the Break Out Report

Earnings – Leadership - Momentum

Volume # 1, Issue # 8 Feb. 16, 2003 ELM - the Profit Tree

Commentary

War = Destruction

There are good wars and there are bad wars. A good war is a war of self-defense – fought to preserve and enhance freedom from enemies who would destroy it. But war is and always must be a last resort. Much is made of the failure of Neville Chamberlain to bring the "peace in our time" he promised. But the challenge he faced was to try and prevent the destruction that war ultimately brings. He tried to avert the V2 rockets that devastated London. Unfortunately, Chamberlain proved to be wrong. Hitler was untrustworthy and soon set about implementing his imperialist aims.

The situation we face today is similar. Saddam Hussein is a ruthless tyrant even among his own people. In the wake of the terrorist attacks on America of 9/11, the Americans are re-assessing the threat posed by Hussein. The problem today is that toxic chemicals and poisons are easily transported. A small vial of nerve gas can kill hundreds if not thousands. And a dirty bomb, strategically placed, could kill millions.

The big question is whether Iraq really has these weapons or the capability to produce them. And the problem is, the evidence has been found wanting by key international players, not to mention the thousands upon thousands of peace marchers taking to the streets. They are, in John Lennon's words, saying "give peace a chance."

(continued on page 4)

Options Explained Part 4

Greek Philosophy

In our earlier discussions we explained that options can be best understood in terms we are all familiar with. A put option is like buying an insurance policy. A call option is like putting a down payment on something to lock in the price.

We discussed some of the terminology such as strike price, intrinsic value and time value. And we discussed the concept of volatility in relation to theoretical values calculated using something called the Black Scholes Option Pricing Model.

Now we're going to look a bit more closely at some variables that can help us in selecting options to buy or sell. They're called the Greeks. And just like Socrates, Aristotle and Plato, these Greeks can make the difference between wisdom and foolishness.

There are five such variables and they're called the Greeks because they're represented by Greek letters. Two of them are of particular importance and the rest less so. We'll concentrate on the two main ones.

The first is called delta (Δ) and measures an option's sensitivity to changes in the price of an underlying stock. For example, suppose you bought a call option on Microsoft with a strike price of $55. The stock itself is also currently at $55 so the option is at-the-money. We know that if the stock

(continued on page 2)

In This Issue: Marco's Power Performers are Back! (Page 8)

Greek Philosophy *(from page 1)*

goes up, the value of the option will go up and if the stock goes down, the value of the option goes down. But by how much? In general, an at-the-money option goes up about 50 cents on the dollar for the next dollar change in the stock price. It will drop 50 cents for a one dollar drop in the stock price. The delta is 0.5. But here's the rub. The delta does not stay constant. As the price of the stock and the value of the option changes, the delta changes as well. As the stock continues to go up, the delta goes up. As the stock declines, the delta goes down.

What this means is that as you get deeper in-the-money, the option will more closely follow the price of the stock. Take a look at the table below which we have resurrected from our December issue. In this example, Microsoft is at $54.01 on December 10th. A slightly out-of-the-money option with a $55 strike price has a delta of 0.42. This means that if the stock goes up a dollar, the call option will go up 42 cents. But look at the deep in-the-money call option with a strike price of $45. This call option should net you a full dollar for every dollar change in price.

MICROSOFT CORP (MSFT)							54.0100	+0.4800	
Symbol	Last	Time	Net	Bid	Ask	Reference price	Div_freq	Div_amt	Historical Volatility
MSFT	54.0100	12/10	+0.4800	53.9500	53.9800	54.01	0	0	21.840%

Calls							Jan 2003	Puts						
icker	Last	T-Val	Delta	Gamma	Theta	Implied Volatility	Strike	Ticker	Last	T-Val	Delta	Gamma	Theta	Implied Volatility
MQF AH	14.50	14.08	1.00	0.000	-0.002	69.06%	40	MQF MH	0.20	0.00	-0.00	0.000	-0.000	58.33%
MQF AV	12.20	11.59	1.00	0.000	-0.002	64.75%	42.5	MQF MV	0.45	0.00	-0.00	0.000	-0.000	59.29%
MQF AI	10.00	9.10	1.00	0.003	-0.003	60.99%	45	MQF MI	0.55	0.00	-0.00	0.003	-0.001	51.50%
MQF AW	7.90	6.64	0.97	0.018	-0.006	56.89%	47.5	MQF MW	0.90	0.04	-0.03	0.018	-0.003	48.57%
MSQ AJ	5.70	4.34	0.88	0.054	-0.012	48.58%	50	MSQ MJ	1.35	0.24	-0.12	0.054	-0.010	44.32%
MSQ AK	2.55	1.13	0.42	0.103	-0.021	42.45%	55	MSQ MK	3.20	2.02	-0.58	0.103	-0.018	39.02%
MSQ AL	0.90	0.13	0.08	0.038	-0.007	40.37%	60	MSQ ML	6.60	6.01	-0.92	0.038	-0.004	36.91%
MSQ AM	0.25	0.01	0.01	0.004	-0.001	39.37%	65	MSQ MM	11.10	10.88	-0.99	0.004	0.002	38.62%
MSQ AN	0.10	0.00	0.00	0.000	-0.000	42.61%	70	MSQ MN	15.90	15.86	-1.00	0.000	0.003	36.89%

And if you look at out-of-the money call options, their profit potential diminishes rapidly the farther out you get. An out-of-the-money option could be called an out-on-a-limb option unless you have enough time for the stock to make the necessary gains to make you profitable. In our example, the $70 strike price January call is essentially worthless unless Microsoft makes a huge move in a very short period of time.

The other interesting thing to note is the delta for put options. They are negative reflecting the fact that they are inversely related to the stock price. Stock goes up, put goes down. The put delta is

(continued on page 5)

The Break Out Report

is published twice a month by Break Out Publishing.

Editors: Marco den Ouden & Ken Ballard **Email us:** marco@breakoutreport.com
Website: http://breakoutreport.com ken@breakoutreport.com

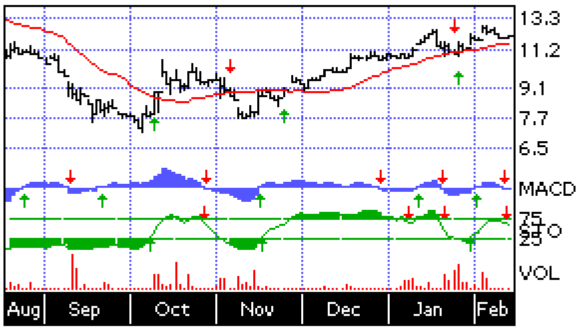
Articles this issue by Marco den Ouden unless otherwise indicated.

Subscription: $14.95 a month or $150 a year

Watched List Update

Stocks on the Move

The four stocks below are all on the move and worth a closer look if you don't already own them. One, Couche-Tard, has been in a slump since a stock split in July (didn't William O'Neil warn about that in *How to Make Money in Stocks*?) but looks poised for a rebound. Read the info with the chart below. It is not yet a buy – but getting close! The others are all buys in our book. Check out our Model Portfolio Update for graphic updates on two other potential reversals. (See page 11)

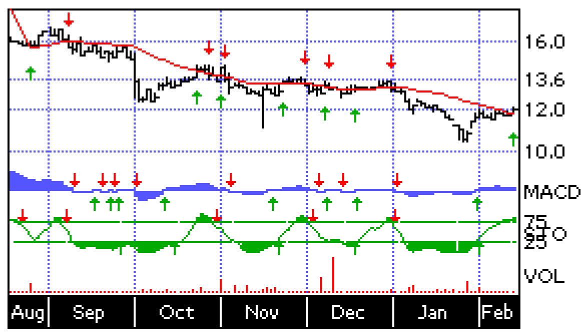


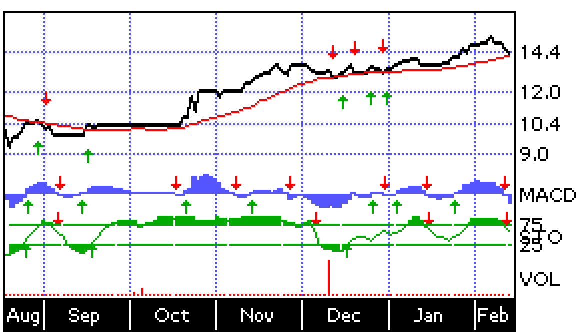
Bennett Enviro (BEV) **Profiled: May 25/01**
Price then: $3.50 **Price Now: $12.08**

⇦ Bennett Environmental has been one of our favorite stocks since we first featured it in May 2001. It was up 500% for us at one point and underwent a sharp correction in the summer. Its current strong uptrend was recently confirmed by a bounce off the MA. It's up 245.1% since profiled and may regain that 500% mark yet!

Couche-Tard (ATD.B) **Profiled: Dec. 4/00**
Price then: $5.75 **Price Now: $11.99**

Alimentation Couche-Tard, Canada's largest ⇨ convenience store chain, had a solid run through July 2002 before dropping 40% to $10.38 in mid-January but still up 108.5% since featured. It's now bounced up through the 30 day moving average which is still trending down. Wait for the MA to confirm a new uptrend before buying!



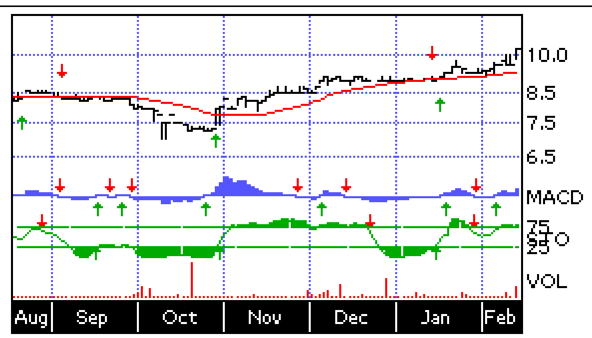


Ridley Inc. (RCL) **Profiled: Mar. 2, 2001**
Price then: $8.50 **Price Now: $14.25**

⇦ Feed producer Ridley Inc. has been on a tear since October, climbing almost 50%. It's up 67.6% since we first featured it. Right now it's testing the moving average again and if it bounces to the upside, this may be a good buy point. The company recently beefed up its management to further its growth.

Zargon Oil & Gas **Profiled: Jan. 29, 2001**
Price then: $4.70 **Price Now: $10.25**

Up 118.1% since profiled, this junior oil ⇨ and gas company continues to perform well despite a dip in earnings in the quarter to Sept. 30th. With soaring oil prices we expect it to continue its growth. It is at 52 week highs and prospective buyers could jump right in or wait for a pullback.



War = Destruction *(from page 1)*

Ultimately, war may happen. But of one thing we can be certain – war, even justifiable war, entails destruction. So it was with some concern that I saw a wretched old canard pulled out at a panel discussion leading up to the Financial Forum in Vancouver this weekend. The offender was someone who I thought would know better, Diane Francis of the National Post. A report of the forum in The Vancouver Sun quoted Ms. Francis as saying "War is beneficial to the economy, let's face it." I don't usually write to public figures but I quickly sent her an email on this point.

The fallacy, I told her, was known as the Broken Window fallacy and refuted absolutely in Henry Hazlitt's *Economics in One Lesson*. In print for over fifty years, this classic work built on the premise of the great French essayist Frederic Bastiat in his essay *What is Seen and What is Not Seen.* Bastiat's and Hazlitt's point is that in examining economic actions, particularly in the field of public policy, we must look beyond the obvious to trace all the consequences of the action. Which brings us to the Broken Window fallacy.

Hazlitt presents the simple story of a shop keeper and a boy with a rock. The boy hurls the rock through the shop window and runs away. A crowd gathers and commiserates with the shop keeper and condemns the youth. Until, that is, some wag in the crowd reflects aloud that every cloud has a silver lining. The shop keeper now must buy a new window. That creates work for the glazier who now can afford to buy some new tools. That creates work for the tool maker and so on. Why with this ripple effect, the whole economy will benefit from the boy's act of destruction. You could even call him a hero for such service to the nation.

The fallacy is that it looks at the obvious effects and ignores the unseen effects. What is not seen is that the shop keeper was planning to buy a new suit. That would have created work for the tailor who would have then employed the services of someone else and so on. This "ripple effect" does not happen and cancels out the one noted by our amateur philosopher. And society as a whole is, in fact, poorer. The economy could have had a window and a new suit. Now it just has a window because the suit is never made.

War, in fact, is the Broken Window fallacy writ large. War is destruction. War does not create wealth. Production creates wealth. War destroys wealth.

It is not surprising then that the continuing threat of war is wreaking havoc on the stock market. This week the markets continued to be choppy and ended up advancing modestly, all of the gains made on Friday. It could be looked at as a relief rally. Relief that war and its attendant destruction have not yet arrived. But the situation remains tenuous. Data is in the table below.

	Year-to-Date Change			Weekly Change		
Index	**Jan. 1, 2003**	**Feb. 14, 2003**	**Change**	**Feb. 7, 2003**	**Feb. 14, 2003**	**Change**
TSX Comp	**6614.54**	**6487.13**	**-1.93%**	**6477.74**	**6487.13**	**0.14%**
DJIA	**8341.63**	**7908.80**	**-5.19%**	**7864.23**	**7908.80**	**0.57%**
NASDAQ	**1335.51**	**1310.17**	**-1.90%**	**1282.47**	**1310.17**	**2.16%**
Gold	**347.50**	**352.20**	**1.35%**	**370.50**	**352.20**	**-4.94%**

Toolbox Tip

Comparison Charting

Here's a little known feature of the Online Investor Toolbox I just found out about last week. You can get the percentage change for a stock by simply putting a comma after it in the New Symbol box and clicking Go. You can compare two or more stocks by putting all their symbols in the box separated by commas and clicking Go. Don't put in spaces. The symbols and commas must be contiguous.

Thanks to Shamir Bhatia for that one. (Shamir tells me he got it from Dick Meeres so thanks to Dick too!) If you have a Toolbox Tip, why not let us know by email.

Greek Philosophy *(from page 2)*

equal to the call delta minus 1.

How can you use delta? Well, if you're buying LEAPS and want to capture dollar-for-dollar gains with the stock price, you want to buy LEAPS deep enough in-the-money to do so.

Another way to use delta is to calculate how many options you should buy or sell to insure a portfolio. Because of this, delta is sometimes called the neutral hedge ratio.

For example, suppose Microsoft is at $55 and you own 1000 shares. You want to insure the stock against expected volatility and are willing to temporarily forego some upside to do so. With a delta of -0.5 for at-the-money puts, you have to buy puts on 1000/0.5 or 2000 shares (20 contracts) to safeguard your position. If Microsoft drops a dollar, your options gain 50 cents each. Your gains on the puts exactly match the loss on the stock itself. Or you can do the same by selling calls. The effect on your portfolio is neutral.

Tied in closely to delta is gamma, the measure of the change in the delta for a change in the underlying stock. If you are hedging your portfolio against losses (using options as insurance), you want gamma to be as small as possible.

Two other infrequently used Greeks are Vega (sometimes called Kappa) and Rho. Vega measures the change in an option price for each percentage change in volatility. Rho measures the change in an option price for a percentage change in the risk-free interest rate (the federal bank rate).

But the really important Greek after Delta is Theta (Θ), the measure of change in an option price for each day closer to expiry. As we mentioned before, the time component of an option price is like an ice cube and melts away to nothing as the expiry date comes closer. If you're out-of-the-money, the option will expire absolutely worthless.

But time decay is not uniform. The time value of an option melts away faster and faster as the expiry date gets closer. With a long term option such as a LEAP, the time decay is almost negligible. But in the last two months of an option's life, the time decay accelerates exponentially, decaying faster and faster until it is gone.

You'll note too from our Microsoft example, that the further in-the-money you get, the more an option's value is made up of intrinsic value. A deep in-the-money option has very little time value and changes almost dollar for dollar with the underlying option.

All the Greeks are inter-related and constantly changing over time and as the stock value changes. To track them all is difficult even for the professional. But checking out the Theta and the Delta of an option is a decidedly useful tool in the option trader's toolkit. Use them!

Next month we'll look at some basic options strategies. But for a more complex strategy, see page 9.

Revision

Portfolio Trading Rules

We finally got around to updating our Trend Watch feature on the website a couple of weeks ago. And in doing so, we revised the trading rules we established last month once again.

We had given primacy to our 10% rule, looking for confirmation with the moving average. But we ran into contradictions with some stocks in a positive trend by our 10% solution and in a negative trend by moving average and vice versa. After some consideration we decided to give the 30 day moving average primary importance and added the following two Exception Rules:

- Exception Rule # 4: Where the moving average is in a clear downtrend and the stock gains 10% from its recent low, we shall wait for the moving average to confirm the trend before buying.

- Exception Rule # 5: Where the moving average is clearly in an uptrend and the stock declines 10% from its recent high, we shall wait until the moving average confirms the trend change before selling unless it is off 15% or more from its interim high.

The complete set of trading rules are posted on the Subscribers Only portion of the website.

We've also changed our trend tables to reflect this change. Check them weekly for updated buy/sell recommendations and stop losses.

Technology Pick

ACD Systems International (ASA –TSX)

(website: www.acdsystems.com)

In the Spring of 2001 I won a digital camera. And after almost two years of using it, I'm hard pressed to understand why anyone would want to use a film camera ever again. Consider the advantages. The pictures are electronically recorded and can be transferred to your computer hard drive, after which you can erase the memory disc and reuse it. You don't ever have to spend $20 a roll to develop film ever again. You can touch up your pictures to get rid of red eye and other problems. With modern printers and paper you can print out the ones you want with comparable quality to film. You can send photos easily to loved ones far away as e-mail attachments.

Very simply, digital photography is revolutionizing the industry. And yet, digital cameras have barely penetrated the market, a market that is huge. Digital camera adoption, though, is growing at an annual compounded rate of 16% a year and is expected to reach 51.1 million units by 2007. If it really takes off, those results could explode exponentially, just as Internet use has.

ACD Systems International is a leading developer and manufacturer of digital imaging software. Its flagship ACDSee software is the leading software worldwide for managing, enhancing, viewing and sharing digital images. Its other products include VideoMagic™ video editing software, FotoSlate™ photo printing software and FotoCanvas™ photo editing software as well as products for portable units like the Palm Pilot. Its software has won many accolades from users and reviewers including the Editor's Choice Award from PC Photo Magazine.

Besides millions of consumer users, ACD Systems has 33,000 corporate clients including such major companies as ATI Technologies, Microsoft, Boeing, Canon, General Motors, Dreamworks, the White House Communications Agency and both Harvard and Oxford Universities. It is available in eleven languages in 125 countries.

Much of the company's sales penetration has come from successful marketing programs with original equipment manufacturers including Kodak, Canon, Pentax, Leica, Toshiba and Hewlett Packard. The company has also developed a Software Developer's Kit (SDK) so third parties can create add-ons and enhancements. The company has SDK agreements with Sanyo, Sony and Kodak. And the company has a solid web marketing program as well getting 15 million hits a month at its website.

Quarterly Earnings per Share

To Dec. 31st	2001	2002	% Change
EPS	$0.00	$0.08	Turnaround
Revenues (000s)	$4,800	$6,900	+43.8%

Annual Earnings per Share

To Mar. 31st	2000	2001	% Change	2002	% Change
EPS	$0.04	$0.00	-400.0%	-$0.14	n/a
Revenues (000s)	$5,217	$11,764	+125.5%	$16,738	+42.3%

(Continued on page 7)

ACD Systems *(from page 6)*

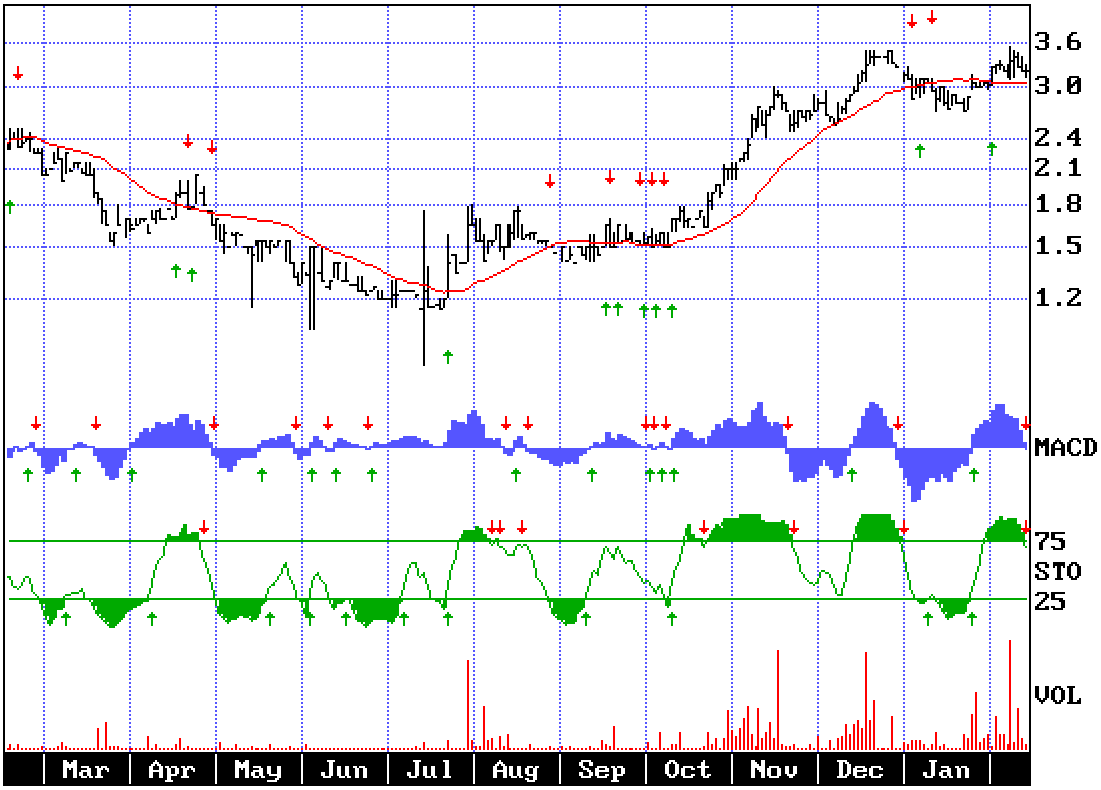


Chart Analysis: Like many a hot tech stock in late 1999, this puppy soared from $2 to almost $25 in the first quarter of 2000. And then, like so many others, ACD Systems crashed to a low of $1.16 in July 2002. But this reflected an overblown market, not an overblown company. Revenues continued to grow throughout the last three years. And in mid-2002 it turned the corner to profitability. That has seen the stock soar three fold since. The stock recently tested its moving average and has bounced solidly through with very strong volume. It is in a consolidation phase that will likely see it push to new highs very soon.

Stats as of 02/14/03	Phase 2 Analysis
▪ Hi/Lo Ratio: 3.94	▪ Price Pattern: A
▪ RS: 87.60	▪ Volatility: A
▪ Shares: 21,854,865	▪ Estimates: A+
▪ P/E: 80.0	▪ Snapshot: C+
▪ Price: $3.20	▪ News: A

Phase 2: We give ASA an A for both price pattern and volatility as it has been gaining steadily. Analysts have boosted their predictions sharply with $0.25 a share profits predicted for 2003. The overall rating is Strong Buy and we give it an A+. The snapshot is weak with the company losing money in fiscal 2002. But trailing earnings to Dec. 31, 2002 are profitable and, in fact, the most recent quarter showed profits double the trailing earnings. We give it a C+. Remember, this is a turnaround play. News is solid with new releases of its software and new licensing deals including a bundling agreement with Ilford, a leading manufacturer of computer photo paper. Another A.

All charts courtesy of Investools. Visit their website at http://me.investortoolbox.com/welcome.html for more information on their courses and online tools.

Mutual Funds

Marco's Power Performers

(for January 2003)

This issue we bring back a long-running feature we used to have on our website – my unique take on mutual funds. I call my picks my Power Performers. These are mutual funds that have returned a better than 20% annual compounded return in each of the one year, three year and five year periods. Better than 20% in the last year indicates the fund is doing well now. Better than 20% in five years shows it has staying power. And better than 20% over three years shows consistency.

When we originally carried the feature, the numbers of funds occasionally became quite large. And so we decided to create a separate category – Marco's Super Power Performers. These generated better than 25% returns in all categories. With the market slump, the number of qualifying funds slumped to a precious few. And Canadian funds were in short supply, US funds dominating. So we created a third category – Performers – with a 15% criterion.

We were curious to see how the funds would stack up now in the fourth year of a bear market. Could any have possibly done well and qualified in this period? The results are below.

Super Power Performers			
Fund name	**1 yr %**	**3 yr %**	**5 yr %**
Sprott Canadian Equity	23.66	38.65	32.01
Resolute Growth	37.12	41.03	27.41
Power Performers			
Dominion Equity Resource	34.42	33.64	20.15
Performers			
Bissett Microcap-F	26.68	18.03	22.80
BluMont Hirsch Performance	15.30	15.12	18.11
Royal Precious Metals	111.87	50.13	17.91
Mackenzie Universal Precious Metals	63.43	47.83	17.90
Mackenzie Universal Precious Metals(US$)	70.20	45.28	16.76

Out of a universe of around 1650 mutual funds in Canada, only 14 had five year returns better than 15%. 14! That's less than 1%! That is a scary statement on mutual funds if you ask me.

And of those 14, only 8 showed any consistency of growth. But it is truly amazing that two Canadian equity funds that are not precious metals oriented came out as Super Power Performers. These are the real winners here.

Sprott Canadian Equity is a small to mid-cap fund which currently has great exposure to precious metals. Its top holding is the Central Fund of Canada, a closed end precious metals mutual fund. Its top ten include Goldcorp and High River Gold. But its number 2 holding is Coolbrands, the makers of Eskimo Pie Ice Cream sandwiches. Other top holdings include Energy Savings Income Fund, Farm Credit Corporation, Hurricane Hydrocarbons and Nautilis Group, a company that makes exercise equipment.

Resolute Growth has exposure to energy, real estate and biotechnology. Its top holding is Cangene Corporation, followed by Morguard Corporation, Navigo Energy, Resolute Energy, Sherritt International, Genesis Land Development, Enghouse Systems, Dimethaid Research, Pulse Data and True Energy.

(continued on page 9)

Option Strategies

Writing for a Living

Who would have thought that the most active options traders in Canada would operate out of the B.C. town of Kelowna? Strange but true. Traian Moldovan and Robert Holmes work for TD Waterhouse in Kelowna but their clientele are from all over the map. Why have these clients chosen to place their funds with these guys? Because they have mastered turning cash into cash flow through options.

It's often been noted that options are risky, that the vast majority of options expire worthless. That is misleading to some extent because the vast majority of options traders trade in and out of

(continued on page 10)

Power Performers *(from page 8)*

Both funds, unfortunately, require heavy investment – a minimum of $50,000 for Resolute Growth and $25,000 for Sprott Canadian Equity. All are considered Canadian content in your RRSP except the Mackenzie Fund in US dollars.

It's worth looking at what each of these funds has done on a year to year basis and for the year-to-date.

Fund	YTD	2002	2001	2000	1999	1998	1997	1996
Sprott Canadian Equity	-0.90	39.30	43.71	44.03	53.40	-16.57	n/a	n/a
Resolute Growth	-1.42	40.17	24.40	76.24	29.89	-12.16	-5.38	49.07
Dominion Equity Resource	-3.90	41.27	14.45	49.89	36.54	-25.90	-11.63	38.60
Bissett Microcap-F	-2.20	36.24	22.11	6.82	63.47	-8.24	n/a	n/a
BluMont Hirsch Performance	-0.62	13.16	25.00	14.50	52.64	-7.59	n/a	n/a
Royal Precious Metals	-1.61	153.11	34.37	-9.63	-11.36	-14.59	-33.72	38.76
Mackenzie Universal Precious Metals	-5.23	89.65	44.42	8.64	5.05	-21.59	-35.23	34.09
Mackenzie Universal Precious Metals(US$)	-1.43	91.21	36.04	4.52	11.39	-26.78	-37.93	33.66

Note how a very strong current year can skew the overall results. Royal Precious Metals had a spectacular 2002, up 153.11%. But it lost money in four of the last seven years – not very good. Both Mackenzie precious metals funds and the Dominion Resource Fund, on the other hand, have positive results in five of the last seven years and four of the last five. Even though their most recent year is not as flashy as Royal's, they are stabler and a less risky buy.

These resource funds, of course, are invested primarily in precious metals. So let's look instead at the other two small caps to see what their holdings are.

Bissett Microcap-F includes many of the stocks from our Watched List in its top holdings. These include Brampton Brick, BW Technologies, Dalsa Corporation, IPL Inc., Viceroy Homes and Home Capital Group. If you like our approach to stock selection, you could buy this fund as it seems to follow a similar approach.

And Blumont Hirsch has the following in its top picks: Agnico Eagle, Canada Life, Creo Inc., Industrial Alliance Life, IPL Inc., Peyto Expoloration, Placer Dome, Power Corporation, TD Bank and Trican Well Service. Three are in my Watched List and one other is featured in my book.

All of the funds are down for the year-to-date, including oddly enough, the precious metals funds. Nevertheless, they should certainly be considered for your RRSP this year!

Writing for a Living *(from page 9)*

them. Whether these trades are profitable or not is not factored into the general observation that most options expire worthless. Nevertheless, the fact that most options expire worthless has some interesting implications.

If people holding calls and puts at expiration generally lose their investment, who then makes that money? The answer is obvious – the people who sold the options. And the secret to Moldovan's and Holmes's success is that they focus on the winning end of things. They focus on writing (selling) options.

More specifically, they focus on selling both calls and puts on indexes, their favorites being the OEX and the XAU. Here's how it works.

The OEX is the S&P 100 Index and it is a high priced item. On January 17th, for example, the OEX was 457. That also makes the options pricey and potentially very profitable on the sell side.

Moldovan and Holmes write both puts and calls on the OEX for their clients using an approximate spread of 100 points. So on January 17th, for example, they sold two March calls with a strike price of 500 and a premium of $4.20 as well as two March puts with a strike price of 400 and a $4.50 premium. That works out to a total premium of $1740 less transactions costs of $90 a trade for a net cash flow of $1560 for their clients. In US dollars yet!

What is their obligation under the trades? Remember that a call gives you the right but not the obligation to buy a security at a set price by a certain date. A put gives you the right but not the obligation to sell a security at a set price by a certain date. Liability is limited to the premium. With option writing, the obligations and liabilities are quite different.

Writing a call gives you the obligation to sell a security at a set price by the expiry date if the call purchaser exercises her right to purchase. Writing a put gives you the obligation to buy a security at a set price by the expiry date if the put purchaser exercises her right to do so.

The liability with writing a call is unlimited if the writing is naked, that is, if you don't actually own the stock to sell and have to buy it on the open market. If you own it, it is called a covered call. (See Ken's piece on covered calls in the January 4th issue) and your liability is limited to whatever your cost price was for the security. The liability with writing a put is the strike price of the put.

In our example, if the OEX moves above 500 by the expiry, the call writer is obligated to sell the OEX to the call buyer at 500. The liability is the difference between the price on the open market and 500. So if the OEX moves to 510, say, it will cost the writer $2000 for two contracts. To mitigate this factor, Moldovan and Holmes monitor their client accounts carefully and if there is a danger of being called out, they roll over the trade. That is, they sell a further call two months out and use the proceeds to buy back the dangerous obligation. The trade is a wash.

They have been doing this successfully for several years now, and during the last two years of this bear market (from February 2001 to January 2003) they have averaged a cash flow of $1355.25 a month after transaction costs. There was only one negative cash flow month – July 2002 – after the OEX suffered its largest two month decline of 23.51%. The loss was $1120. All the other months were positive ranging from a low of $162 to a high of $2513. And that's all in US dollars!

Because there is a potential liability, they require clients to put up $100,000 Canadian in a cash account which earns 2.7% a year on top of the cash flow from the options writing. This cannot be in an RRSP. If you want to put up securities instead, they require $200,000. The return on the $100,000 given the data noted above is 25.2% a year plus the 2.7%.

What's the real danger here? I asked Traian what the consequences would be of a 1987 style one day crash. He replied that he'd probably jump through his office window! But if that sort of downside scares you, you can also hedge your position by using some of the cash flow to buy protective puts.

Robert Holmes also manages similar trading using the XAU gold index. The cash requirement here is significantly less – just $25,000. If you want to find out more, contact Traian at traian.moldovan@td.com or Robert at robert.holmes@td.com. Or if you're in Vancouver, attend our Break Out Investment Club meeting on the 27th. Traian Moldovan will be our guest speaker.

Our Model Portfolio

Initial Position: $50,000 (Jan. 11, 2002)

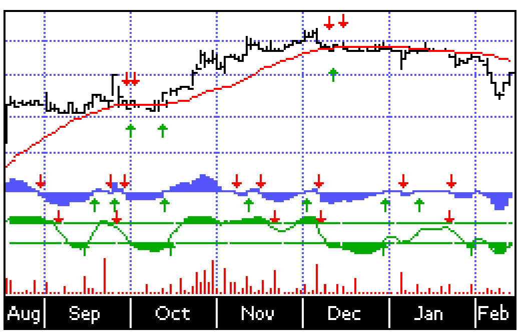
Current Position: $61,848.79 (+24.64%) Down 0.87% YTD

Wow! Busy month! One of our stocks saw us whipsawed, buying back a position only to sell it again shortly thereafter. That stock was Mega Bloks which we bought back at the opening price of $22.50 on January 21st. But Mega Bloks hit our stop loss again when it closed at $21.25 on Feb. 13th and we sold at Friday's opening price of $21.50. This is our second time selling off Mega Bloks so we are especially cautious on it but still long term bullish.

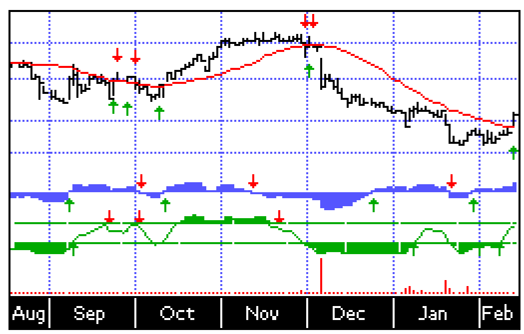
Two other stocks in our portfolio hit their stop losses and were sold this week. And two were up 10% from their recent lows indicating a buying opportunity may be imminent.

First the sells: IPL Inc. hit our stop loss when it closed at $22.60 on Feb. 10th and we sold at the following morning's opening price of $23.00. Goldcorp also hit our stop loss on Feb. 10th when it swooned to close at $17.77. We sold at the next morning's opening of $17.55, something we hated to do because we are bullish on gold. But a short to intermediate term correction is at work and we don't know how long it will last or how severe it will get. So we followed our rules and sold. All these stocks are now in downtrends and we'll want to see a change in the Moving Average and an increase of 10% from an interim low before buying back. We'll hold the cash for now.

Possible buys: Meanwhile, both Dalsa and Westjet were up 10% from their interim lows. Dalsa closed at $16.47 Friday, up 10.54% from its recent low closing price of $14.90. Westjet closed at $15. 75, also on Friday, up 12.98% from its recent low price of $13.94. But as per our revised rules, we want both an uptrend in the 30 day MA as well as a 10% gain from an interim low to buy. Do they qualify? Look at the two charts below:



Dalsa Corporation – Feb. 14, 2003



Westjet Airlines – Feb. 14, 2003

Both are still in downtrends and we will wait for the moving average to start sloping upwards in both cases. Such a new trend must be confirmed and confirmation for us will be if the moving average starts moving up and the stock corrects and then bounces off the MA to the upside. This may take a week or more in each case. Looking at the charts above, as well as considering recent news, we expect such a confirmation with Westjet but are uncertain about Dalsa.

Two contradictory factors are in play with Westjet. On the positive side, the company continues to record record profits and is growing. Air Canada came in with a stunning loss a week ago and announced cost-cutting efforts including selling off Jazz, its low-cost rival to Westjet. The national airline had tried playing Westjet's game, but Westjet's customers are a loyal breed and all Air Canada succeeded in doing was cannibalizing its own sales. People were switching from Air

(continued on page 11)

Portfolio Update *(from page 11)*

Canada to Jazz, not from Westjet to Jazz as it had hoped. Westjet also is launching service to Montreal, positioning itself to take over Air Canada's role as Canada's national airline when that company goes belly up. On the negative side, the airline industry is still under a cloud since 9/11.

Our current cash position is $29,279.10. Forzani will be replaced if not repurchased by Mar. 6th.

Forzani Group (FGL – TSX)

# of Shares: 0	**Stopped Out:** +4.3%
Bought on: Oct. 16th	**Price Then:** $18.78
Sold on: Dec. 6th	**At:** $19.60

Notes: We'll continue to hold this cash position open for when Forzani gives us a buy signal. After March 6 we'll look elsewhere.

Peyto Exploration (PEY – TSX)

# of Shares: 825	**Bought on:** July 16th
Price Then: $6.16	**Price Now:** $12.89
Gain: 109.3%	**Stop:** $11.28

Notes: FirstEnergy Capital has given Peyto a target price of $14.50 according to The Growth Report of Oct. 31st.

Dalsa Corporation (DSA – TSX)

# of Shares: 0	**Stopped Out:** -5.4%
Bought on: Nov. 18th	**Price Then:** $18.50
Sold on: Jan. 9th	**At:** $17.50

Notes: Dalsa is up more than 10% from its interim low and now needs confirmation of the trend change from the moving average.

IAMGOLD (IMG – TSX)

# of Shares: 1549	**Bought on:** Dec. 6th
Price Then: $5.69	**Price Now:** $7.56
Gain: 32.9%	**Stop:** $7.03

Notes: Despite a retrenchment in the price of gold, IAMGOLD is hanging in there and has not yet hit our stop. We're watching carefully!

Goldcorp (G – TSX)

# of Shares: 0	**Stopped Out:** +2.3%
Bought on: Dec. 6th	**Price Then:** $17.15
Sold on: Feb. 11th	**At:** $17.55

Notes: Goldcorp got stopped out with the downturn in the price of gold. We expect this to be temporary but wait in cash for now.

Mega Bloks (MB – TSX)

# of Shares: 0	**Stopped Out:** -4.4%
Bought on: Jan. 21st	**Price Then:** $22.50
Sold on: Feb. 14th	**At:** $21.25

Notes: Mega Bloks was bought back on Jan. 21st only to be stopped out again on Feb. 14th. We'll hold the cash for now.

Home Capital Group (HCG.B – TSX)

# of Shares: 370	**Bought on:** Oct. 16th
Price Then: $13.25	**Price Now:** $15.40
Gain: 16.2%	**Stop:** $14.02

Notes: The stock broke through resistance to touch $15.75 and could move higher still after a short pullback.

IPL Inc. (IPI.A – TSX)

# of Shares: 0	**Stopped Out:** -2.1%
Bought on: Dec. 16th	**Price Then:** $23.50
Sold on: Feb. 11th	**At:** $23.00

Notes: Unfortunately IPL has taken a bit of a dip and we were stopped out. The long term trend is still up but current trend is flat.

Niko Resources (NKO – TSX)

# of Shares: 135	**Bought on:** Nov. 26th
Price Then: $22.25	**Price Now:** $25.15
Gain: 13.0%	**Stop:** $24.64

Notes: Niko is correcting from its recent highs but hasn't hit our stop yet. With oil prices surging, we could see it move up again soon.

Westjet Airlines (WJA – TSX)

# of Shares: 0	**Stopped Out:** -5.3%
Bought on: Oct. 18th	**Price Then:** $18.54
Sold on: Dec. 10th	**At:** $17.56

Notes: A solid earnings report, extension of services and problems at Air Canada have moved Westjet forward. Almost a buy!