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You, the trader, assume the entire risk as to the results and performance of the trading methods.
Rule One Transformational Investing - Webinar #5
Rule #1 Transformational Investing Course

1) Rule #1 Investing through the 4Ms
2) Payback Time and 10 Cap Rate
3) Analysis of a Wonderful Company from A-Z
4) How Options work and how we use them
5) A Rule One Put (ROP) – A Perfect Trade
6) How Technical Indicators work and how we use them
7) Rule #1 Short Term Trading rules and strategies
8) How Credit Spreads work and when we use them
9) RUT Expiration Day BPS System Trade and Money Management
10) Risk Management and managing a trade gone bad
11) Rule One Short Strangle (ROSS) and other Ruler combination trades
12) Lowering Cost Basis and Creating Equity Bonds
13) Review and Q&A from real trading experience
Tonight’s Class Topics

• Creating the “Story” – Overview of the fundamentals
• How we set up our first tranche with a ROP
• Two objectives when selling a ROP
  -- Buying the company at your MOS/PBT
  -- Collecting enough profit if it turns into just a short term trade
• Selling a Rule One Call (ROC)
R.U.L.E.R.S

- **R** = **Radar** - What’s on your radar (Meaning)?
- **U** = **Understand** – Do you understand or can you understand (Meaning, Moat & Management`)?
- **L** = **Love** – There should be something about the company to love (moat, management, corporate culture; products).
- **E** = **Event** - Why is this business on sale? MOS/PBT/CAP Rate
- **R** = **Reduce Basis** - ROP/ROC/Dividends/Buybacks.
- **S** = **Story** – Rational explanation and then invert.
Meaning turns into “story”

- Show someone (spouse, friend, investment partner) you deeply understand the business and the investment advantage it offers.
- “Story” is what we get after a thoughtful, deep analysis of a company.
- We should be able to explain the Meaning and Moat of a company to our investing partner.
- Then invert the “story” (the things that are wrong or could go wrong) to make sure you have looked at both sides - that you are not submitting to “buyers bias” and wearing rosy colored glasses.
Long Term Mindset

- Our long term mindset is dictated by the concept of **certainty**.
- One of our best allies is time itself.
- We have time for Mr. Market to correct himself – going from a rational price to a fearful price back to a rational price and even beyond - to a greedy price.
Two Mindsets

• As Rule #1 Investors, we do both long term investing and short term trading.
• These are two different mindsets:
  – Long-term mindset is about a ten year investment in a Wonderful Business that we are certain to make money on over time.
  – Short-term mindset is about making a small profit in a short period of time on any kind of stock or security and knowing that we will have losses.
-Understanding Markets-

“Be fearful when others are greedy and greedy when others are fearful.”

-Warren Buffett

“In the short term the market is a voting machine, in the long term a weighing machine.”

-Benjamin Graham
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Buy Rule #1 Stocks at a Discount

• As you do your due diligence, you are going to find companies that satisfy the Four Ms.

• These will be companies that you want to own when they go on sale and hold for a long time.

• This small group of companies will be your greatest source of profits over your investing career because with your certainty about their durability and value, you can really “load up the truck.”
Rule One Puts (ROP)
Buying Rule #1 Stocks at a Discount

- You want wonderful companies but you want to purchase them on sale.
- Use your Margin of Safety (MOS) and Payback Time Price (PBT) or Cap Rate Value to know where to buy.
- A ROP strategy allows you to collect money for selling an option premium on a wonderful company at or below your “buy price.”
- You get put the stock at your buy price OR you make a nice return on your risk capital with the premium you collected. A “win-win” is a beautiful thing!
Example – Price Near Green Zone

Stock Price: $30.42

MOS Price: $25.40
Selling Rule #1 Puts

- Since you adhere to your Margin of Safety rules, you won’t buy this stock at its current price – it is just a little too high.
- This is where we use a Rule One Put (ROP) IF it is a Wonderful Company that you would love to own for the next twenty years.
- You can sell a PUT at a strike price that is near the MOS.
- The strike price minus the premium collected should give you a MOS price on the stock if it gets put to you.
- If the stock price drops below the strike price at the contract expiration, you get put the stock (100 shares/contract) at a price that you are happy to pay – your MOS.
- If the price is not below the strike price at expiration, you keep the premium and make a nice, “no risk” return.
- Do this month after month to stockpile, lower your cost basis and/or collect short term cash flow!
ROP – Choosing a Strike Price

• Your strike price can vary somewhat as long as it gets the Cost Basis of your stock to your **Margin of Safety or lower**.

• The contract month can vary to get the best Cost Basis and ARORC. Using a LEAPS is possible here.

• As an example, a stock is trading at about $28 and you valued the company at $50 (sticker). The MOS is $25.

• The $26 PUT strike price is selling for $1. If you were put the stock at contract expiration your Cost Basis would be:

  \[
  \text{Strike Price ($26) minus credit received ($1) = $25 (risk capital)}
  \]

• If you are not put the stock, you need to make enough premium to have made it worthwhile:

  \[
  \frac{\$1}{\$25} = 4\% \ (\text{RORC})
  \]

  \[
  \text{Multiplier} = \frac{365}{45} = 8.1
  \]

• 4\% \times 8.1 = 32\% \text{ annualized rate of return}
Tonight’s Class Topics

• Creating the “Story” – Overview of the fundamentals
• Long Term Investing vs. Short Term Trading
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ARORC is calculated by:

- **Strike Price** minus **Premium** equals **Risk Capital**.
- **Premium** divided by **Risk Capital** equals **Return On Risk Capital (RORC)**.
- **The Multiplier** equals 365 days divided by the number of days left in the contract.
- Multiply the RORC by the Multiplier for the **ARORC**.

Example: if a stock has a buy price (MOS/PBT) of $29.
- May16 $30 (strike) PUT – $1.00 (premium) = $29. (risk capital)
- $1.00/ $29.00 = 3.4% (return on risk capital)
- 365 / 36 = 10.1 (multiplier)
- **3.4% x 10.1 = 34% (ARORC)**
What May Be Close To “On Sale?”

• We will select a specific company where current stock price is within about 20% of MOS/PBT.
• We will achieve the objective to acquire the stock at our below MOS/PBT if we get assigned the shares.
• We will choose a strike price and contract that will yield about 30% ARORC or better.
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Selling Rule #1 (Covered) Calls

- As a Rule #1 investor you are going to own stock in wonderful companies for long periods of time as you wait for Mr. Market to go from fear, where the stock was underpriced, to greedy, where the stock is overpriced.
- The largest percentage of your time as an investor will be spent researching these companies. Then you wait for them to go on sale so that you can buy them at a Margin of Safety.
- Then you wait some more for the stock to get to the sticker price (fair value). Then you wait some more for Mr. Market to get greedy and overprice the stock so that you can sell it for a huge profit.
- When it comes time to sell, we can use Covered Calls. They can help us generate cash flow, lower our cost basis and increase our overall return-on-investment (ROI).
Terms Relating to Covered Calls

- **Covered** - The term, “covered” means you own the enough shares of the stock to “cover” the obligation you made when you sell call contracts.

- **Basis** - The average price you paid for your stock shares. We sometimes sell covered calls to try to lower our cost basis by collecting premium and not having our shares “called” away.

- **Sell/Write** - You will hear the term “sell” or “write” used interchangeably when you sell an option contract.

- **Time Decay** - Refers to how the option premium changes value as time goes by. By selling an option, time decay works for your trade.
If one of your Rule #1 stock investments becomes overvalued and enters the Red Zone you can sell covered calls to let the shares go at a nice premium.
To Sell a Covered Call:

- Own the stock.
- Choose a strike price that you would be happy to sell the stock at in case it does get “called” away.
- Identify a ceiling where you think the stock price may slow down or pause for awhile so that you may be able to keep the premium AND the your stock.
- Choose a contract month that gives you enough time to get a good premium (time = risk = premium)
- Sell-To-Open (STO) a call(s) against the stock that you own.
- Remember you sell 1 contract for every 100 shares you own.
Covered Calls

Use your knowledge of trends and FACs to pick the right time and place to sell a Covered Call.

**Conditions for Covered Calls:**
Bullish stock that is
- In a strong uptrend
- Approaching a ceiling
- Or In a neutral trading channel
Selling calls at ceilings can help you maximize the premium you will receive on Rule #1 stocks you own and lower your Cost Basis quickly.
Managing Your Covered Call Trade

What to do if the stock price goes above your strike price?

1. Do Nothing: Wait to see if the stock stays below the strike price

2. Buy the option you sold back: ceiling broken and bullish short-term uptrend appears to be starting

3. Roll up and out: You can buy the option(s) you sold back and sell another option at a higher strike price either in the same month or in the next expiration month.

4. Let the stock get called away: at expiration, your broker will take your stock and give you the money.
Homework

- Pick your Wonderful company that is closest to the MOS/PBT price.
- Pick a contract as far out in time as necessary to get enough premium so that if you have to buy the stock, your cost basis will be very near your “buy price.”
- Show this data and all math related to the calculations:

  Stock Symbol:
  Contract Month:
  Strike Price:
  Premium at Mark:
  Risk Capital:
  Return on Risk Capital:
  Multiplier:
  ARORC:

You can send your homework to: ahariton@ruleoneinvesting.com