

Financial Foresight

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“Optional” Income

Are your bonds and CDs paying less interest than a few years ago? Are you looking for more income from your portfolio? Would you like to reduce your risk while continuing to own stock? If you answered “yes” to any of these questions then utilizing options may be a good strategy for you.

You may have heard of options before and thought they sounded risky or meant for active traders. For some options you would be correct, but for others there are strategies that actually lessen risk while providing added income. The latter option is what we will focus on in this issue.

Buying or selling an option essentially involves placing a bet that a stock will or will not move significantly in price by a certain date. The buyer hopes that the stock will move, well beyond the set price, “strike price”. If it does, the buyer can purchase that stock at the strike price at any time prior to the maturity date. With every option, the buyer pays a predetermined “ask” to the seller, or a fee to the seller.

In the buyer’s best case scenario, they will now own a stock worth more than they purchased it for, less a modest fee. The buyer is not committed to purchase the stock. However, they have already paid the “ask” (or fee) to the seller whether or not the final stock transaction occurs.

The seller’s best case scenario would involve the option expiring, with the stock making only modest gains. The seller would still earn the predetermined “bid” price. The bid is the “ask”, less the amount taken by the market facilitators.

Unlike many investments that never mature, option contracts do have a maturity date. They will expire on the third Saturday of the contract month. An April 2009 option would

expire on April 18. However, the transaction may be completed prior to that date.

Options get their value by the following:

Time: The further out the contract maturity date is, the higher the “ask” price is for the buyer. (There is a better chance the stock price could make significant gains.)

Strike Price: The closer the strike price is to the current stock price the higher the bid and ask will be. (Again, there is a good chance the stock price will move prior to the maturity date.)

Volatility: Companies that are more volatile usually will require a higher bid and ask. (The stock price can change dramatically.)

Options are sold in lots of 100 shares. However, not all stocks have options, and even for stocks that do have options, they may not be available every month.

Let’s look at an example of how an option might work for you. Lets say you own 500 shares of ABC company which is trading at \$40 a share on April 1. You feel pretty strongly that the stock may not move much higher or may even go down a little. First, you can simply hold onto the stock for tax or portfolio reasons. If you felt strongly that it was going lower you could sell outright. On the other hand, if you felt the price was going to make significant gains, again, you may hold onto it. If you suspect the stock may stay about the same or make modest gains, this is where you may consider selling an option, or “writing a covered call”.

Let’s assume you write a covered call and agree to sell your ABC shares at a strike price of \$42.50 by the option expiration of

the third Saturday in May, 5/16/09. For this, you receive the bid (or “premium”) of \$1.25/share or \$625 (based on 500 shares). For the same \$42.50 price the June option would pay you a bid of \$2.00 per share, or \$1,000 before commission. You decide to keep it short term and sell the May option for \$625. Here are your three possible outcomes by the option expiration:

1. ABC stock goes below the current price of \$40.00 by May 16, and the stock is not purchased. In this scenario you still keep the \$625 but your stock is worth less. However, you were prepared to hold the stock anyway, so the \$625 bid you received reduced your downside risk by \$1.25/share.

2. ABC stock moves up slightly to \$42.49. Again, the stock is not purchased. This is likely the best scenario as you keep the \$625 as well as the stock which has gone up \$2.49/share, making your total gain \$3.74/share over the seven week period. At this point you may decide to write a new call for a future month and receive additional income.

3. ABC stock moves up from \$40.00, past \$42.50, up to \$50.00. In this case you keep the \$625 option premium but the option buyer purchases the stock for \$42.50. You still made \$3.75/share or \$1,875 total (($\2.50×500) + \$625). What you “lost” is the gain from \$42.50 up to \$50.

If you write enough calls you will have stocks called away from you from time-to-time. If you would be upset that you missed the run up on any stock, this strategy may not be for you. Also keep in mind that in flat or modestly moving markets many of your calls may expire allowing you to keep the stock. In bull markets this strategy can backfire so you need to be careful about when you write calls and understand the outcomes. With that said, options can generate extra income for your portfolio.

Month	Strike Price	Bid	Ask
May	\$42.50	\$1.25	\$1.50
June	42.50	2.00	2.25
Sept	42.50	3.50	3.75

How to Protect Your Home from Medicaid and Nursing Homes

By Glenn A. Jarrett, Esq., CFP®

The home occupies a unique position in Medicaid qualification. A home is an exempt asset when determining the resources available to an applicant for long-term care coverage by the Medicaid program. If the applicant moves out of the home into a nursing home, the home can continue to be an exempt asset. However, in order for the home to be exempt once the applicant moves out, the applicant (or a family member) must establish in writing that the applicant has an “intent to return” to the home, no matter how unlikely that return may be as a practical matter. Whether or not the intent to return is established, if the home continues to be occupied by a spouse or dependent relative, the home will continue to be an exempt asset.

The home of an individual applying for

Medicaid is considered an exempt asset, up to \$500,000 in equity. For these purposes, one’s “home” includes all contiguous land. One’s home can be a house, condominium, mobile home, or portion of a multi-family dwelling in which the applicant resides.

Transferring the home into a trust, partnership, LLC, or corporation, will cause the home to lose its exempt status. However, transferring the home back into the name of the applicant will “cure” this result.

Under Federal law, Vermont must seek recovery for Medicaid payments made on behalf of a nursing home resident who was at least age 55 when the individual received such assistance. Such recovery may only be against the individual’s “estate” as defined for purposes of state probate law. The home is an available asset to reimburse the state under the estate recovery rules, following the death of the Medicaid recipient.

Enhanced Life Estate deeds, sometimes called “Lady Bird Johnson deeds,” are

popular in Vermont as a method to avoid estate recovery. It is a deed transferring the home, typically to younger family members, with the retention not only of a life estate but the unlimited power of disposition. Since the grantor has not parted with dominion and control and can essentially revoke the transfer at any time by simply deeding the same property to someone else prior to the grantor’s death, the conveyance does not incur a transfer penalty. Nonetheless, the deed removes the property from the grantor’s probate estate, avoiding estate recovery, since Vermont only looks to the probate estate for recovery. This is an extremely useful tool when trying to preserve what is often the family’s biggest asset, the home.

Glenn Jarrett practices with the Jarrett Law Office. This article is for informational purposes only and is not intended to constitute comprehensive or specific legal advice. The author stresses the need to engage appropriate legal and financial professionals when devising your individual estate plan. He can be reached at glenn@vtelaw.com or (802)864-5951.

LTC Insurance Critical for Nest Eggs Cracked by Stock Drop

By Duncan A. Winton

It wasn’t that long ago that, when the topic of long-term care (LTC) insurance was brought up to a wealthy person, they would brush off the idea, saying “I can self-insure.” But the drop in the Dow has shown many investors that they and their retirement plans are no longer invincible. If they weren’t worried before about outliving their money, they may now be worried. Burden their financial picture with the cost of possible long-term care, and the worry escalates.

The S&P 500 is down 41% in the last year. This is as good a number as any to estimate the losses that stock market investors have sustained. Using this index, the stock portfolio worth a million a year ago is now worth less than \$600,000. What was two million is now less than a million two. Ten

million is now less than six. Those are some scary numbers!

What’s an investor to do?

One smart strategy is to leverage the dollars that are left by purchasing insurance. Instead of burdening a portfolio with having to be both big enough and liquid enough to self-insure, a policy can be purchased. Once a new policy is in place, the newly-insured investor has now dramatically shored up his or her financial situation if care were to be needed. Though he or she may no longer be in a position to write large personal checks for long-term care, he has bought, for pennies on the dollar, a LTC insurance policy that will write the checks on his behalf. Investors can find some consolation when they realize that, once the financial risk of needing long-term care is shifted to an insurance company, the need to recoup recent stock market losses is mitigated.

The LTC insurance solution is superior to

self-insuring in several ways. The policy can be written to include a guaranteed inflation benefit (such as 5% compound) that is independent of market forces. The insurance policy premium can sometimes be tax-deductible and the proceeds are almost always tax-free. Compare this to the cost of tapping into a qualified retirement plan to pay for long-term care, or the market risk inherent if the self-insurer had to sell either real property or stocks.

The losses that investors have sustained in the stock market should serve as a wake-up call. Even wealthy individuals can be vulnerable if they are dependent on stock market values to pay for their long-term care. Now more than ever, it makes sense for even wealthy people to purchase long-term care insurance.

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