APPENDIX C

Brokerages and Order Types

SELECTING A BROKERAGE HOUSE

The significance of brokerage commissions should not be ignored. An investor’s choice of brokerage house has a large impact on overall profitability. Whether you are investing in covered calls or LEAPS, you must use a discount broker. Discount brokers have cheaper rates of brokerage/commission because they provide an execution only service (they do not provide research or advice). Both covered call and LEAPS investors make a significant number of transactions each month and realize small profits on each of these transactions. Therefore, transaction costs have a very high bearing on profitability with this method of investing.

Again, the impact of different commission structures at various brokerage houses is very significant and should not be ignored. Not selecting a competitively priced broker is no different than ignoring the operating expenses in a traditional business.

If you are investing in the U.S. market, there are several discount brokers very suitable for this type of investing. Deep discount brokers are even better, as they have extremely cheap commissions, so small that commissions needn’t be accounted for when considering profits on trades. For example, one industry-leading deep discount broker charges commissions of just $0.75 per 100 shares and $0.75 per option contract—with no minimum trade size! If an investor buys 100 shares of a $30.00 stock, this is a $3,000 investment. The commission for this stock purchase and the sale of one option contract would total just $1.50, or 0.05 percent of the invested capital. This is a remarkable rate of commission, and, for all intents and purposes, the trade is practically commission free.
The brokerage industry is constantly evolving with new online players entering the market and existing brokerage houses regularly making changes to trading platforms and commission structures. The current industry best brokers for using this technique can be found at www.compoundstockearnings.com/brokers. We highly recommend that investors use one of these brokers because trading platforms and transaction costs have a dramatic effect on profitability.

**COMMON ORDERS USED IN ONLINE BROKERAGE PLATFORMS**

There are four basic kinds of orders that investors can use with the covered call and LEAPS techniques. The first two of the following relate to price execution and the second two pertain to order duration.

1. Limit (LMT). A limit order is one that is price specific, for example, buy 100 C shares at $45.00. The order will not be filled unless it can be filled at a price of $45.00 or less. Limit orders are the safest way to buy or sell a stock or option, and they should be used as often as possible.

2. Market (MKT). A market order is one that is not price specific, for example, buy 100 C shares at market. The order will be filled at the best price available in the market; a price is not guaranteed.

3. Good til Canceled (GTC). A GTC order will sit in the market until the investor who placed it cancels it or it executes. For example, a GTC limit order to buy 100 C shares at $45.00 will sit in the market until the shares can be bought at $45.00 or the investor cancels the order.

4. Day Order (DAY). A day order will only sit in the market until the end of the trading day it was transmitted. For example, a day order to buy 100 C shares at limit of $45.00 will be purged from the market at the end of the day if it has not executed.

**CONDITIONAL ORDERS AND THE 10¢ AND 5% RULES**

Conditional orders are an invaluable tool for LEAPS investors utilizing the 10¢ rule who are not able to monitor the market continuously throughout the trading day. These orders allow investors to place an order into the market that is conditional on certain events occurring, for example a stock or option trading at a certain price.
LEAPS investors can use conditional orders to automate the process of buying back a call under the 10¢ and 5% buyback rules. Thus they can conduct their LEAPS investing for only a few hours a day, rather than being at the computer for the entire day waiting for situations to arise. Take the following new position for example:

- Long 2 JPM Jan 2007 $35.00 LEAPS @ $5.00
- Short 2 JPM Dec 2005 $40.00 Calls @ $1.00

Conditional orders allow investors to place an order to take care of the 10¢ buyback rule as follows:

- Buy back Dec 2005 $40.00 call at market if bid price of Jan 2007 $35.00 LEAPS reaches $5.10.

A simple limit order also allows investors to take care of the 5% buyback rule as follows:

- Buy back Dec 2005 $40.00 call at limit of $0.75.

By using the conditional order format, investors can ensure the rules are being followed without sitting at the computer all day. Compound Stock Earnings recommended brokers accommodate conditional orders.

**CREDIT SPREADS AND THE DELTA LOW BRIDGE**

Credit spreads are an invaluable tool for delta low bridge (DLB) investors who are not able to monitor the market continuously throughout the trading day. These orders allow investors to place an order into the market that will execute when a certain price spread can be realized on the sale and buyback of two option contracts.

For example, take the following DLB investment:

- Long 2 JPM Jan 2007 $35.00 LEAPS @ $5.00
- Short 2 JPM Dec 2005 $40.00 Calls @ $1.00

Credit spread orders allow an investor to place an order into the market that will allow the call to be bought back and the LEAPS to be simultaneously sold when the investor can realize a predetermined profit. In this case, the predetermined profit would be the LEAPS cost plus 5 percent, or $5.00 × 0.05 = $0.25. The credit spread order system will execute the
buyback of the call and the simultaneous sale of the LEAPS if a credit difference of $0.25 can be realized in the market.

Investors can also place a limit order into the market to take care of the 5 percent profitable buyback of the call if the market price drops.

As with conditional orders, credit spread orders can allow the DLB investor to follow the rules without being at the computer throughout the entire trading day.