

Safe Signals

We've talked in past issues about some of the pros and cons of investing in oil companies. Whether that's picking a mega-oil company like Exxon Mobile (XOM) or a company that deals with refining petroleum products like Valero Oil (VLO) the idea of getting a little back after all you give at the pump should be appealing to most investors.

Oil stocks don't always move in perfect harmony with the price per barrel of crude, but they always move and that's important for option traders. Valero Oil for example has traded as high \$78 and as low as \$45 in the past year. That's more than 76% movement up or down. If you owned 1000 shares of VLO and wrote covered calls on them month in and month out and did nothing else you would make on average 3.5% monthly because of the volatility of this stock. With its average price in the past year of \$61 per share, that's a little over \$2100 monthly. If your bill at the pump each month is more than that, you probably shouldn't worry about the price of gas right now. If it isn't, consider letting the big oil companies pick up your gas tab this year.

Scott Jefferies

Editor

The Signal Newsletter



Table of Contents

- A Week in Review1
- The SOS2
- Watch for the Signals4
- Trade Updates.....5
- Learning the Options5

A Week in Review

The three major indexes each gave up between 3 ½ to 4% this past week and oil prices were the culprit behind the drop. The price per barrel of crude oil started out this week at \$126 and before a small pullback on Friday got as high as \$135. If this push up on price by the oil speculators continues the markets could see a much rougher summer than what housing slumps, sub-prime lending issues, and credit crunches could ever hope to bring about themselves.

Other items trying to push the market last week were new home starts and initial claims and while both were in line with market expectations neither were able to give traders enough confidence to start buying. Both reports also came after the release of minutes from the last Fed meeting.

Shortly after the Fed announcement last month of another rate cut there was much speculation about the end of cuts being here. The market behaved bullish overall as evidenced by 4 of the last 5 weeks ending bullish in the three major indexes we follow. The speculation was that rate cuts were over due primarily to improvements in the overall economy, but with the release of the minutes the Fed revealed that the possible halting of rate cuts was due more to inflation worries. Further speculation was that the inflationary pressures were tied almost directly to the price of oil and gas. Call it speculation if you will, we just call it common sense.

Is it any wonder that infaltion is at risk of increasing at unmanagable rates when the price of oil has more than doubled in one year and that even a year ago when the price per barrel was pushing up through 60, 70, and 80 we were concerned about the effect it would have on the overall economy? Is it any wonder that a recent report out shows the price of wheat, corn,

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The Signal

and soy products are likewise going through the roof? Will it be a surprise to you when you can afford a gallon of gas easier than a pound of flour? Oil prices are simply out of control and we can only hope that a real pullback is on the horizon. If not, expect more bears than bulls going through the rest of the year, and store some wheat for a rainy day.

For the week the major markets looked like this:

	Started	Ended	Change	Change%
DJIA	12986.80	12479.63	-507.17	-3.9%
NSDQ	2528.85	2444.67	-84.18	-3.3%
S&P 500	1425.35	1375.93	-49.42	-3.5%



This Week's Safe Option Strategy

Research In Motion Ltd. RIMM - Volatility Strangle

Research In Motion Limited engages in the design, manufacture, and marketing of wireless solutions for the mobile communications market worldwide. It provides

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platforms and solutions for access to time-sensitive information, including email, phone, short messaging service, Internet, and intranet-based applications. The company's technology enables an array of third party developers and manufacturers to enhance their products and services with wireless connectivity to data. Its portfolio of products includes the BlackBerry wireless platform, the RIM Wireless Handhelds product line, software development tools, and other hardware and software solutions. The company's BlackBerry wireless solution comprises wireless devices, software, and services. It also enables the use of personal information management functions, such as calendar, address book, task list, and other functions associated with personal organizers.

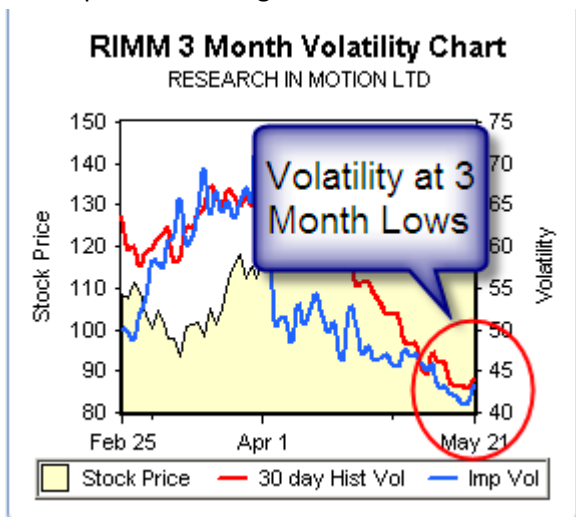
The Technical Signals: Research In Motion is currently trading bullish with all time highs since the three for one stock split. At the same time there has been a recent pullback to the 20 day EMA. The company has a history of moving big around its fixed economic events, but our trade is based more on the implied volatility (IV) being very low as RIMM is still 5 weeks away from its next fixed news event. Recent support and resistance give it a very good chance of moving big before hitting a barrier, psychological or otherwise, and even with little movement at all the trade could profit as IV increases

The Trade: A strangle trade takes advantage of a stock that has a tendency to move big in one direction or the other. When you combine the volatility aspect in this trade the move does not have to be as big. The long call has nothing keeping it in check for profit after the loss on the put has been overcome.

The trade combines long calls and long puts both near but slightly out of the money and both in the same month of expiration; usually three or more months out. The two option instruments are placed at different strike prices (the

The Signal

same type of trade with the strike prices the same on both options is called a straddle). Movement is needed in at least as big an increment as the total debit of the trade to guarantee profitability in a traditional strangle, but in a volatility play that is often not the case because whatever option side is losing is also being slightly offset by increased IV. Say for example the stock moves down after placing the trade: the put will not only gain value, but could do so at a faster than normal pace as the fixed news event (earnings in this case) gets closer. Meanwhile the call is losing value, but that loss can be partially mitigated by the increase in IV. In other words the call won't lose value as fast as the put gains value. The same would be true but in reverse if the stock moved bullish after placing the trade. While it is a safe trade in the sense that either direction can produce a profit and you are therefore not guessing what direction the stock will or needs to move, you could still lose the enter debit if the stock moved stagnant or flat for too long a period of time. For that reason we usually target 10-15% profit on the trade and hope to be closing it in 2-3 weeks at the most.

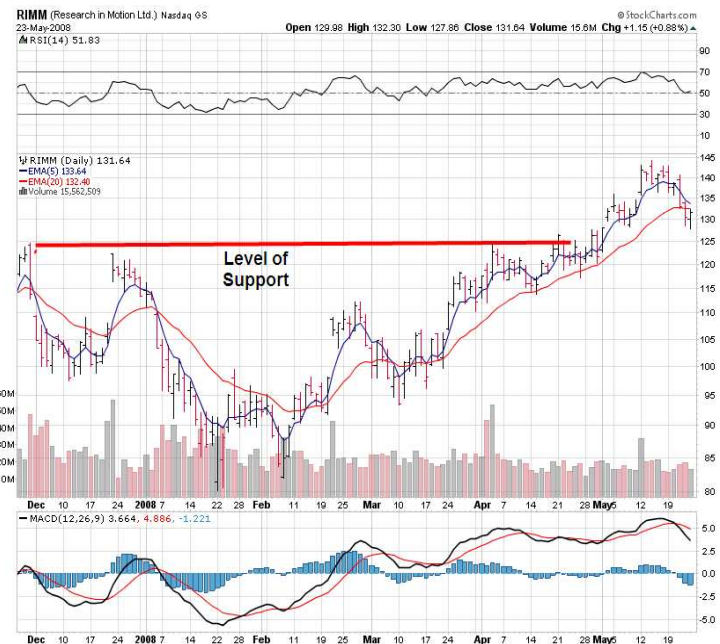


The Exit Plan: On this trade we simply set an automatic closing of the trade when a 15% profit can be achieved. It doesn't matter if the stock moves up or down. All we want is movement. With the volatility factoring in we don't even

need the fast movement sometimes required to make a straddle or strangle profitable.

If the stock stays flat (unlikely but not impossible) we have to decide if one leg is slightly better off than the other and go with that leg as our primary money maker, but we have the added pressure of trying to offset losses in the other leg to help the trade along. The losing leg will therefore be modified to either a credit spread or calendar spread. The modification to a sideways movement is not uncommon and requires paying closer attention to the trade day in and day out. While we don't expect something like that with RIMM we have to remember that past performance is never a guarantee of what a stock will do in the future.

One last note on exiting the trade: RIMM reports its earnings on June 25 and with the trade being placed with September options we do have plenty of time to look at other scenarios if the trade is not profitable by that time. Patience is key in this trade.



The Signal

Jun 08 Calls	(25 days to expiration)	RIMM @ 131.64	Jun 08 Puts
Jul 08 Calls	(53 days to expiration)	RIMM @ 131.64	Jul 08 Puts
Sep 08 Calls	(116 days to expiration)	RIMM @ 131.64	Sep 08 Puts
RULE	18.54 0 18.45 18.60 00 1,650 Trade	125.00	RULUE 11.25 0 11.00 11.10 00 1,364 Trade
RULV	15.95 0 15.85 16.00 00 3,995 Trade	130.00	RULUV 14.00 0 13.35 13.50 00 2,121 Trade
RULW	13.60 0 13.50 13.65 00 2,132 Trade	135.00	RULUW 17.00 0 16.00 16.15 00 2,530 Trade
RULH	11.50 0 11.45 11.50 00 2,607 Trade	140.00	RULUH 19.50 0 18.90 19.10 00 520 Trade
Dec 08 Calls	(207 days to expiration)	RIMM @ 131.64	Dec 08 Puts
Jan 09 Calls	(235 days to expiration)	RIMM @ 131.64	Jan 09 Puts
Jan 10 Calls	(599 days to expiration)	RIMM @ 131.64	Jan 10 Puts

Buy to open 130 strike long puts for \$13.50 per share.
 Buy to open 135 strike long calls for \$13.65 per share.
 Total debit per share is \$27.15
 Max Risk is \$27.15
 Target Return is 15% or selling to close both options for \$31.25

Wed: RL, AEO,
 Thurs DELL, COST, SHLD, HNZ, BIG,
 Fri: TIF,

The news let's us know that the cost of oil is still going up. \$4.00 a gallon gas does hurt our pockets but does it make you go and cash in your profitable positions in the market to pay for it? Warren Buffet over the weekend also let the world know he thinks we are already in a recession and it will last for a long time. Don't forget the Federal Reserve said its monetary policy will probably remain on hold until the rate cuts and the tax rebate stimulus package plays out. According to the experts, "the experts are split over whether oil prices will cause broad-based inflation, further economic weakness, or both at the same time". So how was your weekend?

The reason that I mentioned everything in the last paragraph is to make this point, NOBODY KNOWS where the market is heading right now. The United States have never had energy prices so high. Technically we broke the DJIA 12,800 mark with 12,200 now the next level of support. With so much uncertainty, would it surprise you if the market ranges between these two levels?

REMEMBER, there are still stocks that are moving nicely through all of this. Look for those stocks, with an international presence, that have shown good earnings over the last couple of quarters. There are stocks in industries such as energy, tech, and shipping that are shooting through the roof. You may have noticed we continue to trade some of the same stocks over and over again. Why? We don't have a problem continuing to make money on fundamentally sound stocks. Continue to trade those stocks you are familiar with and hedge your trades, especially this week.

Watch for the Signals

Signals to Watch for in the Upcoming Week and Why.

Economic Reports

May 27	Consumer Confidence	May
May 27	New Home Sales	Apr
May 28	Durable Orders	Apr
May 28	Crude Inventories	05/24
May 29	Chain Deflator	Q1
May 29	GDP	Q1
May 29	Initial Claims	05/24
May 30	Personal Income	Apr
May 30	Personal Spending	Apr
May 30	PCE Core Inflation	Apr
May 30	Chicago PMI	May
May 30	Mich Sentiment	May

Stocks to Watch

Mon: MEMORIAL DAY _ MARKETS CLOSED

Tues: BGP,

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The Signal

To continue to learn the economic reports click on <http://biz.yahoo.com/c/e.html>

The [Consumer Confidence](#) Conference Board conducts a monthly survey of 5000 households to ascertain the level of consumer confidence. The report can occasionally be helpful in predicting sudden shifts in consumption patterns, though most small changes in the index are just noise. Only index changes of at least five points should be considered significant. The index consists of two subindexes - consumers' appraisal of current conditions and their expectations for the future. Expectations make up 60% of the total index, with current conditions accounting for the other 40%. The expectations index is typically seen as having better leading indicator qualities than the current conditions index.

Trade Updates

AEO Collar Trade = Prepare to Collar again for earnings on May 28th

V Calendar Call = Closes trade for 15% profit in 20 days.

GME = Trade is open and collared. Possible modification forthcoming if it appears the stock is going to range between now and the expiration of the puts.

Learning the Options

Covered Calls- When you sell to open a call that is called a short call. When you own stock in the same company or when you own a long call farther out in expiration than your short call you are *covered*. Covered calls give you the advantage of taking credit on a short call but also give the added security of having

stock - or the ability to buy stock - to *cover* your obligation should stock price trend above the strike price of your short call.

A simple covered call strategy involves buying or already owning a stock and selling to open a call one month or less in expiration and just slightly out of the money. The idea is to let the call expire worthless and capture the entire premium while still owning your stock. If you place the call out of the money and the stock trends above the call strike price you still keep the premium of the option, and you also get paid on the increase in the stock since you will have to sell it at the strike price you chose. Here's an example:

Say you own shares of XYZ company at \$50 cost basis. A short call in the next month at a \$55 strike price will pay you a credit of \$2.00 per share. The \$2.00 is yours to keep no matter what the stock does – up, down, or sideways. If the stock trends up but stays below \$55 between now and the expiration of the short call you keep your stock and your \$2.00 credit and your obligation to sell the stock at \$55 expires. You can start again next month and do the same thing over and over. If the stock ever trends above \$55 the person who paid you the money for the call has the right to exercise his or her option and force you to sell your stock. You would then profit the \$5.00 increase on your stock as well as the \$2.00 credit for your call. If the stock trends down, you keep the \$2.00 credit, but you are losing money on your stock. You have to be sure it is a stock you want to keep long term, or you have to consider collaring the trade by adding long puts.

Using a long call in place of the stock ownership is a good way to leverage your position and achieve the same thing, but it comes with added risk as the long call can eventually expire worthless and stock cannot.

Covered calls are great income generators if you have chosen the right stock and picked the right time to write

The Signal

the call. A good covered call strategy can net you 1.5 - 3% every month if you have chosen your stock well. But, if we all chose stock that well we would never need do anything but buy the right stock at the right time and sell it at the right time and make loads of money every year in the market.

Usually people write covered calls on the Monday following expiration Friday (the third Friday of each month when that months options expire) looking to take advantage of the volatility bleed off that accelerates in the month of expiration. But writing the call on the Friday before can often produce a better result in the next month due to the higher volatility in the price of the call just before expiration. Remember, implied volatility is created by excitement and anticipation over what a stock price might do. Trading volume usually increases just prior to expiration Friday and therefore option prices are usually just a bit higher. That's good for covered call writing.

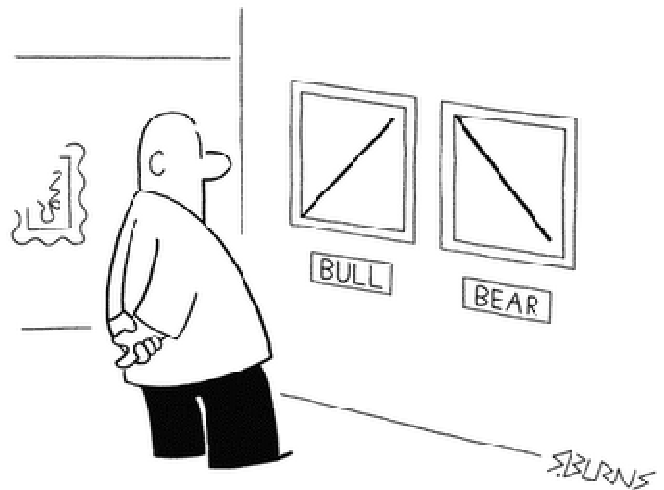
One of the biggest mistakes we see with covered calls is traders staying in a position for too long. If you are at risk of losing your stock and are uncomfortable with that, or if you are at risk of losing money on a long call that is being called out you should roll the covered call. Rolling a covered call is simply buying to close the existing call and selling to open a new call in it's place. You can roll a short call virtually any direction when you own the stock. You can roll out and up meaning out in time and up in strike price; or you can roll out and down, or simply out or in and down, and so on and so on.

The last important thing to remember on covered calls is the relation of the stock price and the delta (how fast the option will change in price relative to the movement on the stock) on the option. People often think that a long term covered call can "lock them into a position" until the expiration of the short call or force them to suffer a loss. The exact opposite is true. If a short call far out in

expiration trends in the money the stock will always have gone up at a faster rate than the call. In other words you will always be able to buy back the call and sell the stock without losing money from where you started. It's important to learn the rights and obligation of all the option instruments and understand them thoroughly before you trade them.

Next week in the "Learn the Option" segment we will talk about credit spreads and the risks and rewards that go with them. To learn about other option instruments and trades feel free to visit our website and view past issues of The Signal Newsletter.

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