

[00:27:32.72] Now back to the other possibility of position management techniques, sort of, getting out of the position. Specifically, when you're close to maximum profit. Let's analyze that a little bit deeper. Here we have the covered call that we outlined at the outset. I'll go back to that paragraph in just a second.

[00:27:51.48] We have the stock rising. And the call option that we sold is trading at parity. In other words, it's trading for exactly its intrinsic value. If the-- we'll go back to the paragraph here. If the stock were to rally, say, up to \$70, and we're short the 60 call, that call is \$10 in the money. If it's trading for \$10, or more

realistically, maybe 9 90 bid offered at 10, 10 there's no more time value left.  
It's trading at parity.

[00:28:28.55] At this point, closing the entire trade, meaning sell the stock at 70, buy back the short call for close to 10. That's going to result in the maximum potential gain of \$5 or \$500 on the position.

[00:28:44.52] So if you find yourself here prior to expiration where closing the position can almost get you that maximum profit, with whatever time is left remaining before expiration, you virtually have all risk and no potential for further gain.

[00:29:01.76] And that is when this decision to close the position might be something that you look into doing. Might be a little bit congested here. So Konstantin, as we think about this and in trading behavior and maybe instincts of investors, what things might they need to think about or perhaps avoid in this circumstance when their short call is in the money and at parity?

**Konstatin:** Yeah. Ed, going back to basics is always a good place to start from again. So going back to basics, meaning what I'm speaking with clients, I always say, listen, if you didn't have a position on right now, would you establish the same

exact position as you have at the current moment? If the answer is no, then you know you have to make a change of sorts.

[00:29:52.70] The only reason why you would be making a change is because your outlook has changed, the dynamic in the market made you believe that there are other potential possibilities that you haven't foreseen before.

[00:30:06.11] So not trading for the sake of trading-- oh, I just want to roll something, let me click a few buttons. Or I want to leg out of this thing, let me buy to cover the short call and then I'll figure out when to sell another. Trading for the sake of trading because you have a strategy in mind, you have an idea about direction, time, and volatility for that underlying.

[00:30:31.82] Again, making that adjustment, truly making an adjustment is closing one trade and opening a brand new one. So you have to go through that revaluation cycle, going back to basics. That's the way I like to think about it.

[00:30:43.43] Now Ed, one-- you know, I guess, one maybe overwhelming things for clients, again, is when they first start out is this lingo. It's like, well, short at parity. Or how do I know if I've maximized my return on capital if I'm sitting

there and I bought some SPDRs at \$400 a share, and I got 40 grand of capital invested in the underlying. And I sold some calls above.

[00:31:16.35] So my net capital invested into a position with 22 days to expiration is a little shy of 40 grand. What do I do? How do I know I've maximized my profit potential? Well, if you open the option chain in Active Trader Pro-- and we're going to build on this option chain, start adding some columns to it throughout the next two and 1/2 hours or so.

[00:31:40.74] But notice that you could right click on any one of these columns and add a column from a dropdown. Now what I'm going to do here, Ed, is I'm going to add the intrinsic value column, and I'm going to add the time value column.

[00:31:58.04] Now you mentioned a call trading at parity at expiration. So we normally deal with this type of scenario add in an environment where an underlying is trending higher and trending higher with a lot of momentum. So more likely than not, we're dealing with this scenario in the bull market condition for the underlying security of interest.



[00:32:23.04] But, effectively, you sold a call against the stock. And at the time when you were selling that strike, you thought that maybe the stock is going to get to that level but not surpass it by a great amount. And then what it ended up happening is the stock goes through the strike. Now you're sitting there questioning your initial judgment saying, well, I wish I would have done XYZ if I would have known.

[00:32:46.62] The good thing about this is we have to keep ourselves honest. If we think the stock is going a substantially higher, a covered call position is not the strategy of your choice. So moderately neutral to moderately bullish to begin with. But what these two columns help you evaluate is that exact point Ed was making. What am I looking for? When I'm going to covered call strategy, time value of an option that I'm selling is my asset.

[00:33:18.57] OK, that is the value that is going to be decreasing my cost basis in the position that I own or I just established. So you are looking for a circumstance where the time value of an option it's pretty close to zero. If it's close to zero, you know that there is nothing more to extract out of that strategy, out of that net capital committed between now and the expiration cycle.

[00:33:49.03] If you're dealing with that circumstance where the time value is reading zero, you know that your capital is just basically stuck in that position, and there isn't a whole lot of additional benefit at all that you can make if the stock either oscillates where it is or continues to go higher.

[00:34:09.05] Now, naturally, the risk of the stock collapsing still persists. So that's something that we need to be keeping in mind. Now any time-- Ed, and you could be a judge for yourself for where that normal balance is of how close to zero you wanted to get.

[00:34:27.10] Listen, if I have the stock, let's say, at \$400. If I bought SPDR at 400 and I shorted at \$370 call against my stock originally, and I have a \$1.78 of time value left in this trade between now and about three weeks from now, I know that the maximum amount that I can generate from this strategy if the stock stays above 370 is \$178.

[00:35:01.32] Now if you think you can make that \$178 with the capital you've got committed to the position somewhere else, you're likely unwinding this thing. You're closing it down and doing something else with that capital. So stick to these columns. I think as you're first starting out, they're going to be very helpful.

[00:35:17.50] Remember, intrinsic value is effectively what you could get if you bought the stock and exercised your right, or bought the call and exercised your right to buy the stock right away. The time value piece is the asset for us if we are a call seller against a position we own, all right. Ed, back to you.

**Ed:** Yeah, that's a very slick and useful tool there seeing that time value column. It tells you it's as Konstantin said how much more can I make on the position that I have on. And judging from the amount of capital you have tied up how much time is remaining, at some point as that number shrinks, you might make that decision to move on to a different trade.

[00:35:59.13] Let's move to the other strategy to talk about here in session one, stock repair, which really is a management technique by itself. The strategy itself is an attempt to manage a position that has not gone well particularly in specifically a long stock position. And to do so using options to repair that, bring it back to a break even so you don't take a loss on the share position and not commit more capital. And we'll see what you give up in exchange for that.

[00:36:30.73] So what is it-- it's really a ratio spread, which we'll outline in an example aimed to reduce the break even point of a losing stock position. And this might

be a choice for an investor who doesn't want to take additional risk to the downside, does not want to commit extra capital, wants the benefit of a lower break even point. And in exchange for that, is willing to forego this trade turning profitable. And we'll see how all that works out in the example.

[00:37:02.05] So no more additional funds needed for this strategy. Which means the downside risk of loss is going to stay the same, and you get the benefits of the lower break even point. Alternatives to this, you have a losing stock position. You're going to reevaluate.

[00:37:17.13] Konstatin just said, whatever it is you're doing, you're constantly evaluating today, is this the position I want today? I wanted it yesterday, I wanted it last week, but do I still want it today based on my analysis? And you want to be honest with yourself about that.

[00:37:32.01] If it is, you could hold the position as it stands and do nothing, waiting for a rebound. You could buy additional shares. Cost averaging in, committing more capital. Maybe doubling the amount of shares that you have. Lowering your break even point, but increasing the capital commitment and increasing the risk of loss to the downside.

[00:37:53.52] Or maybe this is stock repair strategy using options. So let's look at some numbers here. This investor hypothetically was long 100 shares from 65. Stock has retreated. It's down to 57. This investor is still bullish, by the way.

[00:38:08.52] We have to say that they're still bullish, but maybe not as aggressively bullish up to that 65 level. And they've decided maybe a bounce is going to occur, and they'd like to get out of this position. They'd like to recover their losses, get out of the position without taking additional downside. But all the way to 65 is looking less likely.

[00:38:31.32] Doing nothing is something they could do if they think that 65 does come into play. Cost averaging in, doubling up their shares, doubling up their risk exposure, or doing stock repair. And let's see what that looks like. Starting with this 100 share position from \$65, now the stock's trading at 57.

[00:38:54.72] This strategy involves buying one of the at long money calls. Where is the stock today, right now? 57. So buying a call there-- let's just stop for a second-- that's going to cost something. You're going to pay the premium of the 57 strike call. You didn't have to pay for additional shares so to the downside, your risk is still tied to 100 shares of stock. But to the upside, above

57 not only is the 100 shares working in your favor, but the 57 call is also working in your favor.

[00:39:29.70] So you make back money, we'll say at twice the speed above 57, as you would lose it. This is that feature of no additional capital-- no additional risk beyond the 100 shares, but making your money back faster from the long call. And then adding in two short call options.

[00:39:49.93] The strike selection here is a little bit gray. You can find the sweet spot for you, but generally a starting point. The short strike is halfway in between. Where your initial entry is on the shares and where the stock currently is, that's an \$8 drop. Halfway in between, 61 strike.

[00:40:09.37] More or less you're trying to execute the options pieces at even money. Buying the 57 calls, selling 2 to 61s, doing the options portion for a net debit or credit of 0. That's no further out of the money or out of pocket cost.

[00:40:26.20] But now that's 61 short strike that you have two short options on if assigned, if the stock were really above that level, not only does that obligation require you to deliver the 100 shares that you already own but it would also negate further upside potential from the 57 call that you own. And this is what

you give up. In exchange for the benefits, you give up that potential for upside profit and upside gain from here.

[00:40:54.32] So Konstatin, a position management technique as a strategy, from here investors can choose what they would like to do. Again, if things change in the middle of this strategy throughout the lifecycle of the option strategy, you're reevaluating and deciding what the best strategy is for you moving forward. But maybe we can take a further look at the options chain with this dynamic.

**Konstatin:** Yeah, Ed, I would love to. We are set to discuss different types of strategies that we could implement, some single leg, some multi leg in the third hour. But this is effectively kind of like doing two things at once. So you're selling a call against the stock that you own, that's portion number one. Creates a covered call or a buy right strategy in your account.

[00:41:40.21] And then you do, effectively, a bull call spread. You buy one call and sell another call against it. So what is a ratio call spread? Sounds fancy. But you're buying one call or you're selling two, and you own 100 shares of stock.

[00:41:54.56] So, Ed, I think what helps, again, just going back to the tools that are available to you and how you can evaluate these strategies and what would

happen in the real world by plugging in some numbers into a simulator before you go through with it. That's important.

[00:42:14.91] So, Ed, what I'll do-- and I'm looking very quickly here at the board, so I'm coming up with a scenario. I'll explain the method behind my madness in just a moment here. But let's say-- OK, very good. So I'm seeing something that makes sense to me.

[00:42:30.47] I'm going to go back to the profit and loss calculator here. And what I'll do is I'll eliminate the strategy that we've created a little bit earlier. And what I'll lay out is a scenario, Ed, where let's say you're in a situation where you bought the stock. Say you bought it at 410. So you bought it last week at some point, now you're down on it. You're down decently over a couple of days.

[00:43:00.40] And you're saying, effectively what I'm looking for, really, is not to make money on the strategy, but I would want to make my money back over the next three weeks. And if I can make my money back and break even or maybe make a little bit on top of that, I am a happy camper. But I don't think that the security has the prospect of going down substantially from here.



[00:43:29.27] This is very important. A stock repair strategy is not a strategy for a bearish biased view. You're thinking that the security has the potential of going higher, you just don't think that it's going to be higher with a lot of gusto.

[00:43:44.29] So let's say that we're paying 410. That was our initial cost basis. So we're down close to \$1,000. What I'm going to do is I'm going to create a spread strategy around it. And notice what I'm doing here.

[00:44:00.45] I'm buying one call and I'm selling two. I'm going out to that third Friday of the month, or March, and I'm going to do a-- let's see-- 410. So I'm going to do a 405, 412 spread around the position. So buying the 405 call, selling 412s twice. Now what that basically gets me, Ed, is not quite a credit, but a little bit a tiny little debit of approximately \$0.24 midpoint.

[00:44:39.16] Now naturally you would try to get it as close to a credit as possible, so you might finagle the strikes around. But effectively, the short strike needs to be close or a little bit above your original break even point for the stock. So that's how you're gauging it.

[00:44:57.24] Let's say that we're doing a 405 by 411 or a \$0.33 credit. Now I'm going to go ahead and apply it. And this strategy by itself looks very different from

what Ed was sharing with us a little earlier. So how can we make it look the same? We're going to use our control key on the keyboard. And we're going to select the stock together with it.

[00:45:22.16] Now what that does is the tool combines the spread, the ratio spread, and the stock together, and evaluates it. What do I have here? I have a flat top at expiration, and I have losses all the way down. The lower it goes, the worse it gets for me.

[00:45:41.45] Again, how do I make my money back? The stock goes up in value. My break even now is 407.34 on this strategy. Between 407.34 and 411, I'm making money and I'm capping myself there. So the maximum that I could make on this strategy is around \$733. Between now and approximately three trading weeks from now, how do I lose money? Well, stock continues to go lower.

[00:46:12.21] So, again, a strategy where you think the stock is not going to be-- or in this case exchange traded product -- is not going to explode higher, but it might be stair stepping there and not substantially exceeding your original cost basis. So you're lowering your cost basis, giving the stock the potential for-- it to work for you, but capping your upside through expiration.

[00:46:36.00] So an interesting strategy. Again, pretty complicated if you think about it in individual legs. But as you build this out and use the tool, it certainly helps tremendously. Ed, we have a couple of minutes left here. We want to make sure that we hit a few questions that are coming through from audience participants. I'll take the first one that's going to be very simple.

[00:47:00.27] The first one was, can you repeat what were the three pillars that the strategy desk talks about often with clients? Absolutely. Those are, where do you think the underlying is going? So having an assumption for direction. Up or down or sideways, trend less between an observable level of potential support and resistance in your view.

[00:47:23.15] Time, how long do I think the security is going to take to get to where I think it's going? And, three, volatility or implied volatility. And that piece, of course, is going to be elaborated on in session two. We would love to have you in that session where we're discussing vol.

[00:47:40.94] Ed, one interesting question that I get asked very frequently as well-- you're having a tremendous amount of experience in this business, I'm curious what the answer is that you're going to give. What is the percentage of options

that expire worthless? And how many of them were short-term options? Do you have any insight into where those dynamics lie right now?

**Ed:** On the first part, yes. The second part, no. But it is an interesting question that I do get from time to time. There is this-- what I would call a myth that has been circulated around over the years that most options expire worthless.

[00:48:15.95] OCC data, consistently year over year, shows that open options positions are closed about 70% of the time. So they don't expire worthless, they're closed through an executed closing transaction. The profitability of those is really difficult to determine because that would depend on opening price and closing price. But 70% closed and don't live until expiration.

[00:48:46.13] Of the remainder, 20% are held through expiration and expire worthless, while the other 10% or so get exercised at some point in time. And I think this myth comes from ignoring all those closing transactions and focusing on only the options that are held to expiration.

[00:49:05.51] How many expire worthless? Well, there, yes, close to 70% or so of those expire worthless. But when you're looking at the entire pie of all options' volume, the majority of those get closed out before forever living till expiration day.

**Konstatin:** Ed, that's fantastic. I want to remind everyone in the audience that, I mean, in fact, we have a follow up session for questions only. I know that my colleagues in the background are working hard to answer as many as they can verbally.

[00:49:34.17] But if you're interested in follow up questions, specific scenarios that you would like to discuss further in detail, [fidelity.com/coaching](https://fidelity.com/coaching), click on that webinar follow up. We've got one scheduled tomorrow for 12 o'clock Eastern Standard Time.

[00:49:48.90] Ed, we'll wrap up with this, I think maybe summarizing the thought process here. Don't get overwhelmed by all this new lingo. Try to approach it from the perspective, let me find out more.

[00:50:08.16] You cannot break the simulator in Active Trader Pro. Play around with it, add different types of positions, change the evaluation structures, and figure out what it actually accomplishes. How do I lose money? How do I make money? Always start by maybe thinking about risk first, profit second instead of the other way around.

[00:50:32.94] If you're right and you pick the right trade and strategy, you're going to make money. Don't worry about that part. Worry about the part of, how do I keep more of the capital that I work so hard for? And so that's what we try to do.

[00:50:47.42] Ed, more to come, of course, in session two. Join us. We're going to be diving in deep into option Greeks and volatility in session two. And, of course, discussing individual strategies in session three. Thanks, everybody. We'll see you again soon. Ed, thanks so much for your expertise.

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