
THE OPTIONS HANDBOOK

*How to SUPERCHARGE Your Option Trading Profits
with Bernie Schaeffer*

A Publication of
Schaeffer's Investment Research, Inc.

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WELCOME TO BERNIE SCHAEFFER'S *OPTION ADVISOR*

Thank you for subscribing to the world's foremost options newsletter. We are delighted to have you aboard and extend our best wishes for profitable trading.

Whether you are an experienced trader or brand new to the exciting world of options and directional trading, we are here to enhance your knowledge and help you navigate through an increasingly complex variety of trading strategies. Bernie Schaeffer's *Option Advisor*, which is published monthly with periodic updates available either by phone or online at SchaeffersResearch.com, will support you with education along with providing handpicked trades.

You are in excellent company. Among his many accomplishments since launching this publication in 1981, Bernie Schaeffer was inducted into the Dick Davis Hall of Fame, is ranked number five in the world for market timing (as tracked by *Timer Digest*), and received the "Best of the Best" award from the Market Technician's Association in the field of Sentiment/Psychological Analysis. Along the way, he launched his award-winning website, SchaeffersResearch.com. You can trust Bernie's experience, independence, and ability to select the best trades in all market conditions.

Bernie Schaeffer's *Option Advisor* will help you avoid the three most common mistakes that traders make:

- 1) As far back as the 1920s and 1930s, traders have spent most of their energies on the long/call side of the market. Ignoring the short/put side of the market cost many traders dearly in the spring of 2000 during the Nasdaq plunge. The *Option Advisor* will actively trade both sides of the market, depending on market conditions, thus helping our subscribers avoid this often costly mistake.
- 2) A second common trading mistake is not controlling losses. Bernie provides well-defined exit points via closeout dates for each trade. In addition, trades that are not performing to expectations will be closed early via phone and online hotlines. Traders must rigorously limit losses while letting wins run or the losses will typically outweigh their profits. The *Option Advisor* takes a very disciplined approach to targeting profits and cutting losses short, which translates into real profits over time.
- 3) The third mistake is not staying in the market or trying to jump in and out during choppy periods. The truth is, the vast majority of these traders miss the profit opportunities provided by volatile market conditions (see #1 above). Sadly, because they are on the sidelines, they also miss the "super profit" opportunities when the market trends sharply. The fact is, most investors miss these periods because the big money has already been made by the time the trend is established and reported. The *Option Advisor* serves to keep you in the game. The combination of the leverage provided by options, strict loss control, and letting wins run acts

to preserve capital and allows you to be in prime position for those sharp market movements that are often very profitable.

Two words about losses - expect them. They are part and parcel of aggressive, active trading. For example, a sequence of 50 trades that contains 20 winners (40 percent - a highly respectable winning percentage as the best traders in the world generally have win rates below 50 percent) has a one in five chance of having a string of 10 losses in a row! It is critical to commit the proper amount of capital, follow strict money management guidelines, limit losses, and let wins run. Stay the course...you have to be in the market to earn the profits! We talk extensively about this subject in our discussion of money management in Section 1.

We urge you to take advantage of the many resources available at our website, SchaeffersResearch.com. Named as *Forbes* magazine's "Best of the Web," our visitors tell us the timeliness and variety of our observations and commentaries are invaluable. While you're on our site, sign up for our FREE services, including *Monday Morning Outlook*, an online publication that will help your trading week get off to a faster start.

In addition, you will find a wealth of educational information and an opportunity to preview and purchase our Home Study Program. Educated traders are successful traders, and we strive to provide the most comprehensive and practical options and directional trading educational materials available anywhere.

Please feel free to contact us at any time with your questions, suggestions, and comments. You can reach us through the website (SchaeffersResearch.com), via e-mail at service@sir-inc.com, or toll-free at 1-800-327-8833 from 8:30 a.m. to 5:30 p.m. eastern time on days the market is open.

On behalf of the staff at Schaeffer's Investment Research, thank you again for your business and for making us a part of your trading day!

EXECUTIVE SUMMARY

Please read this handbook carefully and completely. It will enable you to better understand the Option Advisor newsletter and all its aspects and benefits.

Each monthly issue of Bernie Schaeffer's *Option Advisor* provides you with thoroughly researched option recommendations (calls and puts) in two distinct portfolios – Aggressive and Put Selling. The first page of the newsletter contains a market commentary and a summary of these recommendations. Pages 2, 3, and 4 display charts and supporting comments underlying each of the recommendations. Page 5 summarizes current open positions and trades closed during the previous month and discusses a particular option trading strategy or methodology. Page 6 contains a diverse assortment of information pertinent to the newsletter, developments in the options market, and other news items of interest.

The Aggressive portfolio consists of short-life and longer-term calls and puts purchased for their exceptionally large profit potential. These options also carry an associated higher degree of risk. The Put Selling portfolio contains both put selling and straddle/strangle strategies that are designed to take advantage of the time-erosion component of options and a large expected move by the underlying stock, respectively.

Profits are achieved by selling at prices that yield gains well in excess of the average losses. While these recommendations are thoroughly researched and analyzed, you will experience some losses on individual options using our trading approach (or any options trading approach, for that matter). Our goal is to limit these losses such that they are more than offset by the much larger profits that you will achieve on your successful positions. For example, during a period of market decline, you could lose 50 to 60 percent on your call positions in the Aggressive portfolio, but profit by an average of 100 percent on your put positions for an excellent overall gain. By diversifying using the *Option Advisor's* carefully selected calls and puts, you reduce your risk and free yourself of worry about market direction, yet retain the large profit potential of short-life options.

Choosing to invest in one or both of the *Option Advisor* portfolios will depend on your current investment objectives and temperament. However, you should attempt to enter each trade and commit equal (or as equally as possible) dollar amounts to each recommendation within a particular portfolio. This takes the guesswork out of deciding which trade will likely be a winner and which may be a loser. Remember that there will always be losing trades. Profits are made by cutting losses short and letting profits run their course. Guessing which trade will be profitable and which won't will have dire consequences if you guess incorrectly. If you are unable to enter all trades within a portfolio, we suggest diversifying as much as possible by buying both puts and calls on stocks in different sectors (if available).

The Aggressive portfolio will perform best during periods of strongly trending or volatile markets (up or down), and will perform poorest during trendless or “trading range” markets. Therefore, a fair trial period for judging performance with this portfolio should be long enough to encompass at least one period during which the market is strongly trending.

The Put Selling portfolio will perform well in most any market environment. Put selling is a neutral to bullish strategy that requires the underlying stock to go up, stay flat, or even decline somewhat. By selling premium, this strategy takes advantage of time decay – the decline in an option’s value over time – which accelerates as an option approaches expiration. Straddles and strangles involve buying both puts and calls simultaneously. This strategy is designed to capture large moves by the underlying stock in either direction and is well suited to markets with high volatility that lack any overall directional movement.

Remember that huge profits are the rewards of an intelligent options trading program. But the prerequisite for such a program is the staying power provided by a sensible commitment of capital. Therefore, the funds that you commit to an options trading program should not exceed those dollars that can be lost without undue financial hardship. We recommend that you commit to the *Option Advisor* portfolios a fraction (up to 20 percent) of what you normally would allocate to trading stocks. Any greater commitment will only lead to anxiety, and worst of all, emotional and illogical trading decisions. We want you to enjoy and profit from your trading. Thanks for making Bernie Schaeffer’s *Option Advisor* an integral part of your options trading program. We wish you much success in all your trading.

SECTION 1

MAXIMUM PROFITS AND REDUCED RISK IN LISTED OPTIONS TRADING

The huge profit potential in listed options

The basic principle of our approach to options trading is simple, yet profound and powerful:

Listed options offer the greatest profit potential of any investment vehicle. Profits of 100 percent or more can be realized, particularly using the kinds of options recommended by the *Option Advisor*. Risk, on the other hand, is limited to your original cash outlay. Therefore, to attain maximum profits trading listed options, aggressive investors should never target for a profit of less than 100 percent for most options trades. This will ensure that your target risk/reward ratio is always in your favor. The losing strategy followed by most option traders is to accept small profit objectives, while risking 100 percent of their investment. To win at options trading, your gains must exceed the inevitable losses that will occur.

Before we talk about the mechanics of the *Option Advisor*, it's vital that we introduce a factor that many believe is the most important – and most ignored – consideration to investment success...proper money management.

Have an intelligent money management system that preserves capital

The first step toward intelligent money management is to trade only with that portion of your capital that can comfortably be devoted to speculation. This will permit you to act rationally and to sleep soundly, neither of which is possible when your nest egg is at risk.

Once you have determined your trading capital, there is one final important rule. Never risk your entire trading capital on a single trade. This rule holds regardless of how successful you have previously been and regardless of how attractive the next trade appears. There will always be losing trades. By compounding your capital after a few profitable trades, you are exposing yourself to some potentially very painful dollar losses once that loser comes along.

Always keep a large portion of your trading capital in reserve. By doing this, you will then have the staying power to ride out the losers so you can ultimately profit from the winners (including those winners that show “paper losses” early, but are eventually closed out for gains). This intelligent money management approach also allows you to invest in additional recommendations as they come along, as there will always be a number of open trades that take away from the capital available to purchase new positions.

Logic versus emotion

Why do many option traders embrace a losing strategy? Usually, for reasons related to human *emotion* rather than to *logic*. After all, people trade options in the hope of achieving substantial profits. But “human nature” often interferes, usually in the form of two major culprits:

Fear - Purchasing an option involves the risk of a total loss of one’s investment. However, in exchange for the assumption of this risk, the investor has the opportunity to realize profits of many times the initial investment. Many investors “bail out” of a position when they have a small loss for fear of sustaining a total loss. Unfortunately, they are robbing themselves of the potential for huge gains and negating their reason for buying options in the first place!

Greed - The other side of the emotional coin is greed. The options investor will accept the possibility of a total loss as the price for achieving large gains. So far, so good. So where does the greedy investor go wrong? The answer is both simple and financially tragic. *No* profit level is enough for this individual. If he doubles his money, he wants a triple. If he achieves a triple, why not aim even higher? This process never ends. The result? Some very healthy “paper profits” become tiny realized gains when the direction of the underlying stock reverses. In fact, many paper *gains* actually become realized *losses*!

It is clear that the fearful investor sharply limits his profit opportunities, and the greedy investor lets his profits slip away. What are the cures for these very human, very common, yet very financially costly afflictions? Let’s deal with them individually.

Fear - how to eliminate its negative impact

Many investors are attracted to options trading by the unique opportunity to achieve profits of many times their original investment. This is particularly true of the aggressive options recommended regularly by the *Option Advisor*. Unfortunately, a basic tenet of options trading is often ignored or forgotten: To be in a position to realize the profit rewards of the options market, you must be financially and emotionally capable of withstanding the ups and downs of the options marketplace. Even the most profitable trades often show “paper losses” at some point. Very few options go straight up, simply because very few stocks go straight up or straight down. If a trader panics out of a position with every downward blip in price, he will ultimately be a loser in options trading. So how does an investor cope with fear?

Use only your trading capital for options trading - Never buy puts or calls with money needed to pay bills or meet potential emergencies. Intelligent trading decisions are rarely made when “scared money” is involved. You should restrict your option commitments to funds that can be lost without undue financial hardship.

In determining your trading capital for an options program, it may be helpful to use the dollars invested in a common stock portfolio as a frame of reference. For illustrative purposes, if \$100,000 were to be invested in common stocks, we would generally consider an investment of up to \$20,000 in the *Option Advisor* portfolios as an equivalent risk (with the remainder invested in riskless or nearly riskless instruments such as Treasury bills or money market funds).

Of the capital you do devote to our recommendations, we rarely recommend that it be 100-percent invested. We suggest maintaining a cash reserve that can be devoted to new opportunities as they develop, as well as provide a cushion of protection. For *Option Advisor* trades, we usually suggest that no more than 30 percent of your options trading capital be devoted to the trades in either portfolio. In fact, we clearly specify the percentage of your cash to be allocated to the new recommendations each month. Thus, your minimum account size should be large enough to allocate sufficient capital to the trades in one or both portfolios and to maintain an adequate cash reserve.

As a rule, your entire trading capital should never be at risk at any one time in the options market, regardless of how attractive the current situation appears. Remember, there will always be losing trades in the options game. Therefore, with rare exceptions, it's best to keep a portion of your trading capital in reserve.

Know your risk threshold and don't exceed it - Clearly the options trader has a higher risk threshold than the unleveraged common stock trader. The options trader is willing to accept the possibility of a large loss in exchange for the possibility of gains far in excess of their maximum possible loss. However, the process does not end there. Each options trader must identify their own risk threshold.

Some traders will be attracted to straight option purchases via the *Option Advisor's* Aggressive portfolio, a strategy that possesses the largest profit potential as well as the highest probability of a large loss if the underlying stock moves dramatically against expectations.

On the other hand, the Put Selling portfolio is ideal for investors looking to generate income in their portfolio with the possibility of acquiring a quality blue-chip stock at prices below current levels. Put Selling involves selling an out-of-the-money put on a quality stock that the investor would be willing to buy if the stock took a temporary plunge. However, in most cases, the put sold will expire worthless, allowing the investor to pocket the premium without ever having to buy the stock. While there is a margin requirement when selling these options, this commitment of funds is significantly less than the outright purchase of the equivalent number of shares. Plus, we've added straddles and strangles to this portfolio to benefit from large stock swings *regardless* of the ultimate direction.

An options trader who exceeds his risk threshold will react emotionally and, usually, incorrectly. The *Option Advisor* provides you with a broad spectrum of aggressive *and* conservative trading approaches, so you can always trade in accordance with your risk threshold.

Diversifying options positions - A major advantage of trading in options is “truncated risk,” whereby your loss is limited to your initial investment, yet your profit is theoretically unlimited. Diversification will allow you to use truncated risk to its maximum advantage. Diversify your option positions using the *Option Advisor’s* principle of *two-dimensional diversification*. The key to achieving profits in options trading is to maximize your chances for very large percentage gains. This requires the financial and emotional staying power provided by our first two trading rules, to assure that you will be around to achieve these huge profits. The next step involves the risk-reducing and profit-maximizing technique of *diversification*. By always carrying several different option positions, you will maximize your chances to achieve one or more huge winners and minimize your chances of incurring large losses.

We strongly believe that such diversification should be in two dimensions. First, option positions should be established in several underlying stocks in unrelated industries. Second, invest in puts as well as in calls. This strategy will put you in a position to profit *regardless* of overall market conditions, so that guessing wrong on the overall market does not severely deplete your trading capital. However, the ratio of calls to puts will vary according to our overall market view. Many people believe that the only way to make money in the market is to take a bullish position on an advancing stock. You can just as easily take a bearish position by buying a put, while still enjoying the advantage of the “limited risk” offered by options.

Stay the course - It is important for the savvy options investor to realize that it is unwise to exit a trade as soon as a position moves against them. Many options traders will purchase an option at 6 and then, out of fear, sell it the same day should it decline to 5. Assuming that (1) you have not changed your market outlook, (2) you are using only your trading capital, (3) you are purchasing options within your risk threshold, and (4) you are sufficiently diversified in calls and puts, there is never a need to panic and sell. An option is purchased for its huge profit potential, which can only be fully realized by allowing positions to remain open for a reasonable period of time.

Overcome greed with target entry and exit points

The trading rules outlined here will maximize your chances of having several very profitable option positions at any given point in time. The important question that any investor must ask, because it will ultimately determine their bottom-line profitability, is “When do I sell?”

Determine your target exit point and your closeout date before you trade - A target exit point is merely the option price that would result in a substantial, yet

attainable profit. The closeout date determines exactly when the position is to be closed out if your target exit point is not achieved. By closing out aggressive positions prior to option expiration, you avoid the severe deterioration in premium that occurs in the final weeks of trading, thus conserving capital.

The *Option Advisor* contains recommendations for two distinct portfolios: Aggressive and Put Selling. These recommendations include specific closeout dates and target profits that are tailored to each situation and expressed as percentages of your purchase price. The target exit points for the Aggressive portfolio are set at target profits of at least 100 percent. The Put Selling portfolio targets profits of around 10 to 25 percent (straddles/strangles will usually target profits of 50 percent and higher).

Using your purchase price and the target profit, you can determine your target exit point. Set your profit objectives in advance and determine your target exit point before you trade or at the time you make your option purchase. By doing so, you avoid the consequences of one of the major stumbling blocks to achieving trading profits - greed. It is virtually impossible for most investors to set reasonable profit goals once a stock has advanced substantially in price. That “extra point” or “extra half-point” becomes a moving target with each advance in the stock’s price. It is not surprising that often the target is not achieved, and the investor is forced to panic out because of tumbling prices.

It is not advisable to deviate from your target exit point once you have established your position unless we specifically instruct you to do so. The target exit point is determined before your trade, and it is based upon logic. Once you have entered the heat of the battle, the tendency will be to base your decisions upon emotion and, therefore, your decisions will be incorrect. Resist the temptation to sell at a loss prior to the option achieving its target price. You will be yielding to fear, robbing yourself of some potential gains. Also, resist the temptation to raise your profit objective as the price of the stock nears your target exit point. You will be yielding to greed, and your profits will slip away.

You should not take profits haphazardly - Taking profits haphazardly encompasses a multitude of sins. It includes having no specific profit objective (the greed syndrome) as well as setting illogical and insufficient profit objectives (a 10-percent gain) or emotional profit objectives (“This will be my lucky week”).

Use a maximum (minimum) entry price – When we send you a trade recommendation, one of the most important pieces of information is the maximum (or minimum) entry price. This indicates the maximum (minimum) premium you should pay (accept) to get into a trade, regardless of how the underlying stock is moving at the time. Sometimes trades run away from us above (below) the maximum (minimum) entry price. It’s very important to exercise discipline and not

chase trades, as you'll overpay (accept less) in too many situations relative to the few trades you might miss.

Because the entry price is based on our assessment of the probability that the trade will be successful, paying too much for an option, even when we are targeting for a 100-percent return, will decrease your potential reward while the risk remains unchanged. For instance, a trade with a profit potential of 100 percent and a maximum entry price of 5 would have a target exit price of 10. If we instead entered at 6, the potential profit drops to 67 percent because our target exit price does not change. This upsets the risk/reward balance for the trade and will likely result in a decreased overall profit over the long run.

You can be successful with a winning percentage of under 50 percent

The principles of money management in options trading cannot be mastered without a firm grasp of the statistical probabilities involved. In his esteemed book, *Trading for a Living*, Dr. Alexander Elder sums up the importance of this concept in a word - *innumeracy*. According to Dr. Elder, "Innumeracy - not knowing the basic notions of probability, chance, and randomness - is a fatal intellectual weakness in traders."

Renowned investing and trading coach Dr. Van K. Tharp addressed the issue of winning percentages in the November 1997 issue of *Technically Speaking*, the newsletter of the Market Technicians Association. In his article, "Why It's So Difficult for Most People to Make Money in the Market," Dr. Tharp states, "Most of us grew up exposed to an educational system that brainwashes us with the idea that you have to get 94-95% correct to be excellent. And if you can't get at least 70% correct you're a failure. Mistakes are severely punished in the school system by ridicule and poor grades, yet it is only through mistakes that human beings learn. Contrast that with the real world in which a .300 hitter in baseball gets paid millions. In fact, in the everyday world few people are close to perfect and most of us who do well are probably right less than half the time. Indeed, people have made millions on trading systems with reliabilities around 40%."

It should be noted that Dr. Tharp is not specifically referring to options trading in his discussion of winning percentages. In fact, you should expect winning percentages for option premium buying to be lower than that for trading stocks or futures. Our research shows that successful short-term options traders are correct on roughly 35 to 45 percent of their trades. Although this win rate may seem rather low, there are factors such as fighting time decay and preserving capital by shutting down losing trades beyond a certain point (some of which may ultimately have been winners) that are particularly relevant to options trading. The important point is that positive overall returns over the longer haul result from allowing your profitable trades to run and cutting your losses in other trades relatively quickly.

The concept of limiting losses and letting the winners run cannot be overstated. In his classic work, *The Battle for Investment Survival*, Gerald Loeb states, "Accepting losses is the most important single investment device to insure safety of capital. It is also the action that most people know the least about and that they are least liable to execute ... The most important single thing I learned is that accepting losses promptly is the first key to success." In addition, Loeb says, "The difference between the investor who year in and year out procures for himself a final net profit and the one who is usually in the red is not entirely a question of superior selection of stocks or superior timing. Rather, it is also a case of knowing how to capitalize successes and curtail failures."

Positive expectancy

Dr. Tharp has said that a critical factor to winning is "positive expectancy" - over a large number of trades, you should expect to achieve a positive return for each dollar you risk. For example, in the long run an even bet on "heads" in the flip of a true coin yields a "zero" expectancy. This is based on two key facts - the probability of profit is 50 percent and the payoff for "heads" is equal to the loss when "tails" occurs. The formula for this zero expectancy is:

$$0.50*1 + 0.50*(-1) = 0$$

A positive expectancy for this bet would occur if the coin were not "true," but instead the probability of "heads" was, say, 60 percent. In this case, the positive expectancy would be 20 cents for each dollar bet, as set forth below:

$$0.60*1 + 0.40*(-1) = 0.20$$

Another way to achieve a positive expectancy is for the payoff for a win to exceed the penalty for a loss. If you were paid \$1.20 for each head that occurs when a true coin is flipped but you lost only \$1.00 when it comes up "tails," your positive expectancy would be 10 cents for each dollar bet as follows:

$$0.50*1.20 + 0.50*(-1) = 0.10$$

The Expectational Analysis[®] trading approach underlying the recommendations in each issue of the *Option Advisor* has demonstrated a positive expectancy. For example, over the course of more than 500 trades in the Aggressive portfolio from 1997 through 2002, the winning percentage has averaged 42.7 percent. The payoff on winning trades has averaged 77.0 percent, while the loss on losing trades has averaged just below 47 percent. This yields a positive expectancy of 6.1 cents for each dollar invested as calculated below:

$$0.427*0.77 + 0.573*(-0.468) = 0.061$$

In other words, investing in all of the Aggressive portfolio recommendations over this period would have had a slightly more favorable outcome than getting paid \$1.12 for each “heads” in a true coin flip while losing just \$1.00 for each “tails.” Of course, the positive expectancy from this coin flip game is pretty well guaranteed over enough flips of the coin, whereas there is no guarantee that the results for future Aggressive portfolio recommendations will match those since 1997. They could be better or they could be worse, but it is important to note below that the results have been consistent for most years, which adds a strong element of credibility.

Year	Winning Percentage	Average Win	Average Loss
1997	51.0%	80.0%	50.8%
1998	44.6%	80.1%	42.7%
1999	43.6%	75.2%	48.0%
2000	40.5%	76.9%	51.1%
2001	44.0%	79.2%	44.9%
2002	34.2%	69.7%	43.6%
Total	42.7%	77.0%	46.8%

It should now be pretty obvious that a positive expectancy does not require a winning percentage greater than 50 percent. And it’s clear that the Aggressive portfolio’s performance meets Tharp’s definition of a positive expectancy system that should perform well over the long run.

Losing is part of the game

An offshoot of this lower winning percentage, and something that often comes as a surprise to many traders, is the experience of coping with an extended losing streak. The ultimate goal of achieving profitability will remain out of reach unless great care is taken to control the amount of capital allocated to each position, as even wildly successful traders are not immune to a string of losing positions. In short, the objective in options trading is to “stay in the game” through proper money management techniques that allow you to weather the inevitable storms of losing trades.

To shed some mathematical light on the importance of proper money management, our Quantitative Analysis group created the following table that displays the likelihood of experiencing losing streaks of various lengths based on a range of win rates.

Win Percentage	Probability of seeing at least X consecutive losing trades Within a 50-trade period									
	2	3	4	5	6	7	8	9	10	11
5%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
10%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
15%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	99.9%
20%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	99.8%	99.1%	97.2%
25%	100.0%	100.0%	100.0%	100.0%	100.0%	99.8%	98.9%	96.2%	90.7%	82.2%
30%	100.0%	100.0%	100.0%	100.0%	99.6%	97.7%	92.2%	82.3%	69.1%	55.0%
35%	100.0%	100.0%	100.0%	99.7%	97.1%	89.0%	75.2%	58.5%	42.6%	29.6%
40%	100.0%	100.0%	99.9%	97.6%	88.4%	71.3%	51.7%	34.6%	22.0%	13.5%
45%	100.0%	100.0%	98.9%	90.7%	71.7%	49.1%	30.3%	17.6%	9.9%	5.4%
50%	100.0%	99.8%	95.2%	76.8%	50.8%	29.2%	15.5%	7.9%	3.9%	1.9%
55%	100.0%	99.0%	86.0%	57.5%	31.3%	15.2%	7.0%	3.1%	1.4%	0.6%
60%	100.0%	95.8%	70.4%	37.7%	16.9%	7.0%	2.8%	1.1%	0.4%	0.2%
65%	99.8%	87.8%	50.9%	21.5%	7.9%	2.8%	1.0%	0.3%	0.1%	0.0%
70%	99.0%	73.1%	31.8%	10.6%	3.2%	1.0%	0.3%	0.1%	0.0%	0.0%
75%	95.8%	53.0%	16.8%	4.4%	1.1%	0.3%	0.1%	0.0%	0.0%	0.0%
80%	86.5%	32.0%	7.2%	1.5%	0.3%	0.1%	0.0%	0.0%	0.0%	0.0%
85%	67.2%	15.0%	2.4%	0.3%	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%
90%	38.9%	4.7%	0.5%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
95%	11.5%	0.6%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%

The figures in this table are based on a 50-trade period, or roughly what you would receive over an eight-month period with the Aggressive portfolio. The “Win Percentage” column encompasses a wide range of potential win rates, from five to 95 percent. The table shows the probabilities of seeing anywhere from two to 11 *consecutive* losing trades during the 50-trade cycle, based on the corresponding percentage win rate.

The take-home message is that you must be prepared to ride out the ups and downs of an options trading program in order to reap the ultimate reward in profits. As indicated in the table above, a system with an expected winning percentage of 45 percent has a 71.7-percent probability of seeing at least six consecutive losing trades over a 50-trade period; with a 50-percent winning percentage, this probability is about 50 percent. Given that the Aggressive portfolio has experienced a 45-percent winning percentage, the chances of six or more consecutive losing trades out of 50 are on the order of about 70 percent.

What does this mean to you as an investor in our Aggressive portfolio recommendations? There are six new recommendations per issue, each with a 45-percent chance of being a winning trade. In turn, each issue has a 2.8-percent chance of containing six losing trades. Therefore, over the course of a year, there is a 28.6-percent chance that at least one of the issues will contain no winning trades. This probability increases to 49 percent over a two-year (24 issue) span and to

63.6 percent over a three-year period. This will not mean that our trading approach is defective; it is simply the result of the statistical probabilities.

So not only is it crucial that you implement sound money management practices, it is also crucial that you understand and accept that there will be losing streaks (as well as winning streaks) along the way. A losing streak does not signify that our approach is defective, and a winning streak does not signify that our approach is the road to instant riches. These streaks are simply part and parcel of what to expect along the way to achieving a bottom line profit from the “positive expectancy” of our recommendations.

Given the high probability (and in some cases, certainty) of losing streaks within a given period, it is critical to realize that investors who place too much capital into successive recommendations run the risk of decimating their trading account during a perfectly normal trading cycle. In other words, they will be unable to stay in the game. Those that are able to stay in the game and reap the rewards of the hot streaks and higher returns of winning trades stand a better chance of ultimate profitability over the longer haul.

The moral of the story is that even though low winning percentages and long losing streaks are part of the options buying game, profitability is achievable if you let winners run and cut losses short (that’s our job), while staying in the game by using proper money management principles (that’s your job).

Allocation is critical

In the same spirit of “staying in the game,” we now turn our attention to allocations per trade. We will not attempt to tell you a minimum dollar amount to trade. This is a decision best left to each individual investor that takes into account their overall profit goals and costs of trading (e.g., commissions). Rather, our goal is to discuss the *percentage* allocation to each trade.

In an excellent chapter on money management in *New Thinking in Technical Analysis: Trading Models from the Masters* (Bloomberg Press, available on www.SchaeffersResearch.com), Courtney Smith discusses how to “play the game long enough to master the skills and information needed to become a profitable trader” using a system he calls the *fixed fractional bet*. Simply stated, every trade should represent a set percentage of your *total* account.

For example, let’s say you have \$25,000 available for options trading and you wish to allocate 10 percent of your total account to each trade. You would therefore trade \$2,500 for your first trade. Assume the trade gains 80 percent, or a \$2,000 profit. Because your account size is now \$27,000, your next trade would be for \$2,700 ($0.1 \times 27,000$). Now let’s say your first trade lost 40 percent (remember you need to let your winners run and cut your more numerous losses short), or \$1,000. Your account would now stand at \$24,000, meaning that you would allocate only \$2,400 to your next trade. Notice how this differs from a fixed-dollar strategy in which you would invest \$2,500 in each trade.

We should note that with options trading, it is difficult, if not impossible to trade exactly 10 percent (or whatever percentage you choose) on each trade. It is rarely the case that an option's premium will divide evenly into your dollar allocation for any trade (e.g., five \$5 contracts, or \$2,500). The best solution is to trade as close to your allocated percentage without going over. That is, if your allocated amount for a particular trade is \$2,500 and you're interested in a \$7 option (\$700 per contract), you should trade only three contracts (\$2,100).

Also, do not let your allocation dictate what option you will play. For example, say you have \$2,500 for a trade and your trading system calls for higher-premium in-the-money options. If you have your eye on one priced at 7 (three contracts, or \$2,100), don't opt for a cheaper out-of-the-money option priced at 3 (eight contracts, or \$2400) just so the total trade is closer to your allocated amount. In other words, don't compromise your trading system for the sake of getting nearer to your allocation.

The power of convexity

One of the primary advantages of the fixed fractional bet system is the principle of convexity – playing more dollars on the way up, while fewer dollars are at risk after each losing trade. On the downside, this system keeps you in the game longer by allowing you to weather the losing streaks that will inevitably occur.

For example, if you start with \$25,000 and play the same \$2,500 per trade, you will lose half your bankroll (\$12,500) if you start off with 10 consecutive losses of 50 percent per trade. While it is unlikely that you will have such a streak right off the bat, it is not beyond the realm of possibility. However, the fixed fractional system has quite a different outcome. In fact, this methodology comes out \$2,468, or nearly 20 percent, ahead of the fixed investment approach, as shown below:

Trade No.	Portfolio Amount	Allocation (10% of portfolio)	Amount Lost (-50%)	New Portfolio Balance
1	25,000	2,500	(1,250)	23,750
2	23,750	2,375	(1,188)	22,563
3	22,563	2,256	(1,128)	21,434
4	21,434	2,143	(1,072)	20,363
5	20,363	2,036	(1,018)	19,345
6	19,345	1,934	(967)	18,377
7	18,377	1,838	(919)	17,458
8	17,458	1,746	(873)	16,586
9	16,586	1,659	(829)	15,756
10	15,756	1,576	(788)	14,968

On the plus side, let's assume you enjoy five straight winning trades of 100 percent apiece. Investing \$2,500 per trade will result in a portfolio of \$37,500 (25,000 + 12,500). On the other

hand, the fixed fractional bet system results in a portfolio value of \$40,263, or 7.3-percent better, as shown below:

Trade No.	Portfolio Amount	Allocation (10% of portfolio)	Amount Gained (100%)	New Portfolio Balance
1	25,000	2,500	2,500	27,500
2	27,500	2,750	2,750	30,250
3	30,250	3,025	3,025	33,275
4	33,275	3,328	3,328	36,603
5	36,603	3,660	3,660	40,263

In the real world, of course, you will encounter interspersed winners and losers, although the losers will most likely be more frequent. As we have stated repeatedly, the goal of options trading is to keep afloat long enough to take advantage of the bigger winning trades and the winning streaks that will also occur. And proper money management is the best way to play longer. As Smith states, "...risk management rules are really ways of dealing with the psychology of trading...[which] is the most important aspect of trading...discipline is the key psychological trait that the trader needs to make money. Risk management rules are an effort at trying to enforce the necessary discipline."

Consistency is the key

One other thing we should mention. Don't vary the percentage you allocate trade by trade. Don't double up on a trade after a loss hoping to win your money back right away. There's a technique some blackjack players use in which they double their bet after each loss, the idea being that eventually the cards will turn in their favor and they will be ahead. That's fine (we suppose) if you're betting \$10 chips since you *likely* will have a sufficient bankroll to stay in the game long enough for that to happen.

But options trading is not so forgiving. The wins are not as frequent, the market may be turbulent and volatile, your system may be flawed, and you might run into a series of trades that will wipe you out. Sure, you may get out of the hole with that one winner, but what if doesn't come in time? If you're sitting on the sidelines with no cash, there's positively no way to benefit from those big winning options trades. And as the saying goes, you miss 100 percent of the shots you never take.

One reason we focus on consistency is that options buying by and large involves more losing than winning trades. In exchange for having more losers than winners, you will also achieve bigger average profits on your winners than on your losers. Success is dictated by using proper money management to stay in the game long enough to reap the rewards of the bigger, though less frequent, winning trades. This brings up an issue that we have not addressed – increasing one's allocation after a series of winners. This is just as dangerous as increasing the percentage after a losing trade. Why is this so?

Remember that there will always be losing trades. Guessing which trade will be profitable and which won't will have dire consequences if you guess incorrectly. Putting a higher percentage in a loser and less on a winner will ultimately lead to decreased profits. Of course, allocating more to the winners and less to the losers would result in huge profits. But given that you will likely encounter more losing than winning trades, the odds of picking correctly are stacked against you.

The table below illustrates how increasing your allocation can be hazardous to your portfolio's health. Trader One decided to press his allocation to a third of his portfolio (33 percent) after two big winners, while Trader Two stayed the course. The next three trades produced two 50-percent losers and one 100-percent winner. Despite having a bigger allocation in the winner, Trader One's performance suffered markedly due to the larger amounts allocated to losing trades. This difference will become even more pronounced as the overall winning percentage drops below 50 percent.

Portfolio One (Pressing the Bet)			Portfolio Two (Consistent)		
Portfolio Amount	Allocation	Gain/Loss	Portfolio Amount	Allocation	Gain/Loss
25,000	10%/2,500	+100%/2,500	25,000	10%/2,500	+100%/2,500
27,500	10%/2,750	+100%/2,750	27,500	10%/2,750	+100%/2,750
30,250	33%/10,083	-50%/(5,042)	30,250	10%/3,025	-50%/(1,513)
25,208	33%/8,403	-50%/(4,201)	28,737	10%/2,874	-50%/(1,437)
21,007	33%/7,002	+100%/7,002	27,300	10%/2,730	+100%/2,730
28,009 (12% portfolio return)			30,030 (20% portfolio return)		

Option trading is a statistical game that generally involves a higher percentage of losing trades. Increasing your allocation to recover quicker from a losing streak or to take greater advantage of a winning streak is not in your best interest statistically. Stay with your plan. Be consistent. Your bottom line will thank you for it.

Keys to successful options trading

By applying all of the techniques enumerated in this chapter, you will have effectively *managed (reduced) your risk* and *managed (increased) your reward (profit potential)* so that your target risk/reward ratio is in your favor! Let's review how this is accomplished.

Managing your risk - You are trading only with your trading capital. You are investing in the portfolio(s) consistent with your risk threshold. Your positions are diversified using principles of two-dimensional diversification, and your capital is protected by your pre-determined closeout dates.

Managing your reward - Because you have managed your risk, you will never bail out too early and thus rob yourself of profit opportunities. You are targeting for substantial, yet achievable, profits (usually at least 100 percent in the Aggressive portfolios) using pre-determined target exit points. With this strategy,

you will stand to profit more at your target exit point than you stand to lose. Your target risk/reward ratio is in your favor!

The key to success - Risk/reward management allows you to profit despite the inevitable losses that will occur on specific option trades. In fact, just one large gain could more than wipe out several losses and result in a healthy bottom-line profit! For example, \$1,000 invested in an option that achieves a 100-percent target profit (double the original purchase price) will yield a profit of \$1,000. If two other \$1,000 positions each result in losses of 25 percent, the bottom-line profit would be \$500 (\$1,000 gain less \$500 loss), which is a 17-percent gain on the \$3,000 total investment. This could be achieved in a matter of weeks!

How the Option Advisor further increases your chances for success

The *Option Advisor* Aggressive portfolio recommends both shorter-term and longer-term options based on their risk/reward characteristics. Short-life options have a few months until expiration. They are excellent option trading vehicles since they offer the largest profit potential in the shortest period of time. Target exit points can often be reached in a matter of days or weeks. However, if the move fails to materialize, there is a greater risk of a quick loss. Longer-term options cost more, which takes a greater percentage move to achieve targets. An evolving trend often requires that more time be purchased until expiration, meaning that risk is reduced should the initial move not occur as quickly as expected.

The Put Selling portfolio offers an opportunity to collect premium on solid stocks that we feel will stay above a certain level (the put's strike price). This strategy does not require an explosive move (or any move for that matter) by the stock and can be profitable in most any market environment. What's more, we use short-term puts to take maximum advantage of time erosion – the decrease in an option's value over time that increases as an option approaches expiration. For those situations in which we expect a large move but are unsure of market direction, a straddle or strangle strategy will be recommended. We will use both short- and long-term options for this strategy, depending on our outlook for the stock.

The *Option Advisor* continuously analyzes the hundreds of available short-life and longer-term options. Using our unique sentiment analysis combined with fundamental and technical analysis, we present the timeliest trading opportunities to you every month. We give you the maximum opportunity to reach your target exit points as quickly as possible. Plus, our recommendations allow you to fully achieve the advantages of two-dimensional diversification. The next two sections will discuss our unique selection methods and how you can apply our conclusions to your option trades every month.

A steadfast application of the principles of risk/reward management will substantially improve your chances for success in options trading. We strongly suggest that you refer to this chapter from time to time to refresh yourself with our money management guidelines.

SECTION 2

OPTION ADVISOR TECHNIQUES

Section 1 presented the concepts underlying risk/reward management - the total approach to successful options trading. We demonstrated that risk/reward management maximizes your profit potential by optimizing your target risk/reward ratio, and that one profitable trade could offset several losses. We also discussed how options are ideal trading vehicles for achieving your full profit potential in the shortest period of time.

The importance of selecting the right underlying stock

Trading options using the principles of risk/reward management will maximize your profit potential, even with an average stock selection capability. The greatest success will, of course, result from selecting the right underlying stocks. The underlying stocks on which calls or puts are to be purchased must be “primed” for a quick move. The *Option Advisor* stock selection process, which is based upon our exclusive Expectational Analysis[®] approach, is designed to focus on those stocks that will be the strongest performers on a near-term basis. This is accomplished through a unique combination of sentiment-based tools that are superimposed on traditional technical and fundamental analysis.

Purchasing options recommended by *The Option Advisor* will yield large profits, but *only* if *all* of the following three conditions are satisfied:

- The underlying stock makes a *large move*.
- This move is in the *right direction* (although this is not the case with straddles and strangles).
- The move takes place in a relatively *short time period*.

This final condition must be emphasized. For holders of at-the-money or out-of-the-money short-life or longer-term options, an underlying stock that does not move prior to option expiration is as undesirable as a stock that moves in the wrong direction. In either case, the option will steadily decline in value (i.e., time erosion) until it expires worthless. Therefore, it is critical in selecting underlying stocks to eliminate the deadwood. A stock with a favorable technical pattern and a bright fundamental outlook will not benefit the call option holder if it spends a year consolidating for its next major rally!

The Option Advisor exclusive stock selection methodology

There are two traditional approaches to stock selection: *fundamental analysis* and *technical analysis*. Fundamental analysis deals with factors such as earnings, dividends, price-to-earnings (P/E) ratios, and projections of the strength of the economy. Technical analysis focuses on historical price patterns, volume characteristics, trends, and quantitative analysis to predict future price movement. Taking traditional stock analysis one step further, we have designed, developed, and refined what we term *Expectational Analysis*[®], an approach to market research that incorporates fundamental analysis, technical analysis, and *sentiment analysis* - the dissection and study of the beliefs and convictions of the market. Let's explore each of these components individually.

Fundamental Analysis

Generally speaking, we have found that fundamental reasons for entering a position are not particularly useful for short-term traders, since fundamentals usually assert themselves over a longer period of time. However, this does not mean that fundamentals should be ignored. It is essential that a short-term stock trader have a good knowledge of the company and industry, and of key dates, such as those for earnings, dividends, and industry-wide conferences. We use fundamental analysis primarily as a screen for potential stock plays. For example, knowing that earnings have increased a stock's volatility in the past may make it an attractive short-term play. Another reason we do fundamental analysis is because fundamental knowledge assists us in analyzing sentiment (see below).

Technical Analysis

An important step in our process of identifying profitable investment opportunities is technical analysis. This should not surprise you, as most people take a look at a chart of a stock before making an investment. In fact, there are literally hundreds of books on technical analysis available today. While most of these books focus on using technical analysis as the sole component of a trading system, we believe that technical analysis is best used as an indicator that foreshadows possible price movement. For instance, if a stock experiences twice the trading volume than it did the day before, we view this as a reason to take a closer look at the equity, versus an undisputed reason to buy the stock.

Due to the vast number of technical indicators that have been developed, real-time technical analysis can be a formidable task. Let's use the simple example of moving averages. Commonly followed moving averages include the 10-day, 20-day, 50-day, 100-day, 200-day, and 400-day trendlines. Even without adding intraday moving averages, such as the 200-minute or 600-minute trendlines, monitoring these indicators on a single equity can be very time consuming. Now, multiply this time spent by the thousands of available stocks, and you can see that this is a job suited for computers. That is exactly what SIR has done for *Option Advisor* subscribers. We have taken the technical indicators that have historically given us the best results and created computerized tracking systems to notify us when a stock nears or reaches an important technical level.

One of the primary technical tools we use is based on the concept of relative strength. A stock that is moving up more than the market on up days or holding its own relative to the market on weak days is in a bullish mode. Conversely, a stock that is down more than the market when the market is down or fails to rally significantly on up days is in a bearish relative strength pattern. Once we developed a way to monitor the shifts in relative strength, we found another interesting fact. Stocks that were moving for a reason had a greater tendency to continue to stay in the current relative strength profile than those that were moving based on price alone. In effect, there were underlying reasons that forced the stock to be relatively strong or relatively weak. Such initiators tended to spark the follow-through that promotes the steady trends that allow stock traders to profit handsomely.

One of the major benefits of the trend-initiating relative strength approach is its all-inclusiveness. It does not matter whether “value” or “growth” stocks are enjoying market leadership. Our indicators will pick up the stocks that are moving up or down in relative strength regardless of their nature. Finally, our research has shown us that the biggest winners, with the longest follow-through trends, came as a situation reversed a previous longer-term trend. For example, the first sharp move up after a pronounced downtrend was not an “overbought” condition, but rather only the first in a series of evolving gains. This phenomenon occurs because the crowd is generally stuck in the past. While “smart money” is buying the turnaround situation in a bigger way, other investors are slow to react and only come on board the new trend gradually over time, giving the trend its staying power after the first sharp move higher. These are characteristics of bullish situations that will provide *Option Advisor* subscribers with the biggest “winners” in momentum stock trading. Our research has shown that typical declines will be even quicker, and sharp spikes down in a period of less than one week are generally best used as opportunities to take short positions on stocks. Thus, the *Option Advisor* seeks to take advantage of the similarities of current signals with past knowledge and experience to maximize stock trading profits.

Sentiment Analysis

Indicators that measure the expectations of investors are among our favorite measures, as this area remains among the least understood and least quantified realm of market analysis. Sentiment analysis - the study of the beliefs, expectations, and convictions of the market - is often the missing link that explains why favorable fundamentals and favorable technicals do not always result in favorable future price action.

We have all seen highly touted stocks that report a “positive earnings surprise,” only to decline in price after this positive earnings report. “Profit taking” and “selling on the news” are the explanations that you will read about in the financial press, but the real answer is that expectations were *too high*. If expectations were modest or low, the stock would have rallied on the good report despite the fact that some people would be taking profits.

The analysis of options speculation can provide a good indicator of expectations. By watching the options market, it is easy to see exactly in what direction options players are betting. For example, a large increase in out-of-the-money calls (speculation for a large advance) indicates that expectations are high on the equity. Similarly, a large increase in out-of-the-money puts (speculation for a large decline) suggests skepticism by speculators. Additionally, the total number of puts versus calls can indicate expectations. A decrease in the put/call ratio implies investors are becoming more optimistic, while an increase implies additional fear and suggests that lower expectations have entered the market. Historically, the total number of calls normally exceeds the total number of puts. Therefore, when total puts exceed total calls, the expectations on the market are at or near a low.

High expectations suggest that buying power is depleted and that the stock is vulnerable to disappointments. Why is this so? High expectations generally indicate that most investors are likely to have already made the commitment to buy the stock. When the favorable report is released, there is little or no sideline money left to buy the stock and absorb any selling. Thus, the stock price may fall on “good news.” Under modest or low expectations, there would likely be many skeptical investors waiting to buy. When a positive surprise is reported, enough of this “sideline money” would likely move into the stock, covering any profit-takers. In other words, a low-expectation scenario improves the risk/reward profile of the trade.

When everyone is optimistic and bids up stock prices based on that rosy outlook, the smallest setback can start a stock falling. Similarly, if everyone expects the worst and sells, the smallest ray of hope can make the stock soar.

Short-life and longer-term option recommendations

In the Aggressive portfolio, promising call or put options are recommended on six underlying stocks. The ratio of calls to puts can vary according to our overall market view. Underlying stocks that we expect to outperform the market are call candidates, while anticipated laggards are scrutinized as possible put recommendations. This approach is designed to result in profits whether the market moves up *or* down.

Target profits and option prices may vary according to the magnitude of the expected short-term move. The general target profit for each Aggressive portfolio recommendation is *100 percent*. The strike prices for our option recommendations in the Aggressive portfolio are selected for the purpose of maximizing the profit potential of each situation based upon our movement projections for the underlying stock. For example, a call with a 40 strike price will not often be recommended on a \$30 stock, unless we expect a quick upside explosion in that particular stock. Nor would we recommend a call with a 20 strike price on that same stock, since such a call would be so far *in the money* as to drastically reduce leverage (and hence reduce profit potential). Generally, a mixture of at-the-money, moderately out-of-the-money, and moderately in-the-money options are recommended for purchase in the Aggressive portfolio. The pricing of various options and the subsequent risk/reward tradeoff are important factors in selecting the appropriate option on each underlying stock.

We will also sprinkle some longer-term options (up to six months) into the Aggressive portfolio to profit from anticipated lasting trends in the underlying stock. These recommendations are chosen based on our analysis of the longer-term potential for the stock for either bullish or bearish plays.

The Put Selling portfolio seeks up to three of the most-attractive put selling opportunities. We primarily look at quality big-cap issues with predictable earnings and strongly positive long-term outlooks. Any bad news that causes the stock to decline would likely be only temporary, and would mark a buying opportunity in anticipation of a subsequent rebound. This portfolio will also include at least one straddle or strangle trade, which seeks to take advantage of the underlying stock's volatility regardless of the direction of the eventual move.

We have now presented all of the ingredients needed to successfully trade both short-life and longer-term options in the *Option Advisor*. As we've stated, the optimal strategy consists of applying the principles of risk/reward management to each *Option Advisor* recommendation. A detailed explanation of how to use and interpret the statistics and charts contained in each monthly issue of the *Option Advisor* is presented in the next section.

SECTION 3

HOW TO USE *OPTION ADVISOR* STATISTICS AND CHARTS

In Section 2, we discussed the various underlying factors that result in the *Option Advisor* monthly presentation of the most attractive option buying opportunities.

The *Option Advisor* is mailed to you first-class on the fourth Friday of each month. (Note that in November and December, the newsletter may be mailed on the *third* Friday to avoid conflicts with holidays. Such schedule alterations will be made known in the previous month's issue.)

Alternatively, the *Option Advisor* is also available to subscribers at our password-protected website at SchaeffersResearch.com. Hotlines outlining the new recommendations are available via phone and the website on the Thursday evening *prior* to mailing. To be as timely as possible, all stock, option, and market data is based on closing prices on the Thursday before Friday's mailing.

The first thing that we hope you notice about the *Option Advisor* is that despite the underlying complexity of its stock and option analysis, *the newsletter is easy to interpret and easy to use*. Our format is ideal both for the busy subscriber who seeks an executive summary of our recommendations, as well as for the subscriber who wishes to do further research based upon our data. Let's review the contents of the *Option Advisor*, page by page.

Page 1

Commentary

The *Option Advisor* begins with a general commentary on the overall market, along with a chart of the Dow Jones Industrial Average, Nasdaq Composite, or other relevant major market index. In this section, we attempt to put recent stock and option market movements into perspective, as well as give you some insight into technical and sentiment factors that may be relevant. Schaeffer's Investment Research (SIR) has developed many outstanding market-timing tools, and *Timer Digest* has consistently ranked us at or near the top of all market timers monitored. Though our basic strategy is to insulate you from the impact of overall market changes by recommending a group of well-situated calls and puts, straddles/strangles, and put sells, we will position ourselves appropriately if we conclude that the market will move strongly in either direction over the short term. Our goal is to maximize your profits in *any* market environment.

Recommendations

The “heart” of the *Option Advisor* is contained in the recommendation table on page 1. This section contains all the important data on each option recommendation. The Aggressive portfolio recommendations are listed first, followed by the Put Selling portfolio. As seen in the illustration below, the data is arranged in simple columnar form and is subdivided into “Stock Re-Cap” and “Option Re-Cap” sections. Let’s review these sections for each portfolio.

Portfolio	Underlying Stock	STOCK RE-CAP					OPTION RE-CAP				
		Ticker Symbol	Closing Price 12/27	B = Buy S = Sell	Expiration Month	Striking Price (C = Call) (P = Put)	Closing Asked Price 12/27	Max. Entry Price	Target Profit	Closeout Date	Delta
A G G R E S S I V E	AOL Time Warner	AOEPG	32.43	B	April 35P	4.90	5.30	100%	1/29	55%	
	General Electric	GERI	40.95	B	June 45P	5.90	6.20	100%	2/12	65%	
	J.P. Morgan Chase	JPMRH	36.32	B	June 40P	6.20	6.50	100%	2/12	60%	
	Pulte Homes	PHMDH	45.47	B	April 40C	8.10	8.50	100%	1/29	75%	
	Wendy’s International	WENFE	29.06	B	June 25C	5.10	5.40	100%	2/12	80%	
	Yahoo!	YHZDC	17.77	B	April 15C	4.50	4.80	100%	1/29	75%	
P U T S E L L	Int’l. Game Technology	IGTMM	71.03	S	January 65P	1.25	1.10*	11.9%	1/18	25%	
	Krispy Kreme Doughnuts	KKDNH	45.66	S	February 40P	1.30	1.20*	20.8%	2/15	25%	
	NVIDIA	RVUML	69.38	S	January 60P	1.05	0.95*	12.0%	1/18	15%	
	Genzyme General (Straddle)	GZQBK	59.49	B	February 55C	7.10	10.00#	50%	1/29	70%	
		GZQNK		B	February 55P	2.45				30%	

Aggressive

Each month the most attractive opportunities on both sides of the market are combined to form the Aggressive portfolio recommendations. There are six Aggressive recommendations per issue, each keyed to a separate underlying stock. We recommend that you ideally enter each Aggressive recommendation and that an equal (as possible) dollar amount be invested in each trade. The goal is to achieve profits in any market environment through expert stock option selection. Our staff is dedicated to uncovering the most probable big movers in each direction. Note that a trending market environment is well suited for this portfolio, while the most difficult is a flat or sideways market in which premium may deteriorate on both calls and puts.

Let’s review some examples for clarification, using two recommendations from the Aggressive portfolio shown above.

Stock Re-Cap (1-3)			Option Re-Cap (4-5)	
(1)	(2)	(3)	(4)	(5)
Underlying Stock	Ticker Symbol	Closing Price	B=Buy S=Sell	Expiration Month Striking Price C=Call P=Put
General Electric	GERI	40.95	B	June 45P
Yahoo!	YHZDC	17.77	B	April 15C

We find that the General Electric (GE) June 45 put and Yahoo! (YHOO) April 15 call are recommended for *purchase*. Columns 1 through 5 provide the name of the underlying stock, the symbol for the recommended option, the closing price of the stock, whether the recommendation is a buy or sell (all Aggressive recommendations are buys), and the description of the option. Aggressive options will typically expire between three and six months from the recommendation.

Option Re-Cap (6-10)				
(6)	(7)	(8)	(9)	(10)
Closing Asked Price	Maximum Entry Price	Target Profit	Closeout Date	Delta
5.90	6.20	100%	2/12	65%
4.50	4.80	100%	1/29	75%

Looking at the remaining columns:

Column 6: Here we see that the GE call closed at an asked price (the lowest price a potential seller is willing to accept for the option) of 5.90, while the YHOO call closed at 4.50 asked. Rather than buying the same number of contracts of each, try to allocate equal (as possible) dollar amounts to each trade you enter.

Column 7: The Maximum Entry Price (MEP) is the *maximum* price you should pay for each option recommendation. The options market can be extremely fast moving, and an attractive option opportunity today may have achieved a good deal of its profit potential by tomorrow. By heeding the MEP, you avoid establishing positions in options that have already made a significant move, which reduces the profit potential below an acceptable level.

For the GE recommendation, the MEP is 6.20 (or \$620 per contract), 30 cents higher than the closing asked price of 5.90. If this option is trading at 6.50 when you're ready to establish your new position, we recommend two choices: place a limit order at or below the MEP that is either *good for the day only* or *good-'til-canceled* (GTC). The *day-only limit order* will expire at the close of that day if it is not filled, which is advantageous if the underlying stock should move sharply against you the following morning. Note that if your order is not filled, you will have to place another day-limit order the following morning if you are within the specified entry time frame (usually one week from the recommendation date). GTC orders are suitable for those who do not have the flexibility to call their brokers each morning with a new day order. GTC orders must be canceled if they have not been filled by the end of the recommended entry time period.

Returning to the GE option with a MEP of 6.20, do not be concerned if the option goes straight up from 6.50. There will always be other opportunities to buy options with a more favorable risk/reward profile. Remember that we generally do not suggest purchasing recommended options any later than one week following our Friday publication date, *regardless* of the option price (the recommended entry deadline is provided in the footnotes below the page 1 table). Timing is the key in option trading, and our recommendations are very carefully researched to yield optimal returns at or close to the time they are issued. You will thus achieve your best results by making your purchases during this one-week window and within the MEP guideline.

Columns 8 and 9: In Section 1, we emphasized the importance of using pre-calculated target exit points and closeout dates for each option position. The appropriate target profits for calculating target exit points are set forth separately for each recommendation in column 8. To determine your target exit point, multiply the target profit level by your purchase price and *add* this amount to your purchase price.

For example, the target profit is 100 percent for both the GE and YHOO options. For a GE June 45 put purchased at 6.20, the target profit of 100 percent would be achieved at a target exit point of 12.40. A target exit point table, provided in Section 5, shows pre-calculated target exit points corresponding to various purchase prices and target profits.

If a recommendation does not reach its target exit point by the closeout date in column 9, it is to be sold on the closeout date. The closeout date is usually well over one month prior to the expiration date for the Aggressive positions. In our YHOO example, the closeout date is January 29, nearly three months prior to the April option expiration. Closing out positions before or on the closeout date protects them against the accelerated loss of premium that occurs in the weeks prior to option expiration. There will be times that we extend these closeout dates if we feel that the underlying stock's impending move is favorable to our position. Such extensions will be announced on our hotlines (available via phone or the website).

Column 10: Delta provides an indication of how an option's price will move compared to the stock's price. Specifically, delta represents the percentage of the price movement in the underlying stock that will be translated into the price movement of a particular option. For example, if YHOO were to gain a point to 18.77, the April 15 call option should be expected to move up by about 0.75, given that all other pricing factors remain constant. As a general rule, the delta for a call option increases as the stock price rises, and decreases as the stock price declines. For a put option, the delta increases as the stock price falls, and decreases as the stock price rises. It's also important to realize that delta is not a static variable; its value will change with movement in the underlying stock's price.

To summarize the trading approach for the Aggressive portfolio:

Buying. Ideally invest equal (or as equal as possible) dollar amounts in the six recommendations each month.

Selling. Sell your positions when the *first* of the following conditions occurs:

- At your target profit, if your target exit point is achieved
- In accordance with updated instructions provided on the hotline or in a subsequent issue
- At the price prevailing on the closeout date

Put Selling

Put selling is just the ticket for investors looking to generate income in their portfolio - with the possibility of acquiring a quality blue-chip stock at prices below current levels. As opposed to covered call writing, where the investor purchases the stock at current levels and writes an out-of-the-money call to generate income, put selling involves selling an out-of-the-money put on a quality stock that the investor would be willing to buy if the stock took a temporary plunge. However, most of the time, the sold put will expire worthless, allowing the investor to pocket the premium without ever having to buy the stock. While there is a margin requirement when selling puts, this commitment of funds is significantly less than the outright purchase of the equivalent number of shares.

Put selling takes advantage of the concept of *time decay* - the premium an option sells for declines as the option approaches expiration. Also known as *time erosion*, time decay does not require an options trader to correctly predict the future direction of a stock's movement. Time premium will decay at a fairly predictable rate and will decay most rapidly the closer the option gets to its expiration. Unlike stock trading, where an investor can hold on to a stagnant stock indefinitely without losing anything (except better opportunities elsewhere), the value of an option will decline if the stock fails to move. Our Put Selling portfolio tends to recommend options with one to two months before expiration as this provides the optimal time frame to pocket substantial premiums with rapid time decay. In addition, if the price of the stock drops below a profitable level for the options trader, put selling is a great way to acquire that stock at a lower price, as long as the decline is expected to be only temporary.

The *Option Advisor* Put Selling portfolio screens for up to three of the most attractive put selling opportunities in each issue. Our universe of available stocks includes mostly those deemed to be quality big-cap issues. Thus, any bad news that causes the stock to decline would likely be only temporary, thereby marking a buying opportunity based on the shares' subsequent rebound. Let's look at an example of a Put Selling recommendation from the page 1 table shown previously:

Stock Re-Cap (1-3)			Option Re-Cap (4-5)	
(1)	(2)	(3)	(4)	(5)
Underlying Stock	Ticker Symbol	Closing Price	B=Buy S=Sell	Expiration Month Striking Price C=Call P=Put
NVIDIA	RVUML	69.38	S	January 60P

Option Re-Cap (6-10)				
(6)	(7)	(8)	(9)	(10)
Closing Asked Price	Maximum Entry Price	Target Profit	Closeout Date	Delta
1.05	0.95*	12.0%	1/18	15%

* Minimum entry price

Here we see that the NVIDIA (NVDA) January 60 put is recommended for *selling*. To sell a put, you must have a margin account. A margin account is required by SEC regulations to initiate positions that involve option sales. Most brokerage firms require that you keep a margined amount equal to the greater of (1) 20 percent of the underlying stock price plus the option premium received less the amount the option is out of the money, or (2) 10 percent of the underlying stock price plus the option premium. For the NVDA put, the second calculation results in a higher initial margin of 7.888 ($0.10 \times 69.38 + 0.95$), or \$788.80 per contract.

It is important to realize that there will be some occasions where the quality stocks we recommend in the portfolio will plunge due to market-related weakness or stock-specific concerns. **As a result, you must be financially capable of buying the stock at the lower price if the put option you sold is exercised.** This means that should NVDA plunge to a point below 60, the put buyer may wish to exercise their right to sell NVDA shares at a price of \$60 per share. As a seller at 0.95, you in effect have a breakeven on the position at a stock price of 59.05 (60 minus 0.95), so below 59.05 you begin to show a loss on the position. Our goal is to make sure that the fundamental and technical outlook on the underlying stock has not changed so that we can ride out such temporary volatility as just a blip, as opposed to something more serious. If conditions change, we will advise you to shut down the position, whether before exercise (by buying back the put) or after you've acquired the stock (by selling the stock).

There are several differences in the meaning and function of the Option Re-Cap section for the Put Selling portfolio. One is that the target profit (column 8) is based on the return on margin, which is calculated by dividing the premium received (in this example, \$95) by the allocated margin (\$788.80). As put selling on quality stocks is considered a relatively conservative option trading strategy, this portfolio generally targets profits between 10 and 25 percent. While these target profits seem much lower than the Aggressive portfolio, the higher percentage of winners makes up for the lower return on each winning trade. As with all other investment strategies, there are still losers in put selling; however, the percentage of losing trades is greatly decreased.

Another significant difference is the maximum entry price. In the case of put selling, this price is actually a *minimum* (column 7), since the trader is *accepting* this amount of premium as compared to the call buyer, who is *paying* this amount. Accepting any premium less than the value listed in the maximum entry price column of the Put Selling portfolio will result in risk/reward ratios that we deem unacceptable.

The closeout date for put sells (column 9) is the expiration date of the sold option. Since the object of this strategy is for the sold put to expire worthless, the maximum value of the position can only be realized at expiration. Therefore, the closeout date is the third Friday of the option's expiration month. Also, rather than provide the option's closing asked price, we provide the more relevant closing *bid* price in column 6, which is the highest price any potential buyer is willing to pay for the option. The delta (column 10) is the same as with the Aggressive portfolio.

To avoid more than a minority of losers from occurring, the *Option Advisor* strongly prefers to sell puts predominantly on quality big-cap stocks with predictable earnings and very positive long-term outlooks. This gives us the confidence to ride out many of the short-lived, though sometimes volatile, downdrafts in the stock or market as a whole. As a result, you will rarely see us making recommendations on high-flying tech stocks, as a bad earnings outlook can pummel such stocks much harder, with little bounce potential if bad news is reported. Such volatility does lead to juicier put option premiums, but in our view, such an attraction is not worth the potential downside volatility in your Put Selling portfolio. We want you to achieve more consistent results, which allow steady money management discipline to be applied consistently. And again, we emphasize that equal dollar amounts should be applied to each of the put selling trades whenever possible.

Straddles/Strangles

We recently introduced two similar trading strategies into the Put Selling portfolio – buying straddles and strangles. These strategies offer subscribers an enhanced ability to adapt to changing market conditions by allowing us to vary the strategies recommended each month. For example, we may offer one put sell and three straddles/strangles and follow up the next month with three put sells and one straddle/strangle.

A straddle is the simultaneous purchase of an equivalent number of both calls and puts on the same underlying stock with the same strike and same expiration. The straddle buyer is looking for a large move by the underlying before the options expire, but is unsure of the eventual direction of the move. If the underlying's subsequent move results in one of the options having a premium more than the amount of the combined premium paid for the two options, the straddle buyer will begin realizing a profit. Let's look at an example.

Stock ABC is priced at 50 and an investor purchases an at-the-money straddle, buying both a call and a put at the 50 strike. Both options have the same expiration. The price of the call is 1.90 and the price of the put is 2.10 for a total premium paid of 4. Therefore, the breakeven levels for this trade are four points in either direction (total of the premiums paid), or 46 and 54. Thus, the straddle holder profits when ABC moves more than four points, either up or down, from the 50-strike level by option expiration.

A strangle is very similar to a straddle, except that the options have different strike prices. Typically, the call has a strike above the current stock price, while the put's strike is below the stock price. As with a straddle, the strangle purchaser is looking for a large move by the stock that exceeds either strike level by more than the amount of the premium paid for both options. The strangle can be played at a lower cost, because both options are usually out of the money. Thus, the maximum loss (equal to the total premium paid) is smaller. Using the above example, a strangle buyer purchases the 52.50-strike call for 1.00 and the 47.50-strike put for 1.15. The strangle holder profits when the stock price exceeds the strike prices of the purchased options by more than the combined premium paid. In this case, the total premium of 2.15 results in breakeven points of 45.35 (47.50 minus 2.15) and 54.65 (52.50 plus 2.15). Thus, the stock must drop below 45.35 or rally above 54.65 for this strangle to be profitable.

As mentioned above, a straddle/strangle buyer is looking for a large move in the underlying stock. The advantage of these strategies is that, unlike buying a single option, the direction of the underlying move is unimportant. It is the magnitude of the move that directly impacts the position. Traders purchase straddles and strangles when they expect a large change in the stock price, such as that caused by an earnings announcement, takeover or merger speculation, a pending court decision, a new product announcement, or an uncertain economic report. Another reason to enter these trades is if the trader believes that the implied volatility of the purchased options will increase. Implieds are an important component of an option's price and such an increase will enhance the position's overall value.

When recommending a straddle or strangle, we will provide you with a maximum entry price for the trade as a whole, rather than provide prices for each option. Thus, you should key on the combined premium paid for the total trade, not on the premiums for the individual options. You should discuss how to enter these trades with your broker before your first trade to ensure that your instructions on maximum entry price will be followed properly. Let's look at the example from the page 1 table:

Stock Re-Cap (1-3)			Option Re-Cap (4-5)	
(1)	(2)	(3)	(4)	(5)
Underlying Stock	Ticker Symbol	Closing Price	B=Buy S=Sell	Expiration Month Striking Price C=Call P=Put
Genzyme General (straddle)	GZQBK	59.49	B	February 55C
	GZQNK		B	February 55P

Option Re-Cap (6-10)				
(6)	(7)	(8)	(9)	(10)
Closing Asked Price	Maximum Entry Price	Target Profit	Closeout Date	Delta
7.10	10.00#	50%	1/29	70%
2.45				30%

Maximum straddle/strangle price

This straddle position involves purchasing both a call and put at the 55 strike. Note that the call is in the money while the put is out of the money, which explains the discrepancy in their asked prices. The total amount that should be paid for both options is 10. Therefore, this trade will reach a breakeven point at February expiration if the stock reaches 65 (putting the call 10 points in the money) or falls to 45 (putting the put 10 points in the money). Again, the direction of the move is not as important as the magnitude of the move. While the closeout date occurs before the options expire, there will be times when we extend the closeout to expiration to allow the underlying stock's move to fully play out. Also, we will most always recommend closing the entire position rather than just one of the options.

Footnotes

The footnotes below the page 1 table contain valuable information pertaining to the recommendations. There are three items that you should be aware of:

- The entry window, which provides a date (usually one week after the publication date) by which the positions should be entered
- Current allocations, which contains the portfolio percentages allocated to cash and open positions had all recommendations been followed. These are derived from the monthly recommended allocations to each portfolio and the trades that are closed out throughout the month.
- The percentage of reserve cash for each portfolio that should be allocated to the current issue's recommendations. Ideally, these percentages should be spread as equally as possible across all the recommendations within the specific portfolio. There may be occasions when we will specify a larger percentage for a particular trade. Such instructions will be spelled out in this section.

Pages 2, 3, and 4

The recommendation table on page 1 is designed to give you a convenient overview of our monthly recommendations. On pages 2 through 4, we provide detailed information supporting the recommended underlying stocks. Pages 2 and 3 are devoted to the Aggressive portfolio, while page 4 covers the Put Selling portfolio (including the straddle/strangle trades).

We present a current chart for each underlying stock that shows valuable trend, volume, and pricing information. Next to the chart is our commentary on each stock's short-term outlook. We may refer to the stock's technical position, as well as our specific price objectives for the stock. Sentiment factors – including option volume and open interest, short interest, brokerage ratings, and news stories or magazine covers – will almost always be mentioned, as these are key ingredients of our Expectational Analysis[®] methodology. We may also comment on the specific option recommendations beyond what is displayed in the “Option Re-cap” section on page 1. Or we may mention something of significance from a fundamental standpoint, such as a recent or upcoming earnings report or dividend declaration. The focus of these commentaries will, of course, vary with each stock.

Page 5

Option Strategies & Concepts

Options trading is a subject of considerable depth and breadth. In each issue, “Option Strategies & Concepts” offers in-depth discussions of different aspects of options trading. Some recent topics covered in this column include the option/stock relationship, considerations in option decision-making, option terms and indicators, and a special “questions from subscribers” column. One component of the SIR mission statement is education - another valuable benefit of the *Option Advisor*.

Prior Recommendations

At any point in time, there will always be a number of our option recommendations that are *open*, i.e., the target exit point or the closeout date has not yet been reached. The “Prior Recommendations” section on page 5 provides a listing of open positions for each portfolio, as well as trades closed or opened since the previous issue. We also indicate the date of the hotline in which specific positions were opened or closed. These hotlines are archived on SchaeffersResearch.com as a benefit for our online subscribers.

Page 6

On The Money

The primary goal of the *Option Advisor* is to achieve profits through our short-life and longer-term option recommendations. However, we also strive very seriously to be a one-stop source of important information on the options market. Therefore, the *Option Advisor* devotes the “On The Money” section to provide information that we feel is relevant to *Option Advisor* subscribers. From month to month, you will find some of the following critical information in “On-the-Money:”

- The latest innovations in the options market
- News on hot sectors
- Advance notice of upcoming hotline number changes
- Information on upcoming events and appearances by SIR staff
- Quotes from other investment advisors and the financial press relevant to the stock and options markets
- Notification of a change in publication dates
- Information on SIR products that may be of interest to *Option Advisor* subscribers looking to expand their trading

In short, the *Option Advisor* is your *complete options newsletter*, dedicated to the essential goals of keeping you in the money *and* keeping you informed.

Special bulletins

Your *Option Advisor* editors are always studying the options market for attractive profit opportunities, and they realize that such opportunities do not begin and end with the recommendations contained in each monthly issue. When such immediate opportunities develop, *special bulletins* are transmitted to you via first-class mail and are available on the *Option Advisor* website. These bulletins are provided free of charge, in addition to the regular monthly recommendations.

SECTION 4

OPTION SYMBOLS AND QUOTES

How to read specific option symbols

Option symbols are composed of several parts: the ticker symbol, the month code, and the striking price code. The *ticker symbol* is merely the letters that an exchange uses to represent the underlying stock. For stock codes with more than three letters, the option ticker symbol will be shortened to three letters, usually ending in Q. For example, Microsoft's stock symbol is MSFT, but the option ticker symbol is MSQ. Each *expiration month* has a separate code for both calls and puts (Table 1). In addition, each *striking price* has a separate code, which is identical for calls and puts (Table 2). When listing an option, the option ticker symbol is first, followed by the expiration month code, and then the striking price code. For example, the IBM October 70 call would have the code IBMJN.

TABLE 1	
MONTH	CALL CODE
January	A
February	B
March	C
April	D
May	E
June	F
July	G
August	H
September	I
October	J
November	K
December	L
MONTH	PUT CODE
January	M
February	N
March	O
April	P
May	Q
June	R
July	S
August	T
September	U
October	V
November	W
December	X


TABLE 2		
CODE	STRIKING PRICE	
A	5	105
B	10	110
C	15	115
D	20	120
E	25	125
F	30	130
G	35	135
H	40	140
I	45	145
J	50	150
K	55	155
L	60	160
M	65	165
N	70	170
O	75	175
P	80	180
Q	85	185
R	90	190
S	95	195
T	100	200
U	7-1/2	37-1/2
V	12-1/2	42-1/2
W	17-1/2	47-1/2
X	22-1/2	52-1/2
Y	27-1/2	57-1/2
Z	32-1/2	62-1/2

How to access option quotes from SchaeffersResearch.com

Accessing option quotes on the Internet is convenient and easy and, most importantly, immediate. You don't have to wait until the next day to find out where your option stands - just log on, put in your symbol, and you're in business. And now we've made the process even easier with several enhancements to our website. Let's go through an example of how to access a quote from SIR's website at www.SchaeffersResearch.com.

Let's say you are generally interested in a variety of Microsoft (MSFT) call and put options; you are also bullish on the company and bought an October 50 call (symbol: MSQJJ). To see how your option is doing and to check out other MSFT options, log on to SchaeffersResearch.com and click on the "StreeTools™" tab running along the top of the home page. To view a variety of options at different strikes and expiration months for a stock, click on "Option Montage" under the "Option Tools" heading. Enter the stock symbol (MSFT) in the appropriate box to see prices for near-the-money MSFT call and put option contracts. To narrow or broaden your option search, use the pull-down boxes at the top of the montage page that search by expiration month, amount in or out of the money, etc.

From the montage page, you can click on any option to get detailed information. For our example, we clicked on MSQJJ to arrive at the chart shown below. Alternatively, you can click on "Stock Quotes" under the "Stock Tools" heading and enter the option symbol directly (note that a period must precede the option symbol).

(.MSQJJ)		2.60	0.00	
Price Data Table				
Aug 07, 2002 @ 12:36 (All data 20 minutes delayed.)				
Last Sale	2.60	Tick	Down	
Time of Last Sale	12:00	Exchange of Last Sale	Philadelphia	
Net Change	0.00	Previous Close	2.60	
Percent Change	0	Open	3.00	
High	3.20	Low	2.55	
Bid	2.50	Ask	2.65	
Size of Last Sale	1	Volume	315	
Open Interest	13260			

This information gives you the most up-to-date data on pricing and trading activity (SchaeffersResearch.com quotes have a 20-minute delay). Looking at an individual option quote, there are several pieces of information concerning the most recent transaction:

- The **Last Sale** indicates the trading price of the option in the most recent transaction.
- The **Time of Last Sale** tells you precisely when that transaction took place.
- The **Exchange of Last Sale** indicates the option exchange on which the last sale traded. There are five U.S. options exchanges: Chicago Board Options Exchange, Pacific Exchange, Philadelphia Exchange, AMEX, and International Securities Exchange.
- The **Tick** tells whether the last sale price was higher or lower than the previous sale price.
- The **Net Change** and **Percent Change** show how much, in both absolute and percentage terms, the last sale differed from the previous day's closing price.
- The **Size of Last Sale** gives the number of contracts (remember that one contract usually represents 100 shares of the underlying stock) that were involved in the last trade.

The remaining data gives a summary of the day's transaction activity:

- The **Previous Close** is the final transaction price from the previous day.
- The **Open** is the first transaction price of the current trading day.
- The **High** and **Low** gives the range of transaction prices for the day.
- The **Bid** is the highest price any potential buyer is willing to pay for a particular option at that moment.
- The **Ask** (also referred to as the "offer") is the lowest price any potential seller is willing to accept for a particular option at that moment.
- **Volume** is the number of contracts that have been traded so far during the current day.
- **Open Interest** represents the number of outstanding (or open) contracts in the exchange market on the particular option. It is updated at the end of each trading day.

While you're there, be sure to check out all the other free feature in our StreeTools™ section. Many of the available tools are used by our analysts every day in their trade recommendations, especially the sentiment-based indicators such as the put/call ratios and open interest configurations. Make StreeTools™ a part of your everyday trading regimen.

SECTION 5

THE *OPTION ADVISOR* OPERATIONS MANUAL

This chapter presents the nuts and bolts material you need to act on the *Option Advisor* specific recommendations and provides a glossary of options trading terminology.

Customer service

Now that you are an *Option Advisor* subscriber, you have access to our toll-free Customer Service Help Line. If you have questions that are not answered by this handbook...If you don't understand a strategy...If you need terminology clarified...If you have a question about your subscription...If anything at all seems confusing...simply call toll free at (800) 327-8833. Our representatives are available between the hours of 9:00 a.m. and 5:30 p.m. eastern time to help you resolve any subscription-related issues. In addition, we have established a separate e-mail address (service@sir-inc.com) exclusively for our subscribers for any questions, concerns, or requests about the newsletter or your subscription. Once again, thank you for ordering the *Option Advisor*.

How to use the telephone hotline service

The *Option Advisor* is published and mailed (and made available on our website) on the fourth Friday of the month (in November and December, we may publish on the third Friday). The option expiration calendar in this chapter contains precise mailing dates. To give you the earliest possible access to our recommendations, the telephone hotline is updated on the Thursday evening before publication, by 10:00 p.m. eastern time, with everything you need to know to enter a trade. This includes information on the option striking price, maximum entry price, target profit, and closeout date for each of the selections in our new issue.

The hotline is also updated on a *weekly* basis every *Monday* evening by 7:30 p.m. eastern time. This weekly message includes market commentary as well as a discussion of open positions, including closeout recommendations where indicated. New recommendations may also be included. Special hotlines updates are provided by 12:30 p.m. eastern time on the trading day following a +/- 100-point close on the Dow Jones Industrial Average (on Fridays, these updates will occur by 7:30 p.m. that evening).

For your protection, and with prior notice to all of our current subscribers, we may change our unlisted hotline number to eliminate and prevent unauthorized usage. We also reserve the right to immediately cancel all services and recover damages from anyone found revealing the unlisted hotline telephone number. Your cooperation is appreciated. This hotline information is also available at www.SchaeffersResearch.com.

Website access

Putting the *Option Advisor* on SchaeffersResearch.com has been one of the most popular improvements we've ever made to the newsletter. Simply click on the "My Schaeffer's" tab at the top of our home page, enter your password, and you'll have instantaneous access to the current issue and hotline, plus an archive of previous issues and hotlines. As an added bonus for our online subscribers, we now offer access to our exclusive online Sentiment Trading Tools and other market data to stay up-to-date with every recommendation. You can look at an array of sentiment charts and current market information including our sentiment snapshot, historical volatility charts, a variety of price charts, an options montage, our most recent commentaries on that stock, fundamental data, and more. The handbook and other trading materials are also available. If you'd like to switch your subscription to have online access, please call our customer service department toll free at (800) 327-8833.

Option expiration calendar

The 2003 option expiration calendar, found on the following page, includes all of the important dates for the options trader, including *Option Advisor* publication and telephone hotline dates.

Target exit point table

For your convenience, we have pre-calculated the appropriate target exit points for a wide variety of purchase prices and target profits. Once you know your purchase price for a position, the target exit point can be determined simply by looking under the applicable target profit column. The target profit for each position is shown in every issue of the *Option Advisor* and is provided in the recommendation hotline available on the Thursday before publication.

2003 OPTION EXPIRATION CALENDAR

JANUARY	FEBRUARY	MARCH																																																																																																																																					
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- Expiring option classes cease trading.
- Exchange holiday.
- △ THE OPTION ADVISOR published. Telephone Hotline recommendations available prior evening.

TARGET EXIT POINT TABLE

Purchase Price	Target Profit*				
	50%	75%	100%	125%	150%
5.00	7.50	8.80	10.00	11.30	12.50
5.20	7.80	9.10	10.40	11.70	13.00
5.40	8.10	9.50	10.80	12.20	13.50
5.60	8.40	9.80	11.20	12.60	14.00
5.80	8.70	10.20	11.60	13.10	14.50
6.00	9.00	10.50	12.00	13.50	15.00
6.20	9.30	10.90	12.40	14.00	15.50
6.40	9.60	11.20	12.80	14.40	16.00
6.60	9.90	11.60	13.20	14.90	16.50
6.80	10.20	11.90	13.60	15.30	17.00
7.00	10.50	12.30	14.00	15.80	17.50
7.20	10.80	12.60	14.40	16.20	18.00
7.40	11.10	13.00	14.80	16.70	18.50
7.60	11.40	13.30	15.20	17.10	19.00
7.80	11.70	13.70	15.60	17.60	19.50
8.00	12.00	14.00	16.00	18.00	20.00
8.20	12.30	14.40	16.40	18.50	20.50
8.40	12.60	14.70	16.80	18.90	21.00
8.60	12.90	15.10	17.20	19.40	21.50
8.80	13.20	15.40	17.60	19.80	22.00
9.00	13.50	15.80	18.00	20.30	22.50
9.20	13.80	16.10	18.40	20.70	23.00
9.40	14.10	16.50	18.80	21.20	23.50
9.60	14.40	16.80	19.20	21.60	24.00
9.80	14.70	17.20	19.60	22.10	24.50
10.00	15.00	17.50	20.00	22.50	25.00

* Minimum tick for options trading below 3 is .05 and for all other series, .10. Prices are therefore rounded up to the nearest 0.10.

TARGET EXIT POINT TABLE (continued)

Purchase Price	Target Profit*				
	50%	75%	100%	125%	150%
10.20	15.30	17.90	20.40	23.00	25.50
10.40	15.60	18.20	20.80	23.40	26.00
10.60	15.90	18.60	21.20	23.90	26.50
10.80	16.20	18.90	21.60	24.30	27.00
11.00	16.50	19.30	22.00	24.80	27.50
11.20	16.80	19.60	22.40	25.20	28.00
11.40	17.10	20.00	22.80	25.70	28.50
11.60	17.40	20.30	23.20	26.10	29.00
11.80	17.70	20.70	23.60	26.60	29.50
12.00	18.00	21.00	24.00	27.00	30.00
12.20	18.30	21.40	24.40	27.50	30.50
12.40	18.60	21.70	24.80	27.90	31.00
12.60	18.90	22.10	25.20	28.40	31.50
12.80	19.20	22.40	25.60	28.80	32.00
13.00	19.50	22.80	26.00	29.30	32.50
13.20	19.80	23.10	26.40	29.70	33.00
13.40	20.10	23.50	26.80	30.20	33.50
13.60	20.40	23.80	27.20	30.60	34.00
13.80	20.70	24.20	27.60	31.10	34.50
14.00	21.00	24.50	28.00	31.50	35.00
14.20	21.30	24.90	28.40	32.00	35.50
14.40	21.60	25.20	28.80	32.40	36.00
14.60	21.90	25.60	29.20	32.90	36.50
14.80	22.20	25.90	29.60	33.30	37.00
15.00	22.50	26.30	30.00	33.80	37.50

* Minimum tick for options trading below 3 is .05 and for all other series, .10. Prices are therefore rounded up to the nearest 0.10.

THE *OPTION ADVISOR* RECOMMENDATION FORM

Copy this form for added convenience to record the *Option Advisor* recommendations from the telephone hotline. Recommendations can also be printed from our website at SchaeffersResearch.com. These recommendations are available by 10:00 p.m. eastern time on the Thursday night of publication week (before the fourth Friday of each month as a rule).

AGGRESSIVE PORTFOLIO

Option Ticker Symbol	Buy	Expiration Strike Call/Put	Maximum Entry Price	Target Profit	Closeout Date	Underlying Stock

PUT SELLING PORTFOLIO (including straddles/strangles)

Ticker Symbol	Write/ Buy	Expiration Strike Call/Put	Minimum Entry Price	Target Profit	Option Expiration	Underlying Stock

SECTION 6

YOUR *OPTION ADVISOR* ADDED FREE BENEFITS

Portfolio tracker

This powerful tool can really enhance your subscription. *Option Advisor* subscribers can track their investments using our free Portfolio Tracker right online. This tracker offers you user-friendly methods for following your stocks, mutual funds, bonds, and of course options. It's not only secure, but also flexible and robust.

Just click on the "My Schaeffer's" tab at the top of the SchaeffersResearch.com home page, enter your username and password, then click on Portfolio Tracker...and you're in.

Membership advantage program

As an *Option Advisor* subscriber, you automatically become part of the Membership Advantage Program, offering you new opportunities to save money on quality products from Schaeffer's and our program partners.

The Membership Advantage Program entitles you to:

- Schaeffer's Investment Research: 15 percent off the standard retail price on any book, bulletin, or real-time alert service, including renewals
- *Investor's Business Daily*: 10 percent off a new one- or two-year subscription to *Investor's Business Daily*
- *Barron's*: 50 percent off a three-month subscription to *Barron's* financial weekly newspaper
- Traderslibrary.com: 25 percent off any product on their website

To find out more about this exciting program, go to www.SchaeffersResearch.com/oacard.

GLOSSARY OF IMPORTANT OPTIONS TRADING TERMS

ASKED PRICE	Also OFFERING PRICE. The lowest price any potential seller is willing to accept for a particular option.
AT-THE-MARKET ORDER	Also MARKET ORDER. An order to purchase (or to sell) at the best available price. At-the-market orders must be executed immediately and therefore take precedence over all other orders.
AT THE MONEY	Also ON THE MONEY. An option is at the money when the underlying stock sells at the same price as the exercise price of the option.
BEARISH	An outlook anticipating lower prices in the underlying security.
BEARISH SPREAD	An option spread designed to be profitable if the underlying security declines in price. A bearish spread usually consists of purchasing an in-the-money put and writing an out-of-the-money put. See OPTION SPREAD.
BID PRICE	The highest price any potential buyer is willing to pay for a particular option.
BID/ASKED QUOTATION	The latest available bid and offering prices for a particular option series.
BID/ASKED SPREAD	The difference in price between the latest available bid and offering quotations for a particular option series.
BULLISH	An outlook anticipating higher prices in the underlying security.
BULLISH SPREAD	An option spread designed to be profitable if the underlying security rises in price. A bullish spread usually consists of purchasing an in-the-money call and writing an out-of-the-money call. See OPTION SPREAD.

CALENDAR SPREAD

Also TIME SPREAD. An option spread consisting of the purchase of an option and the simultaneous sale of a *different* option on the *same* security with a *closer* expiration date. The purpose of a calendar spread is to profit from the accelerated loss in time value of the option that is written, relative to the option that is purchased. Calendar spreading is often a *neutral* strategy, but it can also be bullish or bearish, depending upon the options involved. See OPTION SPREAD.

CALL

An option contract that entitles the holder to buy a number of shares (usually 100) of the underlying common stock at a stated price (see STRIKING PRICE) on or before a fixed expiration date.

CALLED AWAY

The process whereby a call option writer is obligated to surrender the underlying stock to the option buyer at a price equal to the striking price of the call written.

CASH SETTLEMENT OPTION

An option through which exercise is accomplished by a payment in cash, rather than by the delivery of the underlying security. The amount of cash settlement is determined by the difference between the option striking price and the price of the underlying security. Stock index and industry group options are cash settlement options.

CLASS OF OPTIONS

A group of puts or a group of calls on the same security.

CLOSEOUT DATE

The date by which a recommended position is to be closed out if its target exit point is not reached.

CLOSING PRICE

The price of a stock (or option) at the last transaction of the day.

CLOSING PURCHASE

A transaction in which an investor who had previously written an option intends to liquidate the position as a writer by buying, in a closing purchase transaction, an option having the same terms as the option previously written.

CLOSING SALE	A transaction in which an investor who had previously purchased an option intends to liquidate the position as a holder by selling in a closing sale transaction an option having the same terms as the option previously purchased.
CONTRACT	A call or put issued by The Options Clearing Corporation.
COVERED WRITING	A form of option writing in which the writer (using calls as our example) owns a quantity of the underlying security equivalent to the number of option contracts written. It is less risky than outright long stock positions.
DAY ORDER	A limit order entered through a broker that, if not executed on the day it is entered, is automatically canceled at the close of business on that day.
DELTA	Also NEUTRAL HEDGE RATIO. The percentage of the price movement in the underlying stock that will be translated into price movement in a particular option series. For example, a delta of 50 percent indicates that the option will move up or down by about half of the movement in the underlying stock. As a general rule, the delta for a call option increases as the stock price rises, and decreases as the stock price declines.
DISCOUNT BROKER	A broker whose commission rates are lower than the norm. Usually provides little in additional services such as investment research and/or advice.
DIVERSIFICATION	An investing or trading strategy in which positions are maintained in a variety of underlying stocks for the purpose of reducing risk and increasing bottom-line profits.
EXERCISE	The procedure whereby the holder of an option notifies The Options Clearing Corporation (through the holder's broker) that he wishes to purchase the underlying stock (in the case of a call) or deliver the underlying stock (in the case of a put) at the exercise price.

EXERCISE PRICE	Also STRIKING PRICE. The price per share at which the holder of an option can purchase (in the case of call options), or sell (in the case of put options) the underlying stock upon exercise.
EXPIRATION DAY (or EXPIRATION DATE)	Also MATURITY DATE. The last day on which the option may be exercised. Listed options cease trading on the third Friday of each month, which is one day <i>prior</i> to their expiration date.
EXECUTION	The actual completion of a buy or sell order on the exchange floor.
FULL-SERVICE BROKER	A broker that provides investment research, information, and advice, as well as the services involved in purchasing and selling securities. Usually charges full commission rates with no discounts.
GOOD-TILL-CANCELED ORDER	A limit order entered through a broker that remains on the books of the exchange trading floor until executed or until canceled by the originator of the order (abbreviated GTC).
INDEX OPTION	An option whose underlying security is a stock index. This includes options on the overall market (such as the S&P 100 Index options) as well as options on narrower-based industry groups. Index options are cash settlement options.
IN THE MONEY	An option is in the money when it has intrinsic value. A call is in the money when the market price of the underlying stock is greater than the option's exercise price. A put is in the money when the market price of the underlying stock is lower than the option's exercise price.
INTRINSIC VALUE	The excess of the market price of the underlying stock over the striking price of the option for a call, or the excess of the striking price of the option over the market price of the underlying stock for a put.
LAST SALE PRICE	The price of a stock (or option) at the latest transaction consummated.

LEAPS	An acronym for Long-term Equity Anticipation Securities . LEAPS are put or call options with expiration dates set as far as three years into the future. Like standard options, each LEAPS contract represents 100 shares.
LIMIT ORDER	An order to purchase at or below (or to sell at or above) a specified price (the limit price). Limit orders can be executed <i>only</i> when the limit price is consistent with the bid/asked quotation at any point subsequent to the entering of the order. Limit orders are either GOOD-TILL-CANCELED or DAY ORDERS .
LIMITED RISK	An investment where the possible loss cannot exceed a pre-determined amount. For option purchases, this amount is the initial cash outlay.
LIQUID (OR LIQUIDITY)	The ease in which a purchase or sale can be made without disrupting existing market prices.
LISTED OPTIONS	Those options that are traded on one or more of the option exchanges. Unlike over-the-counter or unlisted options that must be exercised to have any value, listed options have an active secondary market on the options exchanges. Most traders in listed options close their positions in this secondary market prior to exercise.
LONGER-TERM OPTION	An option contract having more than a few months until expiration. The longest-term options are known as Long-Term Equity Anticipation Securities (LEAPS) , which are options usually having 1 to 2 years until expiration.
MARKET ORDER	Also AT-THE-MONEY ORDER . An order to purchase (or to sell) at the best available price. Market orders must be executed immediately and therefore take precedence over all other orders.

MATURITY DATE	Also EXPIRATION DAY or EXPIRATION DATE. The last day on which the option may be exercised. Listed options cease trading on the third Friday of each month, which is one day <i>prior</i> to their expiration date.
NAKED WRITING	A form of option writing in which the writer (using calls as our example) owns <i>neither</i> the underlying security <i>nor</i> a different option on that same security with the same (or later) expiration date and lower striking price.
NEUTRAL HEDGE RATIO	Also DELTA. The percentage of the price movement in the underlying stock that will be translated into price movement in a particular option series. For example, a neutral hedge ratio of 50 percent indicates that the option will move up or down by about half of the movement in the underlying stock. As a general rule, the neutral hedge ratio for a call option increases as the stock price rises, and decreases as the stock price declines.
NEUTRAL SPREAD	An option spread created to profit from a narrow movement of the underlying stock in <i>either</i> direction. Neutral spreads are most often calendar spreads. See OPTION SPREAD, CALENDAR SPREAD.
OFFERING PRICE	Also ASKED PRICE. The lowest price any potential seller is willing to accept for a particular option.
ON THE MONEY	Also AT THE MONEY. An option is on the money when the underlying stock sells at the same price as the exercise price of the option.
OPEN INTEREST	The number of outstanding option contracts in the exchange market or in a particular option class or series.
OPENING PRICE	The price of a stock (or option) at the first transaction of the day.
OPENING PURCHASE	A transaction in which an investor becomes the holder of an option.

OPENING SALE	A transaction in which an investor becomes the writer of an option.
OPTION	A contract that entitles the holder to buy or sell a number of shares (usually 100) of a particular common stock at a predetermined price (see STRIKING PRICE) on or before a fixed expiration date.
OPTION SPREAD	A position that results from the purchase of an option and the <i>simultaneous sale</i> (or write) of a <i>different</i> option on the <i>same security</i> . See BULLISH SPREAD, BEARISH SPREAD, NEUTRAL SPREAD.
OPTION WRITING	The result of selling options in an opening transaction. See COVERED WRITING, NAKED WRITING.
OPTIONS CLEARING CORPORATION, THE	The issuer of all options contracts traded on the American Stock Exchange, Chicago Board Options Exchange, Pacific Stock Exchange, Philadelphia Stock Exchange, and International Securities Exchange.
OPTIONS EXCHANGE	Any or all of the following markets where option contracts are traded: American Stock Exchange, Chicago Board Options Exchange, Pacific Stock Exchange, Philadelphia Stock Exchange, and International Securities Exchange.
ORDER	An instruction to purchase or sell an option, first transmitted to a brokerage office, and then submitted to the exchange floor for execution.
OUT OF THE MONEY	An option with no intrinsic value. A call is out of the money when the exercise price is higher than the market price of the underlying stock. A put is out of the money when the exercise price is lower than the market price of the underlying stock. The entire premium of an out-of-the-money option is due to its time value.

POSITION	A position is established when an investor makes an opening purchase or sale of an option, or establishes an option spread.
PREMIUM	The price paid by a buyer to the seller of an option. It is quoted on a per share basis. The premium will usually exceed the intrinsic value of the option because of the time value involved.
PUT	An option contract that entitles the holder to sell a number of shares (usually 100) of the underlying common stock at a stated price (see STRIKING PRICE) on or before a fixed expiration date.
RETURN IF CALLED	The percentage gain that a covered writer would achieve should the underlying stock be called away. The components of this return are the original option premium plus any dividends plus any appreciation to the striking price. This is the maximum return achievable by a covered writer. See CALLED AWAY, COVERED WRITING.
RISK/REWARD MANAGEMENT	The complete trading approach developed by the <i>Option Advisor</i> . It results in risk being reduced and reward (or profits) being increased, thereby maximizing the target risk/reward ratio.
ROLLING OUT	Substituting an option of the same class and striking price, but with a later expiration.
ROLLING UP	Substituting an option of the same class and expiration, but with a higher striking price (a lower striking price in the case of puts).
SERIES	Options of the same class having the same exercise price and expiration time.
SHORT-LIFE OPTION	An option contract having from several weeks to a few months until expiration.

STRADDLE	The purchase or sale of an equivalent number of puts and calls on a given underlying stock with the <i>same exercise price</i> and expiration date. The straddle purchaser seeks to profit from relatively large movements in the price of the underlying stock, <i>regardless</i> of direction.
STRANGLE	The purchase or sale of an equivalent number of puts and calls on a given underlying stock, with the same expiration date but <i>different exercise prices</i> . The strangle purchaser seeks to profit from large movements in price of the underlying stock, <i>regardless</i> of direction.
STRIKING PRICE	Also EXERCISE PRICE. The price per share at which the holder of an option can purchase (in the case of call options), or sell (in the case of put options), the underlying stock upon exercise.
TARGET EXIT POINT	The predetermined price at which option holdings would be sold at a lucrative yet achievable profit. It is a key component of the <i>Option Advisor</i> overall strategy of risk/reward management.
TIME PREMIUM (or TIME VALUE)	The portion of the premium that reflects the remaining life of an option. It can also be measured as the amount over the option's intrinsic value.
TIME SPREAD	Also CALENDAR SPREAD. An option spread consisting of the purchase of an option and the simultaneous sale of a <i>different</i> option on the <i>same</i> security with a <i>nearer</i> expiration date. The purpose of a time spread is to profit from the accelerated loss in time value of the option that is written, relative to the option that is purchased. Time spreading is often a <i>neutral</i> strategy, but it can also be bullish or bearish, depending upon the options involved.
TRADING FLOOR	The location at the options exchange where the contracts actually are bought and sold.
TRUNCATED RISK	The ability of an investment to resist additional loss. Truncated risk is of particular relevance to options.

For example, one cannot lose more than the premium paid for an option. Profits, however, are theoretically unlimited on an option and are equal to the intrinsic value of the option less the premium paid (assuming there is no longer any time value remaining).

TWO-DIMENSIONAL
DIVERSIFICATION

An option trading strategy developed by the *Option Advisor* consisting of purchasing calls *and* puts to obtain insulation from the impact of overall market movements.

UNDERLYING STOCK

Also SECURITY. The stock that would be purchased or sold should the option be exercised.

VOLUME

For options, the number of contracts that have been traded within a specific time period, usually a day or a week.

DISCLAIMER

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