These "Rolls" Can Sweeten Your Portfolio

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These "Rolls" Can Sweeten Your Portfolio

By Robert Rapier
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In a recent column, I described a strategy for building a stock portfolio using options. In a nutshell, you determine which companies you want in the portfolio, and then sell puts on those companies below the current market price. Repeat this process until you have filled out your portfolio.

I gave an actual example from my own portfolio using consumer staples bellwether **Walmart** (NYSE: WMT). Instead of buying 100 shares of Walmart for $87.53 each, the closing price on May 4, I sold one put option with a strike price of $85.50 for $1.67 a share. On the expiration date of May 18th, Walmart shares closed at $83.64, so I was assigned 100 shares.

My cost basis was $85.50 minus the $1.67 premium I had received for a total of $83.83 per share. That price represented a 4.2% discount from the price on the day I entered the initial trade.

After the 100 shares of Walmart were in my account, I sold a $90 call option against them with a September 21st expiration date. For this, I received $1.60 a share, further reducing my cost basis to $82.23 per share.

As I explained at the time, the biggest risk in this strategy is that Walmart shares soar between now and the expiration date, because I have capped my potential selling price at $90. If this happened, a $90 selling price would still represent a return of 10% (including a dividend paid the first week in September) in just four months.

Contingency Planning

Last week, Walmart reported superb earnings, and the share price jumped by 10%. So, five weeks from expiration I am holding shares of Walmart that are valued at $100, but which I am obligated to sell for $90. As I explained at the time, I am willing to take this risk for the certainty of receiving the premiums.

However, in the event that you find yourself in this position, there is another profitable strategy you can employ. I will use this actual scenario to explain it.

It may be advantageous to "roll" this option to preserve more of the gains in the share price. Here is how that would work, using actual current prices.

The call option I sold for $1.60 is trading at $9.65 after the surge in Walmart shares. I could simply buy this option back for a net of ($9.65-$1.60) = $8.05. This would mean I no longer have the obligation to sell the stock for $90. With the shares currently trading at $99.25, I could preserve $9.25 of gains by paying $8.05.

There is not much bang for the buck there and, further, there is risk associated with that. Walmart shares could pull back between now and when the option is scheduled to expire. If the actual price of Walmart on September 21st is $95, then I paid $8.05 for only $5.00 of gain. That is not a conservative strategy in my view.

Balancing Risk and Reward

A roll adds an additional step to this strategy to improve the risk/reward profile. Instead of simply buying back the $90 call option, I simultaneously sell another option with an expiration date further in the future, and at a higher strike price. Here is how that would work.

Presently, I can buy back the September 21st option and simultaneously sell an option with a $95 strike price that expires on my birthday - December 21st - for a net cost of $2.40.

What would be gained in this case? I would have preserved another $5 of appreciation on my Walmart shares for a cost of $2.40. If shares trade above $95 on December 21st, I would have earned another $2.60 a share plus a $0.52 per share dividend. This amounts to an additional 3.5% earned for extending my holding period by three months.

I did, in fact, execute this trade.

Again, the downside risk is the same as before. Walmart shares could go even higher between now and then, which could put me right back in this position. But there is nothing stopping me from helping myself to another roll.

Further, if the shares fall below $95 by December 21st, then I get to keep my shares and sell another call option at that time.

This is a decent strategy if you find yourself in the position of having shares called away that you are not ready to give up. The risk/reward has to be worth it, but there are always many different strike price/expiration date choices that may work for you. In my case, an additional 3.5% earned in three months is worth it, as I am targeting minimum annualized returns of 10%.

Watch Your Holding Period

This strategy can be even more valuable if your shares are about to be called away, but you have held them for less than a year.

If a roll pushes the holding period of your shares to more than a year, you will be subject to long-term capital gains when you eventually sell the shares. This can provide a significant tax savings versus the short-term capital gains rate you would be subject to if you sold the shares after holding them for less than a year.

That is just another consideration that can ultimately put a few more dollars into your account.

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See ABOUT THE AUTHOR on the following page.

ABOUT THE AUTHOR

It is hard to imagine anyone better suited to covering the energy-investment waterfront than Robert Rapier. Robert is no armchair analyst—he has two decades of in-the-trenches experience in a wide range of fossil fuel and biofuel technologies, including refining, natural gas production, gas-to-liquids, ethanol production and butanol production. During a six-year stretch at ConocoPhillips, Robert ran a team of engineers in Scotland working on oil and gas projects in the North Sea.

For two years, Robert was an efficiency expert in a Texas petrochemical plant. The process changes he implemented saved the facility $9 million a year. He later worked as the Engineering Director for a Dutch environmental-technology company and provided engineering support for a Chinese facility the company was constructing.

Robert was also a butanol engineer in Germany for the Celanese Corporation, where he designed a novel butanol unit that cut production costs by $5 million per year.

In all, Robert has spent more than a dozen years working on liquid fuels technologies. Along the way he has picked up five patents, including one for a breakthrough way to convert ethane into ethylene (U.S. Patent 7,074,977).

Now, in addition to guiding readers to timely energy plays in his twice-monthly *Energy Strategist*, Robert travels the world evaluating start-up energy companies for deep-pocketed investors. After grilling management and assessing the technology on-site, he makes a go/no-go investment decision. His wealthy private investors and hedge fund backers trust him to make the right choice for the same reason we do: his vast real-world experience in just about every facet of the energy industry. If Robert votes thumbs-up, millions of dollars flow into these cutting-edge outfits.

Robert earned his master of science in chemical engineering and a bachelor of science in chemistry and mathematics (double major) at Texas A&M University. He tells us he was "this close" to finishing his Ph.D. before he decided he was having a lot more fun making money in energy stocks.

A prolific writer, Robert's articles have appeared in *Forbes*, *The Wall Street Journal*, *The Washington Post* and the *Christian Science Monitor* — and he has been a featured expert on *60 Minutes* and *The History Channel*. His new book, *Power Plays: Energy Options in the Age of Peak Oil* (Apress, 2012), helps investors sort through doom and gloom, hype and misinformation to understand the true costs, benefits and trade-offs for each of our major energy options.

In what little spare time he has left, Robert consults for a number of energy projects, including biodiesel, ethanol, butanol, and biomass gasification facilities.