

Always an Option

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Long-Term Portfolio Review

It's getting to that time of year when we have to decide how much we still love our long-term positions.

Obviously, with a 126% year-to-date return, they were a pretty good set of picks but that does not mean they will stand the test of time. **Reviewing your positions is an exercise you should engage in regularly, with stocks AND options I recommend a quarterly review but with options you don't own them forever so my rule of thumb is to take a serious look at them as each 25% of their time value expires.**

Giving yourself a "quarterly" check-up allows you to evaluate whether or not your original premise is still sound. With our usual strategy of selling closer positions against our leaps, it is also important that we evaluate whether we are still getting enough bang for our buck on those sales and, of course, whether we feel the short-term outlook merits additional sales.

This article will cover an overview – how I feel about the stock in general, specific moves will be made after we get a peek at earnings over the next two weeks:

BA (7/25): We never had a doubt about this one, our biggest problem has always been should we or should we not sell calls against them. Once they finally break through \$100 they should test \$105 in short order.

BSX (7/26): They have been a huge disappointment since January. I doubt we will roll these and MDT is much more attractive in this downtrodden space.

CAT (7/20): Ah, I remember the fall, when people made fun of me for buying this stock as it flatlined in Q4. Now the stock is so strong it's hard for us to sell calls against it!

CC (9/20): They already gave us the bad news and iPhone sales aren't going to help them and the consumer is on life support so the only value to these positions is using them as a platform to sell some other poor sucker closer calls, which has been lucrative...

COF (7/19): Reporting the same day as Google is a good way to be ignored and expectations are pretty low on this tremendously undervalued stock. This one is certainly going to be a roll to '09.

GDX (4/11): We just went heavy on gold and have held these naked since April so that's not going to change. The short-term portfolio is where we mess around with the cover plays.

GE (7/13): If this one fails, so does the market. Another definite roll.

GM (8/3): My only fear is that people will wake up and send this stock to 0 while we have puts sold against it.

INTC (7/17): Short term needs to vent from its 50% run since last summer but once it gets over \$25, I expect a test of the '05 high at \$28.

ISE (6/3): Volume has been up 35% but estimates are for just a 25% earnings increase over last year. We've taken huge advantage of a 3-month flatline and even tool half our ridiculous profits off the table but the remainder is still up 243% and needs to be rolled up.

JNJ (7/17): They lost GDT to BSX and hahaha to that! This left \$179Bn JNJ in great financial shape and much less dependent on the stent market. Like GE, JNJ is a keeper but it's a very slow grind.

KO (7/17): Noticing a quality theme here? We did not take a lot of chances this year! Coke is just coming off a good run and we are playing it tight until it breaks out over \$53.

\$10K Portfolio

The \$10KP continues to drag along with a 33% loss. TWX and DIS calls crushed us there, as we didn't have the flexibility to double down on DIS, as we did profitably in the Short Term Portfolio. We have 6 spreads that are waiting for July 20th expiration so we can wring out some precious premiums from our callers and roll over to August, where hopefully we will have a better run.

LVS (6/20): Incredible income producer selling the puts. This will be tricky but we stand to make \$5 this month alone on the \$80 puts we sold. I am short-term bullish on the stock but I doubt earnings will be pleasant.

M (1/4): They leaped up on takeover rumors last week. We are playing this by ear as it plays out.

MOT (1/10): These are '09s that are way ahead and should hold their value as a steady income producer (meaning, as a stock, it's DOA).

MTU (1/22): Small initial entry that never went right. Poor premiums to sell against, needs to be purged. Very hard to figure out what global economic conditions are good for this company.

OVTI (4/23): This did much too well and we are stuck way underwater on the calls we sold. Luckily, we have 18 months of rolls to catch up and we have a nice double on our leaps already.

PGR (7/12): Off to a very disappointing start from our March entry and we've had little luck with out sales but I still like them to finish on the plus side of \$25.

RIMM (7/6): I feel this is overvalued so I sold the Jul \$230s to see how this goes against the (LOL) Jan '09 \$300s. Plan here is just to have a stopper for endless fun selling calls as the stock flirts with \$200.

SBUX (8/1): It broke my heart to have to sell the

Jul \$25s and, of course, they burned me for losing faith! Earnings will be VERY interesting.

SCI (11/15): Owned as a proxy for the stock. Sold off some on mild pullback, expecting it to break \$15 in the fall.

SNDK (7/19): Holding naked into earnings unless we get a nice pop. Expecting upside surprise that leads to break over \$50 but will roll up and out (to '09) just in case. Quick sell if SOX collapse.

TASR (7/25): Got caught by surprise on the strength of this month's move but the position is a huge winner that needs to be rolled up.

TXN (7/23): Is this the year TXN breaks \$40 and gets treated like the exceptional organization it is? These are already up 835% and need a roll.

UNH (7/19): Why am I starting to think 7/19 would be a bad day to miss? We thought putting the option scandal behind them would help but it didn't. This will be a very tough cal into earnings.

WFR (7/26): Another fantastic winner already profit rolled all the way to 2010 (and still way ahead). Nice 30-month income producer!

XOM (7/26): Oh I am so fed up with this! Thank goodness we took most of these off the table. It will be time to give up on this dream if they break \$87 as carrying the weight of this position isn't worth the sporadic rewards.



The Energy Report



by Steven Zachritz

Spotlight: Natural Gas Shale Plays.

Three gassy names to go long; one large, one medium, and one small.

What's A Shale Gas Play? Essentially, shale is a very hard sedimentary rock layer, which sometimes contains natural gas. They're often referred to as "tight gas" reservoirs because very rarely can you simply drill a well and have gas flow to the surface. Once upon a time it was thought that these structures would never be productive but developments in hydro fracturing (fracking) technology over the last decade have allowed them to produce modest amounts of gas per well and vast quantities of gas per field. A couple of the nice things about shale plays are their often-large size and the ubiquitous nature of their deposits. Once you have the play dialed in, wells are drilled on a grid with little to no exploration risk and the whole task becomes more of a "gas manufacturing" project. Though similar to coal bed methane wells in their "manufacturing," nature shale wells initially produce at comparatively high rates but production often falls by half or more within 3 to 6 months. So to keep growing, you've got to keep drilling.

The Grand Daddy of Shales Is The Barnett Shale of East Texas. According to the Texas Railroad Commission, drilling permit requests continue to fly high. Drilling permits jumped from 1,387 in 2004 to 3,180 in 2006. All told, just over 6,000 wells have been drilled in the 17 counties that make up the Barnett Shale. While some counties have started to decline the level of activity and overall productivity continues to expand and another 3,300 locations were in the permitting process as of April 2007.

The big players in the Barnett are massive companies like (EOG) and (DVN), mid caps like (CHK) and a raft of smaller, latecomers. Like the majors, the bigger E&Ps suffer from the "Wal-Mart" syndrome

meaning that they have to either make truly giant discoveries or drill up a resource play like the Barnett in the most efficient manner possible, continually reducing the time and cost of drilling each well.

Of The Big Three In The Barnett I Prefer Chesapeake Energy (CHK) As A Long Term Play. Next year (CHK) is on course to become the largest

natural gas producer in North America driven by the burgeoning growth in their shale plays. Though third in terms of Barnett production, (CHK) has achieved the highest average peak month production from their wells due to a combination of good acreage selection and technical well completion expertise. Furthermore, they've transferred the skill set acquired there to ALL of the major U.S. shale plays crowning them as the pre-eminent U.S. gas shale player. With that title comes more leverage over the service and midstream companies helping to reign in their lease operating expense on a per Mcfg basis relative to their peers.

We don't anticipate 2008 coming to a close with CHK being an independent company. Their extreme focus on natural gas, their lack of a presence in the



soaring cost environment of the Gulf of Mexico and low return environment of the Rockies make them an easy grab for a major looking to “gas up” with a low risk, location inventory rich acquisition. At present (CHK) trades at a 15% discount to its close peers on a 2008 forward multiple and we think it will make one of the majors a nice, almost entirely natural gas division; the same role that Burlington Resources filled for Conoco in late 2005 (BR was purchased for 13x earnings while CHK currently trades for 10.4x earnings). *Besides, with Exxon and Co. trying to “look” as green as possible as the 2008 election approaches, I think the relatively cheap Chesapeake will be too tempting of a morsel to pass up.*

Recommendation: Buy (CHK) Leaps: I like the January 2008 \$37.50 Calls for \$2.10 for a near term move in the stock (including the one I expect during hurricane season). While we wait for a move we can sell Aug \$37.50s, now .55 against 1/2 the position to provide an income of 10% per month while we wait. At an appropriate point we can roll this to next year but, currently, the 2009 options are not well positioned if we assume a takeout strike of \$44 (+30%).

CAN'T GET ENOUGH ZMAN?

Catch Steven and Phil every Wednesday before the oil inventory report on MN1.com



shale play, the Barnett, and one I'd call an adolescent, the Fayetteville. Now let's look at the new kid on the block the Woodford Shale of southeastern Oklahoma. The Woodford came to the spotlight just last summer. Due to the generally thicker shales present here relative to the preceding two plays, the wells drilled here to date have come in at over the twice the

Fayetteville Shale. Similar but smaller shale that has only recently taken flight. The dominant player here is Southwestern Energy (SWN) with (CHK) a close second. A majority of wells drilled to date in the play have either SWN as operator or at least as a participant. Trading at roughly 25x 2008 earnings, (SWN) trades at a substantial premium to its peers. The reason for this premium is that the consistency of the Fayetteville shale affords them the ability to grow production at high double digit rates for at least the next two years, rates unparalleled among the company's mid cap peers.

(SWN) trades almost in lockstep with natural gas prices and as such I like to use it in small doses as a proxy for trading gas and not for long term plays. Since the growth rate is already "built into the stock" I prefer to seek out more undiscovered, "up and comers" in this type of play. *I'll give you that name in a moment but since it operates in both the Fayetteville shale and the next shale we'll talk about you'll have to bear with me for a moment.*

Woodford Shale. We've looked at a teenager of a

size of those seen in the Fayetteville and initial production rates have been uncommonly high in many wells for a shale play. The dominant player here is Newfield Exploration (NFX). They have an interest in well over 50% of the 200+ wells drilled to date in this area.

Recommendation: I like NFX for their ability to add growth through this play. They drilled 47 wells here in 2006 but will drill 150 in 2007 and they're small enough that will make a noticeable difference to their production profile. Also, they've been the subject of recent takeout rumors owing to their core position in the Woodford, the Rockies, and in the Deepwater Gulf of Mexico. Also making them a likely takeout is a recent announcement regarding their desire to sell off certain non-core assets. **I like the January 2008 \$50 calls for around \$3.60, Phil likes it paired with a sale of the Aug \$50s at \$1.23 but only if it fails to break the \$47.50 mark over the next two weeks, otherwise we both like it straight up.**

For A Smaller Cap Shale Play, I Like Tiny Petrohawk Energy (HK). Aside from their active Gulf Coast and consistent mid-continent positions, they have nascent positions in both the Fayetteville and Woodford Shales. The company operates over 75% of its long reserve life (9.6 years) gassy (83% of reserves) assets giving them a good handle on costs which are

among the lowest in the small cap E&P universe we track. Moreover, the company is quick to punt higher operating cost plays, which has reduced its breakeven point below almost all of its peers. The company perennially exceeds and then raises forward guidance while maintaining a very conservative balance sheet. Finally, Petrohawk has very effectively hedged three-quarters of expected production with natural gas floors over \$7 / Mmbtu and ceilings that will give them upside over \$10 this summer and \$12 this winter. *Its inclusion in the two shale plays adds an element of sustainable growth not usually found amongst the smaller E&Ps.*



Recommendation: Buy (HK) December \$17.50 calls with an ultimate goal of the stock seeing \$18 to 20 by early Fall so we are looking to get out at \$2 - \$2.50. Should the stock fall with natural gas this month, Phil also likes the Dec \$15s for \$2 or less.



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Making over 100% or 1,000% in 3 Months

by OptionSage

As the first quarter of 2007 drew to a close, the 500 point drop intra-day drop that occurred late February was still fresh in most trader's minds, uncertainty about the impact of Chinese markets on US markets was prevalent and concerns over the strength of the US economy seemed to reflect the "Great Wall of Worry" that appeared from the East.

In the midst of such uncertainty, the challenge for us as traders was to find a way to independently navigate the uncertainty. How did we do that?

We focused on the fundamentals. As the quarter drew to a close and on the eve of the new portfolio margin rules, I wrote an article on the new Portfolio Margining Requirements, featuring a play on BIDU that allowed us to play through an uncertain period while we waited for what we considered very strong fundamentals to assert themselves:

Purchase BIDU stock: \$96.55
Purchase June 95 Long Put \$6.90

Total Risk = \$8.45
Total Cost = \$103.45

Using the full leverage of the new portfolio margin requirements, we demonstrated how just \$8,450 in margin could control \$96,550 worth of the stock. On Friday, July 06, 2007 BIDU stock closed at \$197.60 having run up a stunning 100%+ in 3 months that could have yielded as much as \$101,050 in profits.

How was it possible to find such a big winner and how can you find future triple digit gains? Let's go over my decision process at the time:

At the time I was focused on certain key metrics for Baidu. You will see Phil often mention growth rate of

a company and Baidu was projected to grow earnings at a stellar annualized pace of 60% over the subsequent 24 months according to research from Zacks.com. But that alone is not helpful unless it relates well to the Price/Earnings multiple. **For Baidu the Price/Earnings multiple was almost a whopping 70!** That's a huge number but could be justified if the growth matched the multiple.

I did a quick comparative analysis with Google to evaluate whether the multiple really was out of kilter with the growth. At the time Google had a lower multiple, just over half that of Baidu's multiple. The next question I asked myself was *"Is it possible that Baidu's multiple will contract significantly over the next few years?"* Obviously this could occur should projected growth rates diminish or, as Phil just pointed out regarding a "worst-case" scenario on Friday: *"China (government) arrests them for sedition (and) delists the company causing it to collapse to zero!"* I knew how much the government supports its star companies so I wasn't expecting such a shock at the time, nor am I now. (I did nevertheless have insurance in play since the stock was technically bearish at the time and earnings were imminent).

Google at the time was a \$120Bn+ company whereas Baidu was simply a small fraction of Google's size in terms of market capitalization. What about the business model? Baidu has a scaleable business model just as Google does. It doesn't have the global reach, admittedly, but I still believed that it would be much easier for Baidu to double from a \$3Bn market capitalization to \$6Bn market capitalization than for Google to double and become a \$250Bn company.

With that backdrop my analysis told me that there was a floor on the multiple Baidu would have because it was highly unlikely to drop below that of Google's multiple (barring a worst-case disaster situation of course!).

Next on the metric list came the earnings per share. Baidu was projected to earn approximately \$3 per share for fiscal year 2008. By my projections that meant that, even if Baidu's multiple contracted to 50,

by Jared Woodard

Baidu should be a \$150 stock over the coming years. However, I did not expect such a drastic multiple contraction to occur. *In fact, even with a conservative 60 multiple* (that is just 1 times projected earnings growth rate - remember Cramer says he is willing to pay up to 2 times growth before he considers a stock is overvalued!), *the stock price target I arrived at was \$180 per share.*

Admittedly I would have been happy to make \$80 per share gain over a year and a half on a cost basis just over \$100. However the ensuing months catapulted the stock higher to almost \$200 per share as of Friday's close, producing a gain of over 100% on the stock and a trade gain in the same ballpark. Personally, I don't hold put options when stocks rally bullish and when Baidu showed a clear direction bullish after earnings I sold my unneeded protective put option to recapture some insurance premium and lower the overall cost of the trade.

Today Baidu is trading at an amazing Trailing P/E multiple of 147 and doesn't look nearly as compelling from a valuation standpoint unless, of course, earnings produces some outstanding numbers. However, other opportunities exist.

If you are interested in finding such opportunities, a great place to start is Zacks.com, where you can scan for stocks that have PEG ratios less than 1.0. The PEG consolidates information we discussed above into a simple metric that tell you what the P/E ratio is relative to the earnings growth rate. Numbers less than 1.0 often suggest a company is undervalued while numbers greater than 2.0 suggest a company is overvalued. Interestingly at the time this article was written Google was trading with a PEG of 1.0, suggesting that at today's prices it is very fairly valued. However, I would encourage you to look at the projected earnings growth relative to its growth rate also and determine for yourself whether you too think it's fairly valued or whether there is room for further growth over the coming years.

Have a fantastic week!
OptionSage 

In this ongoing monthly experiment, we're pitting \$5000.00 of shares in the S&P 500 ETF (SPY) against \$5000.00 deployed in a SPX Iron Condor trade. The purpose of the experiment is to show how market-neutral strategies like the iron condor fare against a simple market-directional portfolio in different types of markets.


The rules, again, are: **Rule 1.** The iron condor trade may never risk more than 15% of the \$5000 account value. **Rule 2.** We will hold the iron condor through to expiration in every instance. **Rule 3.** The SPY shares will be held through the life of the experiment without any further action.

Account values:

SPY account: \$4961.40

SPX account: \$5365

Analysis: Since the inception of this experiment, SPY has fallen just a bit from where we entered, leading to a tiny loss in the SPY account.

The SPX is currently at 1530.44, perfectly within the range of our iron condor. Much of the theta (time decay) has already accrued to our position, which is reflected in the marked-to-market SPX account balance. Barring any major movement over the next ten days, this trade stands a good chance of expiring out of the money, just as we want it to. 

IRON CONDOR:

a market-neutral options strategy with the following structure:

- +1 far out of the money call
- 1 out of the money call
- 1 out of the money put
- +1 far out of the money put



by Andy Wang

Stocks in the solar power related fields have been very popular lately. I have mentioned several picks on Wang's World many times (for instance,

here). But, many of the high flyers have risen so much lately; it is perhaps risky to chase. There are a couple of stocks that I still like. Let's take a look at a comparison chart for: STP, WFR, JASO, FSLR, and SPWR.

As you can see here, JASO has gone up almost 95% in the last 3 month! FSLR has gained 70%, and SPWR with over 35%, which does seem to still have room to go up. But, STP and WFR have only risen less than 10%. I think these two now have the most potential in this group to make some big gains!

Here are the 3 month daily charts for WFR and STP, which share some similarities.

Both of these stocks have made some decent gains recently.



Their daily MAs are about to go into the bullish formation, with 10- above 20- above the 30-day MA. WFR has traded much higher earlier this year (see April), and, should have little problem getting back there. STP needs to get above 39. Once it clears 39, it should have very little resistance.



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