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Michael C. Thomsett

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Michael C. Thomsett

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PREFACE

The Elusive Goal: Low Risk and High Yield

Is it truly possible to match low risk with high yield? Most experts question the idea that there are ways for risk-averse investors to outperform the averages. However, conservative investors can exploit a narrow band of potential strategies to dramatically increase yields and, at the same time, manage risks within their self-defined risk limitations.

To some conservative investors, options are too exotic and too risky. If a range of strategies is too much trouble or contains too many pitfalls, it is not worth pursuing. But we proceed on the premise that a *conservative* investor is not necessarily someone who does not want to expand beyond a well-understood and short list of investment possibilities. Being a conservative investor does not necessarily mean that you are unwilling to examine new ideas, expand your portfolio, or take acceptable risks. It means that you are not interested in speculation or in exposing yourself to the possibilities of high risk.

Investors tend to be aware of the potential for high returns without also acknowledging that such strategies are usually accompanied by unavoidable high risks. This is where the inexperienced suffer losses in the market. The lack of experience that attracts the novice to speculation in options and other high-risk strategies has caused much grief in the market. When we look back at the dotcom years, we see that many first-time investors made quick paper profits, only to lose it all in a sudden reversal of fortunes. But conservative investors know that putting all of their capital in a single industry is ill advised, especially if they select companies that have never reported a net profit or whose stock has risen over $200 per share in a few months or whose actual core business is only vaguely defined.

Given these observations, conservative investors naturally seek methods for using their capital that achieve some very specific goals, including the following:

1. Preserving spending power after both inflation and taxes.
2. Avoiding unacceptable market, liquidity, and diversification risks.
3. Protecting profits without loss of invested positions.

These goals are typical for conservative investors and actually would serve moderate investors just as well. They all involve methods of avoiding loss. As a *conservative* investor, you are not averse to risk in any and every form; essentially, you are averse to unexpected surprises. This is perhaps the most important distinguishing characteristic between you and other investors. The majority of novice investors are surprised when they lose money in the market but, in retrospect, should they have been surprised? In most situations, the novice was operating on certain assumptions concerning potential profits, but was unaware of the related risk or the degree of risk exposure. Otherwise, his or her investment decisions probably would have been different.

With this in mind, we offer a more realistic definition of the *conservative* investor: one who is experienced enough to be aware of both yield and risk, and who makes decisions based on that broad awareness. Conservative investors are not as likely as other investors to be taken by surprise when they lose money in the market. Another aspect of this expanded definition distinguishes between risk profile and the willingness to use creative and alternative strategies. The conservative is not close-minded and does not reject exotic instruments like options merely because of their reputation as high-risk. Instead, the well-informed conservative is likely to examine claims about high-yield potential with an open mind. You may be skeptical and, at the same time, willing to listen to the suggestion that the combination is at least possible. A limited number of strategies do, in fact, offer the potential for various conservative applications to meet the three goals common to conservative investors: preserving capital, avoiding unacceptable risk, and protecting paper profits. We have summarized 12 strategies in this book (see the appendix) and qualified them in terms of risk levels.

This book does not suggest that you have to become an expert in a broad range of complex or exotic options strategies. Instead, it proposes a

rather limited number of strategies appropriate for conservative investors. Our purpose is to respect the risk limitations in the conservative strategy while showing how experienced stock market investors can expand their yield levels significantly, protect existing positions, and come through down cycles in the market intact.

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OPTIONS TRADING FOR THE CONSERVATIVE INVESTOR

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1

SETTING THE GROUND RULES

In any discussion of an investment strategy, we begin with a series of assumptions. Our assumptions tie in to your conservative profile: You have prequalified stock; you believe these stocks will rise in value over time; fundamentals are essential in stock selection; you would be happy to buy more shares; and there are a number of companies that meet your standards. We have identified 10 companies that make up a "model portfolio" to illustrate the options strategies in this book.

This book explains how conservative investors can employ option strategies to (a) enhance current income without increasing market risks; (b) protect long-positions through options used for insurance; and (c) use options as a form of contingency in volatile market conditions.

The Ground Rules

Because you are a *conservative* investor, we base all of the arguments in the book on a series of underlying assumptions. These ground rules should always be kept in mind because they relate to your risk profile and to your investing philosophy. We use five underlying assumptions in this book:

1. *You will limit option activities to stocks you have prequalified.* We assume as a necessary starting point that your portfolio—and the stocks you use for options strategies—includes stocks you believe in as long-term-hold stocks and that you consider these stocks permanent parts of your portfolio (as long as the fundamentals remain strong). This is an important attribute because it is not conservative to buy stocks solely to use for options strategies. A conservative approach to options must include the premise that your activities will be limited to the strongest possible stocks you can find.
2. *You believe that your stocks will rise in value.* A conservative investor naturally expects stocks to rise in value; otherwise, why keep them? But this seemingly obvious point has relevance in the underlying assumptions of this book. Many of the discussions of strategies are premised on a belief that over the long term, the subject stock's market value will rise. Many options strategies work best when stocks do *not* rise, so our second

underlying assumption is in line with the conservative approach. This means you want to accumulate shares of value investments; you expect prices to rise over time; and you will change a *hold* to a *sell* when the fundamentals change. However, at the same time, some options strategies are designed to take advantage of short-term volatility. When marketwide volatility affects short-term prices in your stocks, you have an opportunity to pick up discounted shares, take profits (without having to sell stock), or average down your overall basis. Of course, the proposal that you should average down would be conservative only if the basic assumptions were valid. You would want to employ such a strategy only for stocks in which you have a strong belief as long-term value investments.

3. *You accept the premise that fundamental analysis of* stocks *is an essential first step in the process of examining option opportunities*. There are no fundamental attributes for options. These are intangible contractual instruments, and they have no value on their own; thus, you can only judge the tangible value of stock as a means for selecting appropriate options strategies. Many first-time options traders make the mistake of overlooking this basic reality. They select options (and stocks) based on the immediate return potential, but ignore the very real market risks of the underlying stocks. This violates the conservative tenet that stocks should be chosen for their fundamental strength and growth potential.

4. *In the event of a temporary downward movement in a stock's price, you would be happy to buy more shares.* Some investors may be unwilling to pick up more shares of a particular stock, even when the opportunity to buy discounted shares is presented. In this book, several strategies are introduced proposing that additional shares may be purchased (or exposed to contingent purchase) using options. If this is not the case in a particular situation, then those suggestions should be passed over. You may have a strict formula for diversification or asset allocation that you use to limit risks in any particular stocks, for example, so strategies aimed at increasing your holdings in one stock would contradict your portfolio management standards in such

an instance. Strategies proposing that you set up situations in which more shares may be picked up work *only* if that suggestion conforms to your overall portfolio plan.

5. *You believe that there are an adequate number of available stocks that meet your criteria.* Some investors become convinced that their short list of stocks is the only list available to them. Thus, if they were to sell shares of stock from their portfolio, they would be unable to reinvest profits in equally acceptable stocks. We assume that you do not believe this and that you are aware that probably dozens of stocks meet your fundamental criteria—in terms of price level, PE ratio, volatility level, dividend payment history, and a range of other analytical tests. Accordingly, if a particular stock is sold from your portfolio, we also assume that you are tracking a number of other stocks that you could and would purchase upon sale of stocks you currently own.

Incidentally, this practice makes sense whether you trade options or not. The fundamentals can change for any stock, so if a hold stock changes to a sell, you need to reinvest funds. As a matter of basic portfolio management, every investor probably has a secondary list of stocks that would be used to replace sold stocks from the current portfolio. The need for maintaining this list relates to options trading because some strategies result in selling shares of stock. In those cases, you want to reinvest capital in a new issue on your list of qualified stocks.

A Model Portfolio

In the examples used in the following chapters, we use our five underlying assumptions to demonstrate how options work within the conservative framework. We also developed a model portfolio of 10 stocks, which we use in various combinations throughout. This helps to tie together the various examples and range of possible outcomes. This model portfolio is by no means a recommendation of stocks you should own. It was selected to include stocks with some common attributes. Seven of the 10 have increased dividends every year for the

past 10 years and have also reported low volatility in trading. Eight of the 10 have exhibited rising market value in recent years. (exceptions were Coca-Cola and Xerox). All of these stocks have available both listed options and long-term options (LEAPS®), enabling us to look at a variety of scenarios for each conservative strategy.

Employing a single portfolio throughout the book is also helpful in another way. Not every strategy works well for each stock in our model portfolio, so we can walk through the selection process to demonstrate how a particular strategic decision is made. While your portfolio may contain a number of excellent value investments, some strategies simply do not work at all times or in all cases. You can compare the different potential for strategies across a range of stocks by following the model portfolio throughout the explanations in each chapter.

The values of each stock, current bid, and asked value of every option used in this book are based on the closing prices reported by the Chicago Board of Exchange (CBOE) on October 22, 2004. Table 1–1 summarizes this model portfolio

Table 1–1 Model Portfolio

Stock Name	Trading Symbol	Closing Price*
Clorox Company	CLX	$55.91
Coca-Cola	KO	38.90
Exxon Mobil	XOM	48.70
Fannie Mae	FNM	67.65
Federal Express	FDX	87.78
General Dynamics	GD	100.01
J.C. Penney	JCP	38.20
Pepsico (Pepsi-Cola)	PEP	48.48
Washington Mutual	WM	38.43
Xerox	XRX	14.32

*Closing price as of October 22, 2004

Is this a "conservative" portfolio? That is a matter of opinion and also depends on the timing of purchase, long-term goals, and the individual's opinion about the fundamentals for each corporation. These 10 stocks provide a cross section of stocks that illustrate where strategies work well and where they do not work at all. The actual definition of a conservative portfolio is (and should be) ever changing based on changes in the market, in a stock's market price and volatility, and of course, in emerging information concerning fundamental strength or weakness of a particular company.

Is this information out of date? The data gathered on the closing date—October 22, 2004—is old, but it would be impossible to perpetually update 10 stocks and still meet the publication date of this book. However, all of the information is relative. The relative values of options for a particular stock will probably be consistent from one period to the next—assuming the proximity between closing price and option strike price are about the same, and that months to go until expiration are the same as well. While these relationships can and do change based on ever-changing perceptions about a particular company, the data remains valid. We need to use some measurement in time, and all of these stocks were selected and summarized on the same date. Given all of these qualifications, these closing prices (and the option values used in this book) are fair and reasonable. As of that same date, October 22, 2004, there were about 2,500 stocks that had options available to trade—a lot of choices for conservative investors.

2

OPTION BASICS

The biggest hurdle in the options market is terminology. This chapter explains the basic concepts and defines option terms; introduces call and put strategies; explains how long and short positions work in both types of option contracts; and provides an overview of the options market.

Typically, books about options start by showing how you can leverage a small amount of capital to make fantastic profits, often in the triple digits. Such books tend to quickly become overly technical and complex, so that you end up with two problems. First, you are exposed to the proposition that you can get rich by speculating in options; second, the discussion becomes obscure as the details emerge.

We do not take this approach. Our basic assumption is that, as a conservative investor, you want to know exactly how options might or might not work in your portfolio, and you want the information to be presented clearly and logically. Since we concentrate on a fairly narrow range of possible strategies—only those appropriate in a conservative portfolio—we can avoid a lot of the more exotic potential of options.

Even the most experienced investor struggles with terminology and the meaning of key concepts, so this chapter covers the important matters that you need to master, including explanations of calls and puts in either long or short positions; how option contracts work; expiration of options; strike prices; and time and intrinsic value. In discussing the range of possible strategies, our purpose is not to recommend any particular approach, but to explore and review all of the possibilities. As a conservative investor, you will find only a small portion of these strategies to be of interest; but you can also benefit from knowing about *all* of the potential uses of calls and puts.

The Workings of Option Contracts

In this section, we review the rules of the option contract. The mechanics of expiration, strike price, and time and intrinsic value affect all decisions related to how you should or should not employ options and how risks increase or decrease as you employ a particular strategy.

Option Attributes to Determine Value

Collectively, the attributes of the option contract determine its value. This value relates not only to how high or low the premium is, but also to how the option has *value* as a strategic tool in your stock portfolio. Option contracts refer to 100 shares, so each contract allows the buyer to control 100 shares of the underlying stock. Every option relates specifically to that one stock and cannot be transferred. The *premium* is the cost (to the buyer) or value (to the seller) of the option contract. This cost/value is expressed as the value per 100 shares, usually without dollar signs. For example, if an option's current premium is 6, it is worth $600, and if current premium is 4.75, it is worth $475.

Some strategies make options useful for protecting paper profits, maximizing short-term income with little or no market risk, or hedging other positions. If the option premium is too high (for long-position strategies) or too low (for short-position strategies), then a particular option strategy cannot be justified.

Expiration limits the lifetime of the option. The potential profit period for the option speculator is the flip side of the advantage the short seller enjoys. Just as a short seller of stock sells and has an open position, the short seller is an options trader who initiates a position by selling the option. The short option position can be closed in one of three ways. It may expire worthless, in which case all of the premium received by the seller is profit. It may be closed by buying back at any time, with the difference between the initial sales price and final purchase price representing profit or loss. It may be exercised by the buyer, and the short seller is then obligated to complete the exercise transaction. When a call is exercised, the seller is required to deliver 100 shares of stock at the strike price. When a put is exercised, the seller is required to take delivery of 100 shares at the strike price—shares are "assigned" to the seller.

Intrinsic and Time Value Premium

Option premium has two components: *intrinsic value* and *time value*. The intrinsic value is equal to the number of points that an option is *in the money*. This concept is explained in greater detail later in this chapter; for now, it is important to understand the meaning of intrinsic

value related to the stock price. The strike price is the price at which an option can be exercised; for example, if a call option has a strike price of 45, it means that it provides the buyer the right (but not the requirement) to buy 100 shares at $45 per share. The money rules for this example are as follows:

1. If a 45 call is held on stock currently valued at $47 per share, the option is 2 points in the money.
2. If the stock is valued at $45 per share, there is no intrinsic value. This condition—when strike price and stock market value are identical—is called *at the money*.
3. If the stock is valued below the strike price, there is no intrinsic value. For example, if the strike price is 45 and the stock is selling at $44 per share, the condition is 1 point *out of the money*.

The opposite direction applies to puts. In-the-money intrinsic value refers to the number of points the stock is below the strike price of the option. For example, if the strike price of a put is 40 and the stock is currently selling at $37 per share, the put option contains 3 points of intrinsic value. If the stock is lower than the call's strike price or higher than the put's strike price, there is no intrinsic value.

Time value is the portion of the option premium above and beyond intrinsic value. The longer the time to expiration date, the higher the time value. So, time value is the key to identifying option strategy opportunities. There is also a relationship between time value premium and the proximity between strike price of the option and current value of the underlying stock. A study of option values demonstrates how this relationship works.

Long-Term Options and Their Advantages

The LEAPS (Long-term Equity AnticiPation Security) option is a long-term contract. In comparison, the standard listed option lasts only about 9 months maximum. When various strategies are viewed comparing LEAPS options with listed options, that longer expiration makes a lot of difference to both long and short strategies. There is a far higher time value in a long-term LEAPS option, which may exist for up to

36 months. In the stock market, that is a very long time, and everyone knows that many changes can occur over 3 years. So, if you purchase options, you must expect to pay more for the longer life of the LEAPS option, because you also buy far greater time. For the short seller, the longer period translates to higher income, because as a seller, you *receive* the premium when you open the short position. For that higher premium income, you also have to accept a longer exposure period.

The expiration and, more specifically, the time between opening an option position and the expiration date determines the premium value and affects the decisions made by speculators on the long side and investors on the short side.

Strike Price of Options

Strike price is the second feature that determines the option's value. The strike price is fixed and, in the event of exercise, determines the cost or benefit to every option position, whether long or short. The proximity of current market value to the strike price of the option also determines current premium value and potential for future gain or loss, as well as the likelihood of exercise. For example, if a call's strike price is 30 (meaning it would be exercised at $30 per share) and the current market value of the stock is $34, the call is 4 points in the money. It is quite likely that this option will be exercised in this condition, especially as expiration approaches. If the stock's price declines to $28 per share, the call would be 2 points out of the money; and if the price stops at the strike price of $30 per share, it is at the money.

These definitions are opposite for puts. When the market value of a put is *lower* than the strike price, the put is in the money; and when the stock's value is higher, it is out of the money. These definitions are important because the actual time value and intrinsic value are affected by the relationship of the stock's market price to the option's strike price. This relationship also determines the short side's exposure to exercise. The actual timing of exercise is uncertain; it can occur at any time the option is in the money. When an option is in the money, changes in the option's premium track stock price movement point for

point, so changes in the option's value are more dramatic when a stock's market value changes in the in-the-money range.

Time value premium is the intangible portion of the premium value. Also called *extrinsic* value, time value inevitably declines as expiration approaches. For the option buyer, time is the enemy. Even when the long option is in the money, time value declines as expiration approaches. So, if a speculator pays a lot for time value, it takes substantial price movement to offset that intangible feature. For example, a buyer pays 7 points ($700) for a call that consists entirely of time value premium. By the point of expiration, if the stock has moved 7 points above the strike price, that call is worth only $700, because all of the time value will have evaporated. In this situation, the buyer breaks even (actually, the buyer loses money due to the trading expense on both sides of the transaction).

The Time Advantage for Short Sellers

For the option seller, time is an advantage. The higher the time value premium when the short position is opened, the greater that advantage. Referring to the previous example, if you were to sell a call with 7 points of time value, you could close the position at a profit as long as the premium value was lower than the original 7 points. For example, if the stock were 5 points higher than strike price near expiration, you could close the position and avoid exercise—and make a $200 profit ($700 received when the short position was opened, minus $500 paid to close the position—not considering trading fees).

Intrinsic value of the option premium is equal to the number of points the option is in the money. For example, if your 40 option is held on stock currently valued at $43 per share, the option contains 3 points of intrinsic value. If that call is currently valued at five ($500), it consists of $300 intrinsic value and $200 time value. As another example, if your put has a strike price of 30 and the stock is now valued at 29, the put has 1 point—$100—of intrinsic value because the stock's value is 1 point below the put's strike price. If the current value of the put is 4 points, it consists of $100 intrinsic value and $300 time value.

Long and Short

The decision to go long (buy options) or short (sell options) involves analyzing opposite sides of the risk spectrum. The interesting feature of options is that strategies cover the entire range of risk, often with only a subtle change. Long options is disadvantageous in the sense that time works against the buyer; time value disappears as expiration approaches. Given the certainty that time value evaporates by expiration, it is difficult to overcome that obstacle and produce profits consistently. The less time until expiration, the more difficult it is to profit from buying options; and the longer the time until expiration, the more the speculator has to pay to pick up those contracts. Long options can be used to insure paper profits, but the more popular application of long options is to leverage capital and speculate.

There are circumstances in which conservative investors will want to go long in options. For example, following a large price decline in the market in a short time span, prices of strong stocks may rebound; but not being sure where the market bottom is, investors tend to be the most fearful when the greatest opportunities are present. In these cases, buying calls allows you to control shares of stock, limit potential losses, and expose yourself to impressive gains—as long as prices rebound in a timely manner. This may be a speculative move, but even the most conservative investor may see market declines as buying opportunities, especially if a small amount of capital is at risk.

This does not mean that going long with options *is* conservative or even advisable. But every investor holding a portfolio for the long term knows how market cycles work. Options present occasional opportunities to take advantage of price swings. When overall market prices fall suddenly, conventional wisdom identifies the occurrence as a buying opportunity; realistically, such price movements make investors fearful, and it is unlikely that many people will willingly place more capital at risk—especially since the paper position of the portfolio is at a loss. So, buying options can represent a limited risk for potentially rewarding profits, an opportunity to buy *more* shares of stocks you continue to think of as long-term hold issues. Fixing a strike price far below original cost also reduces your overall basis in that stock if and when you exercise long calls in those circumstances.

Taking Profits Without Selling Stock

The same argument applies when stock prices rise quickly. Sudden price run-ups are of concern to the long-term conservative investor. The dilemma is that you do not want to sell shares and take profits because you want to hold the stock as a long-term investment; at the same time, you expect a price correction. In this situation, you can use long puts to offset price decline. You create a choice using long puts. First, if and when the price decline occurs, you can sell puts as profit; the short-term profit from puts offsets the price decline in stock. The second choice is to exercise the puts and dispose of the stock at the strike price (which would be higher than current market value). You would take this path if your opinion of the company were to change, so that your hold position moved to a sell position along with the decline in stock market value.

You are likely to stick with the conservative path: as long as you want to hold the stock for the long term, you are willing to ignore short-term price volatility. Even so, few investors can ignore dramatic price movement in their portfolio. When prices plummet or soar—especially as part of a marketwide trend and not for any fundamental reasons—the change in price levels may be only temporary. The tendency for some investors is to panic and sell at the low or to buy at a price peak. In other words, rather than following the wisdom "buy low, sell high," investors often react to short-term trends and "buy high, sell low." It helps to ignore short-term trends and to resist the human tendencies toward panic or greed; and conservative investors are more likely to equip themselves with a cooler head during volatile times. Even so, you can retain your conservative standards and, at the same time, use options to exploit the market roller coaster. There are risks involved, but the alternative is to take no action but a wait-and-see approach. Options can help you deal with price volatility on the upside or the downside without losing sight of your long-term investment goals.

The question of speculative versus conservative is not easily addressed. Yes, using options to play market prices is speculative; but at times, you can take advantage of that volatility without selling off shares from your portfolio. The same observation applies on the short side of options, where risks are far different and market strategies can vary as well.

Buyer and Seller Positions Compared

When you short options, you do not have the rights that buyers enjoy. Buyers pay for the right to decide if and when to exercise or whether to sell their long positions. When you are short, you receive payment when you open the position, but someone else decides whether to exercise. Time value works to your advantage in the short position, so you can control the risks while creating a short-term income stream. Risk levels depend on the specific strategy you employ.

The highest risk use of options is the uncovered call. When you sell a call, you receive a premium, but you also accept a potentially unlimited risk. If the stock's market value were to rise many points and the call were exercised, you would have to pay the difference between the strike price and current market value at the time of exercise. For example, let's say you sold a call with a strike price of 40 and you received at premium of 8 ($800). That reduces your risk exposure to as much as $48 per share (strike price of 40 plus 8 points you received for selling the call)—but without considered trading costs. However, what if the stock's market value rises to $74 per share before expiration, and the call is exercised? In that event, you must deliver shares and pay $3,400 upon notice of assignment ($74 per share current market value, minus $40 per share strike price). Your loss would be $2,600 ($3,400 payment minus $800 you received for selling the call).

The uncovered call is the highest risk strategy; in comparison, the *covered* call is the lowest risk strategy. If you own 100 shares, you can deliver those shares to satisfy exercise, no matter what the market price. Upon exercise, you keep the premium you were paid. The greatest argument against covered call writing is the chance of lost appreciation. In the previous example, had you merely held onto your 100 shares, their value would have increased to $74 per share. Because you wrote a 40 call, you would be required to sell them for $40 per share. As a counter to this argument, a couple of points have to be remembered. First, the frequency of large price increases should be studied in comparison to the certainty of option premium you earn for selling calls. Second, as long as exercise creates a profit in the call as well as capital gain in the stock, you earn a profit. For example, let's say your original basis in the stock was $32 per share and the stock is currently valued at $38 per

share. You sell a 40 call and receive a premium of 8 ($800). Upon exercise, your profit is $600 capital gain on the stock plus $800 profit on the short call (plus any dividends you received during the holding period). That is a 43.75% return ($1,400 ÷ $3,200).

The capital gain created when a covered call is exercised may produce impressive levels of profit as long as the basis in stock was far lower. However, for the purpose of comparing option returns under different outcome scenarios, we do not include capital gains as part of the analysis. If you owned stock and simply sold it without writing options, you would earn the capital gains, so we separate stock and option profits in covered call examples. In the above scenario, the option-only return, you received $800 for selling a call when the stock was at $38 per share. This is a 21.1 percent return ($800 ÷ $3,800). To make this comparable to other option returns, you also need to annualize this return.

Understanding Short Seller Risks

The short call may be high risk or highly conservative. In comparison, the short put has varying risk levels depending on the purpose of going short, your willingness to accept exercise, and the amount of premium paid to you at the time you open the short position.

The decision to employ options in either long or short positions defines risk profile; the definition of conservative is rarely a fixed or inflexible thing. It is more likely to define an overall level of attitude about specific strategies while acknowledging that strategies may be appropriate in different circumstances. It is all a matter of timing a decision based on the current status of the market, your portfolio, and your personal decision to take action or to wait out volatile market conditions.

Calls and Call Strategies

As a starting point in any discussion of option strategies, two matters have to be remembered. If you buy a call or a put option, you have the *right* to take certain actions in the future, but you do not have an *obligation*. Second, if you sell a call or a put, the premium you receive as

part of an opening transaction is yours to keep, whether the option is later closed, expires, or is exercised. These two points are crucial in developing an understanding of how option trading works.

Options are contracts that grant specific rights to the buyer and impose specific obligations on the seller. If you think of options as intangible contractual rights (rather than as tangible items such as shares of stock, for example), the entire discussion of how to use options is easier. It may be worrisome for you as a conservative investor to consider trading in an intangible product, but when you relate it to other types of investments, you can appreciate both the logic and the need for options. For example, in a real estate lease-option, you have two parts: a lease specifying monthly rent and other terms, and an option. The option fixes the price of the property. If you decide to exercise that option before it expires, you can buy the property at the specified contractual price even if property values are significantly higher.

Stock market options are exactly the same, but they involve stock instead of real estate. Every option refers to 100 shares of stock, and options come in two types: calls and puts. When you buy a call, you acquire the right to buy 100 shares of stock at a specific price (the strike price) before the option expires. All options have fixed expiration dates, so the time element of options is a crucial feature to consider when comparing option values. For the buyer, a relatively small risk of capital potentially fixes the price of 100 shares of stock for several months. If and when that buyer decides to buy the stock, the call can be exercised to acquire 100 shares at a price below current market value. That is the essence of the call.

Is the Strategy Appropriate?

For your conservative portfolio, buying calls is not an appropriate fit in most applications. Buying calls is the best known and most popular option strategy, but it is usually a purely speculative move. The risks of loss are quite high. Later in this chapter, we discuss the importance of time value and intrinsic value, and how these features make call buying a speculative strategy. There are exceptions. For example, if you are convinced that a stock's market value is sure to rise before the expira-

tion of an option, you can buy calls as an alternative to outright purchase of shares. This strategy would be appropriate when:

1. You are concerned with short-term price volatility, and you do not want to commit funds to buy shares, but you still want to fix the price at the strike price value.
2. You want to buy shares, but you do not have funds available at the moment, so buying a relatively cheap call is a sensible alternative (given the chance that you could lose the money).
3. You are aware of the risk of loss, and you want to proceed with buying a call anyhow.

So, as with any general rule, there are exceptions. You retain your status as a conservative investor even though circumstances may arise in which you would want to buy a call. It is not a conservative strategy, but all investment decisions should be driven by circumstances and not by hard-and-fast rules. While the general rules you set for yourself guide your portfolio decisions, special circumstances and momentary opportunities or limitations can bring about exceptions.

Option Terms and Their Meaning

Every call contains a series of *terms*. These are the type of option, the strike price, the underlying stock, and expiration date.

The *type of option* is one of two, either a call or a put. The two have to be distinguished because they are opposites. If you placed a buy order for an option without specifying whether it was a call or a put, that order could not be filled. All of the terms have to be specified in an order.

The *strike price* is the price of stock that may be acquired if and when the option is exercised. This strike price remains unchanged until the option expires, except in cases of stock splits. You have the choice, as a buyer, of either selling the option to close the position or exercising the option. Upon exercise of a call, you buy shares at the strike price. You "call away" the 100 shares of stock from the seller. If you exercise a put,

you have the right to sell 100 shares, or to "put shares of stock" to the buyer and dispose of stock at a fixed price.

The *underlying stock* is the company on which the option is bought. The company cannot be exchanged; it is as fixed as the strike price. Options are not available on all stocks, but they can be found for the majority of stocks listed on American exchanges.

The *expiration date* is a fixed date in the future specifying when the option expires. This term is critical because after the expiration date, the option will not longer exist. As a buyer, you know that the time value premium will evaporate if your option is not exercised or sold *before* expiration date.

These four terms collectively define and distinguish every option. None of the terms can be modified or exchanged once you buy an option, and the option's value (the premium you pay when you purchase the option) is determined by the terms.

If you accept our beginning argument—that buying options is not normally appropriate for you as a conservative investor, but special situations can bring about an exception to that rule—then it is always possible that going long could be a useful strategy. It makes sense to keep the idea in reserve as one of many possible ideas. It's a mistake to simply reject a possible strategy because it is not a good fit with the general investing theme. However, remember that, for the most part, you will not be willing to speculate by buying options.

The Cost of Trading

Augmenting the complexity of buying is the trading expense involved. This applies to both sides of the transaction. You are charged a fee when you open the position and another fee when it is closed. In any calculation of risk and potential profit or loss, the cost of trading therefore must be included. If you deal with single-option contracts, you limit your exposure to loss. But at the same time, the per-option cost of trading is quite high. With this in mind, option traders often execute transactions using multiple option contracts. This reduces the cost of trading and results in lower per-option cost. But remembering that buying

options is a high-risk venture, using multiple contracts just to reduce per-option trading costs does not reduce overall risk; it increases it, because you must put more capital at risk. For the option buyer, trading costs make the proposition even less likely to turn out profitably.

As a call buyer, the odds are against you. A second possibility is far more interesting and potentially more profitable: selling calls. If you are familiar with selling short, using stock, you know that the sequence of events is opposite than when you go long. You have to borrow shares of stock in order to sell, and opening the short position exposes you to the possibility of loss. If the stock's market value rises, you lose money. So, short sellers expect the price of stock to fall. Eventually, they close the position by entering a closing purchase transaction. Short sellers have to make enough profit to offset the cost of borrowing stock, trading fees, and the point spread between original selling price and final purchase price.

Selling stock is high risk without any doubt. If the stock's value rises, you lose money, and short sellers are continually exposed to that market risk. Two observations about going short on calls: first, the transaction is far cheaper and easier than shorting stock, and second, the strategy can be either very high-risk or very conservative.

In, At, or Out of the Money

Selling a call is easier than selling short shares of stock, because you do not have to borrow calls to go short. You simply enter a sell order, and the premium (the value of the call) is placed into your account the following day. When you sell a call in this manner, you are in the same market posture as the short seller of stock, but possibly at less risk. You are hoping that the price of stock will fall so that your short call will *lose* value. That means you will be able to either close the position profitably with a closing purchase transaction or simply wait for the call to expire worthless. As long as the market value of the underlying stock remains at the strike price (at the money, or ATM) or below the strike price of the call (out of the money, or OTM), exercise will not occur. When the stock's market value is higher than the call's strike price (in the money, or ITM), you are at risk of exercise. The proximity of the stock's current market value to the strike price is summarized in Figure 2–1.

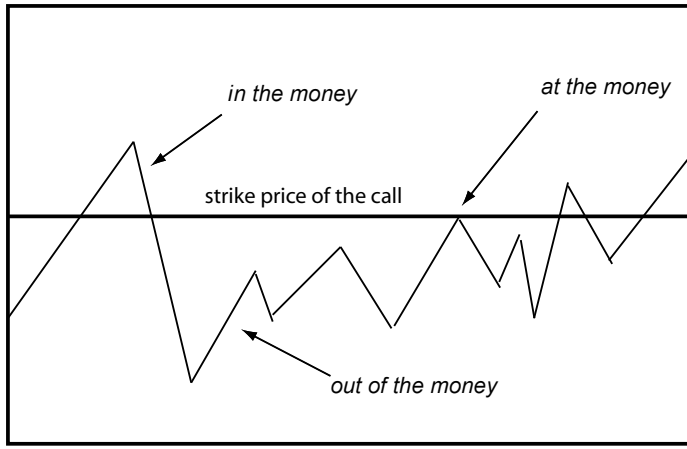

Figure 2–1 Strike price and stock price.

In the figure, you may observe that the option's strike price remains level, but the status of the option relies on stock price movement. This illustrates how a call functions. Whenever the stock's price is higher than the call's strike price, the call is in the money, and whenever the stock's price is below strike price, the call is out of the money.

We can apply the same logic to a put, but the terms are reversed. Referring again to Figure 2–1, if the stock's price were higher than the strike price of the put, it would be out of the money, and if the stock's price moved below the strike price, the put would be in the money.

The relationship between strike price and stock price is critical for anyone who opens a short position in options. The short-call position can be one of the highest risk positions you can assume. However, it can also be one of the most conservative positions. This riddle is explained by whether or not you own 100 shares of stock when you sell a call. If you go short with calls and you do not own the stock, risks are theoretically unlimited because the market value of stock can rise indefinitely. This uncovered call strategy is clearly inappropriate for your conservative portfolio. However, when you own 100 shares, they are available in the event the call is exercised; so in the right circumstances, call selling is highly profitable *and* conservative. Chapter 3, "Options in Context," compares short calls in these contradictory risk profiles, and Chapter 5,

"Options as Cash Generators," provides in-depth explanations of covered call-writing strategies, the ultimate conservative use of options.

Puts and Put Strategies

The put is the opposite of the call. If you buy a put, you acquire the right (but not the obligation) to *sell* 100 shares of the underlying stock. If you exercise a put, you sell 100 shares at that strike price, even if the current market value of stock was far below that level. Like the call, the put expires at a specific date in the future.

As a put buyer, you have one of three possible outcomes:

1. *The put is sold.* You can sell the put at any time prior to expiration. For example, if the underlying stock's market value falls below the strike price, the value of your long put increases, and the put can be sold at a profit. Because time value declines over the holding period, it is a highly speculative strategy to buy puts purely for short-term profits. It is unlikely that you can earn profits by consistently buying long puts without some other reasoning behind that decision. For example, if you believe that stocks in your portfolio are overbought and you want to protect paper profits, long puts can be used as a form of insurance to protect your stock positions.
2. *The put expires worthless.* If you take no action before expiration date, the long put becomes worthless, and the entire premium you paid would be a loss. When you buy puts, you profit only if and when the market value of the underlying stock declines; if the value remains at or above the strike price, your put does not appreciate. Even if the stock does fall a few points, the put loses time value as expiration approaches; so in order to profit, you need the stock to decline enough points to offset your original cost *and* to replace time value with intrinsic value, all before expiration date.
3. *You exercise the put.* If the stock's current market value is far lower than the put's strike price, you have the right to sell 100 shares at the higher strike price. If you own shares of stock and

you bought the put for downside protection, exercise can work as a sensible exit strategy. For example, you may have purchased shares originally when the stock looked like a viable long-term hold, but the financial picture has since changed. If you own one put per 100 shares, exercising the put and selling shares enables you to keep paper profits while escaping from the long position in stock.

The Overlooked Value of Puts

The put's strategic potential is easily overlooked by investors and speculators. More attention is paid to calls. There are good reasons for this. Short calls can be covered by ownership of 100 shares of stock per call, but puts cannot be covered in the same way. The put is more exotic and alien to the mindset of many investors. Most people are used to betting on the potential for stocks to rise in value, but are not as willing to consider the possibility of price declines. This is ironic considering the unavoidable cyclical nature of investing. Prices rise, but they also fall, so using puts as well as calls to speculate on price movement or to protect paper profits presents a number of interesting strategic possibilities.

Where do puts fit for the conservative investor? Several possible applications of puts are worth considering on both the long and short sides. The best known is the use of long puts for insurance. If you buy one put for every 100 shares of stock, you protect your paper profits; in the event of a decline in the stock's market value, the put's premium value increases. So, once the stock's price goes below the put's strike price, loss of stock value is replaced dollar for dollar in higher put premium value.

This protection of paper profits—a form of insurance—is a conservative strategy. You pay a premium for the put because you fear that stock prices have risen too quickly, but you do not want to take profits in the stock. You can use puts in this situation to keep the stock while protecting profits and, perhaps, even taking them without needing to sell stock. This insurance does not have to be expensive. Just as you can select insurance based on varying levels of deductible and copayment dollar values, you can select puts based on their cost and level of protection. For example, if you want to protect all of your paper profits,

you buy puts with strike prices close to current market value; that means you pay a premium with a high level of time value. If you are willing to carry some of the risk, you could buy puts at lower strike prices; these would be far cheaper but would provide less protection. For example, if you originally purchased 100 shares of stock at $42 per share, and today's market price is $52, you have 10 points of paper profits. If you buy a 50 put, you protect eight of those 10 points, but the put is expensive. If you buy a 45 put, you cover only 3 points of paper profits, but the put is far cheaper.

The Insurance Cost of Puts

The put has a limited life, so your protection extends only to expiration date. Using puts for insurance therefore requires periodic replacement of the put. Again, this compares to insurance like health, homeowners, or life policies, where periodic premium payments are required. As with all insurance, the value of paying a premium depends on the premium cost and the protection it provides.

Buying puts can provide benefits beyond mere speculation. Selling puts—going short—presents an entirely different risk profile than the long strategy, but it is not necessarily high risk. Shorting puts may, in fact, be a viable strategy in your conservative portfolio.

A short call can be covered simply by owning 100 shares of stock. That relationship eliminates the market risk and coverts a high-risk strategy to a very conservative strategy. But puts cannot be covered in the same manner. There is an important difference, however. While an uncovered call presents tremendous risks, the uncovered short put has only a limited risk. The stock can only fall to zero value in the very worst case, so the potential risk is finite. On a practical level, a stock's likely market value has a floor somewhere higher than zero, and this level is subjective. You may define the price floor as technical support level, book value per share, or based on recent trading patterns. The point is that the real risk is the difference in points between the put's strike price and the lowest likely trading price per share. Most people consider the technical support level to be that price.

If we accept that a specific price-support level is also a lowest likely trading price, we can also accept the risk of going short with puts. That risk is further discounted by the value of the put premium you will be paid when you short the put. When you also consider that time value is involved, that net risk can be quite minor. Remember, *buying* puts is a long shot for the speculator due to time value premium. But for the seller, time value is a benefit; the farther the time value falls, the higher your profit in shorting the put. You may review recent trading ranges of the stock to judge the safety or risk of selling puts.

Conservative Guidelines: Selling Puts

Is selling puts a conservative strategy? It can be in some circumstances. We have to assume several elements to conclude that short puts are appropriate in the conservative portfolio:

1. *The strike price is a fair price for the stock.* Whenever you short a put, you have to accept the possibility that the put will be exercised. You have to accept the strike price as a price you are willing to pay for the stock.
2. *The premium you receive justifies the exposure.* When you sell options, you are paid the premium. That premium and the length of time you remain exposed to possible exercise have to justify the decision.
3. *The risk range is minimal.* When you consider the spread between the put's strike price and your estimated support price for the stock, minus the put premium, how many points remain? This is the most reliable method for judging whether or not to sell puts.
4. *Ultimately, you would like to acquire shares of the stock.* Whenever you sell puts, you should also be willing to acquire shares. If you really don't want to own the stock, then you should not sell puts. As a conservative standard, you should be willing to acquire shares of that specific stock at the put's strike price.

Example: You have been watching a company for several months, and you like the fundamentals. The stock is currently valued at $62 per share. You decide that if the stock's value declines to $55, you will buy 100 shares. As an alternative, you also consider selling puts. You analyze the values and conclude that it would be a smart move. The lowest likely trading price, in your opinion, is about $46, 9 points lower than your target acquisition price of $55 per share. The 55 put is currently valued at 6 ($600).

Here is the risk profile of these price relationships:

Strike price of the put	$55
Support level estimate	$46
Gross risk margin	$ 9
Minus: put premium	$ 6
Net risk per share	$ 3

Should you sell the 55 put? If the stock's value were to fall below $55 per share, the put would be exercised. Your risk exposure is really at the $49-per-share level (strike price of $55 minus 6 points of premium). The entire premium consists of time value, and your net risk is 3 points. The longer the short put remains open, the more the time value deteriorates. Given the minimal risk, this is a sensible strategy in a conservative portfolio. Were the margins higher, the risk of acquiring stock at potentially inflated values would not make sense.

Puts as a Form of Contingent Purchase

Short puts can be thought of as a form of contingent purchase. When you compare the risk of selling puts to the risk of buying shares outright, it makes sense. Consider the alternative given in the previous example. If you bought shares today, your cost would be $62 per share. If the stock's market value falls, you lose one dollar per share for each point of loss. If the stock falls to $49 per share, your long stock loss is $1,700. Compared to the alternative, selling a put, the risk of buying 100 shares is far greater. In this situation, you are better off selling the

55 put. Your net cost, after considering the premium you receive for selling the put, would be $49 per share, equal to the market value at that time.

This type of analysis—reviewing one decision against another—demonstrates how realistic comparisons can help to define your risk levels. If we begin with the assumption that selling puts short is high risk, we can never get beyond that conclusion. It is true that in some circumstances, shorting puts is extremely high risk. For example, if you short puts on stock you do not want to own, that contradicts your conservative standards. The analysis of any option-based strategy should include a preliminary thorough analysis of the underlying stock and its fundamental strength or weakness as well as a study of its price volatility. If you shop for the richest option premium levels, you end up shorting puts on the highest-risk stocks, which you do not want to do. The previous example demonstrates, however, that in the right circumstances, using puts as a form of contingent purchase is a wise decision.

Listed Options and LEAPS Options

Traditionally, risk assessment for options is based on a very short lifespan, 8 months or less for listed options. The ever-growing popularity of LEAPS—long-term options that last as long as 36 months—changes the analysis. Even for the long position, the risk of ever-declining time value takes on a different context when looking 2 or 3 years ahead.

The availability of long-term options makes long positions more viable in many more situations. Longer term options contain far greater time value, of course, because time value is just that: the value of time. So, compared with a 6- or 8-month time span, a 24- to 36-month option has far greater potential—for both long and short positions.

For example, it is practical to use LEAPS to leverage capital while retaining the choice of buying shares in the future and, at the same time, reducing the cost of buying options. Chapter 6, "Alternatives to Stock Purchase," explains how contingent purchase strategies work. For now, we present only an overview of this powerful strategic approach to the market.

Using Long Calls in Volatile Markets

Let's assume that you have your eyes on several different stocks, and you believe that all offer potential for growth over time. The problem is that the market has been very volatile lately, and you're not sure whether the timing is good for picking up shares. This not-uncommon situation makes it difficult even for conservative investors to time their decisions. The fundamentals work, and long-term prospects are strong; even so, you are not sure about the short-term prospects for a stock. Influencing your decision, annual cyclical change, outside economic forces, and market or sector trends are all affecting the timing of your decision. In this environment, it could make sense to buy LEAPS calls instead of stock. As an initial risk analysis, you cannot lose more than the premium cost of the LEAPS call, so the initial market risk is lower. At the same time, in going long with calls, you would acquire the right (but not the obligation) to buy 100 shares of the underlying stock at any time before expiration. If the LEAPS call has 30 months to go, a lot can happen between now and then.

The risk is that the stock's market value will not rise, or even if it does, it may not rise enough to offset the cost of time value and to also appreciate adequately to justify your investment. There is a solution. You can reduce the cost of buying the LEAPS call by selling calls on the same stock. As long as those short calls expire *before* the long call, and as long as the short call's strike prices are higher than the strike price of the long call, there is no market risk. For example, you buy a 50 call expiring in 30 months, and then sell a 55 call expiring in 21 months. If the stock's market value rises and the short 55 call is exercised, you can satisfy the exercise with your long call, making $500 on the transaction (selling at 55, buying at 50). Or, if the short call expires, it can be replaced with another. A likely scenario in this "covered option" position is that the short call's time value will decline; it can be closed at a profit and replaced with another call. As long as you remember the rule—higher strike prices, earlier expiration—and the number of short positions does not exceed the number of long positions open at the same time, you can write as many covered short positions as you like. It is even possible, based on ideal price movement of the underlying stock, that your premium income from selling short calls can repay the

entire cost of the long-term long LEAPS position. There are no guarantees, but it is possible.

The basic long-short LEAPS strategy is summarized in Figure 2–2.

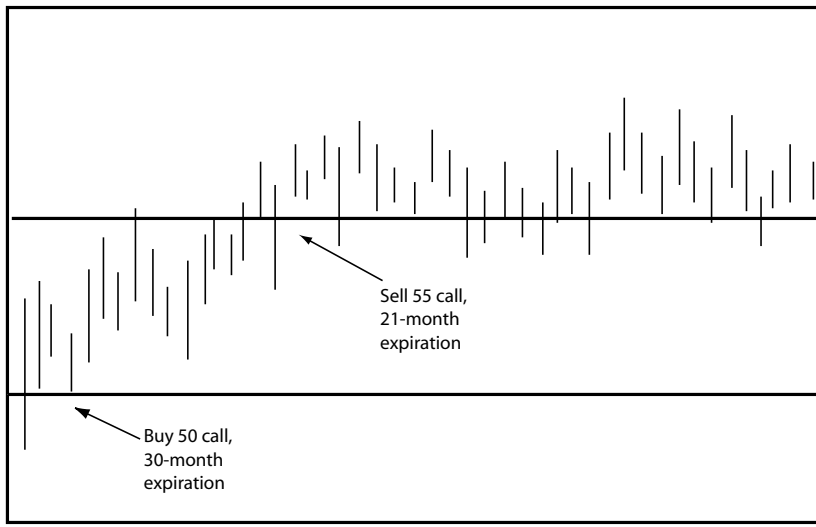

Figure 2–2 Long- and short-call strategy.

In the figure, you see that this strategy has two legs. First, you purchase a long call with a 50 strike price, and later, you sell a 55 call. In order to avoid an uncovered short position, the 55 call *must* expire at the same time as the long call, or before. If the short call outlasts the long call, you face a period in which that short call is uncovered.

This example shows that the ideal price movement in the underlying stock involves a minimum number of points. You want to acquire value in the long position so that you can exercise the long call later; at the same time, you do not want to see the short position rising in value because you want it to expire worthless (or you want to be able to close it out at a profit in the future). Remember, the goal in this strategy is twofold. First, you want to have the ability to exercise the long call and buy 100 shares of stock at the strike price. Second, you want to reduce the cost of the long position with a "covered" short position at a higher strike price. We put quotation marks on the word covered because this

strategy is not the same as covering a short call with 100 shares of stock. The coverage refers to offsetting positions, one long and the other short. If the short position is exercised, you can use the long position to fulfill the obligation. This enables you to mitigate risk in terms of both cost and potential exercise.

The "contingent purchase" with "covered option" strategy is not complex, and it may be a smart fit for conservative portfolios. This question is explored in depth in Chapter 6. The point is that LEAPS options expand the strategic possibilities while also making it possible to reduce many forms of risk.

Using LEAPS Puts in a Covered Capacity

Long LEAPS puts can work in the same way. For example, you may purchase LEAPS puts for insurance on existing long stock positions; and reduce your insurance cost by selling puts that expire sooner than the long put; and that have lower strike prices. This basic strategy—combining long puts and covering them with short puts—is summarized in Figure 2–3.

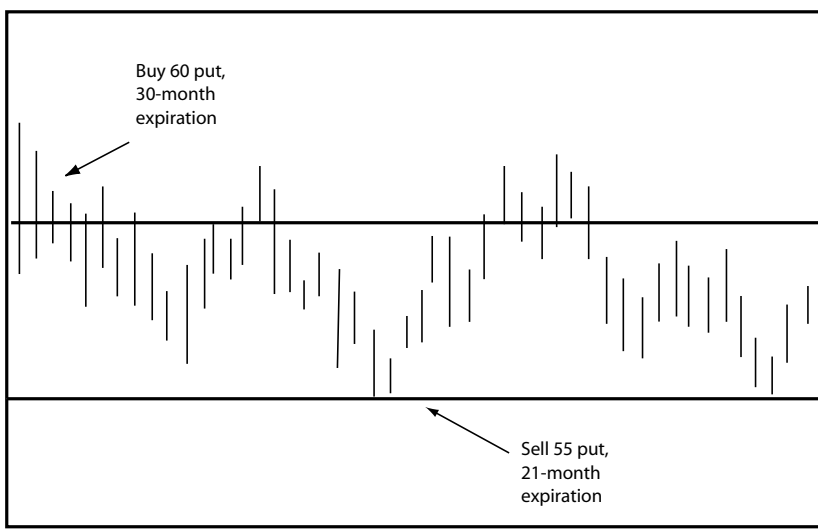

Figure 2–3 Long- and short-put strategy.

This figure is the reverse of the contingent purchase previously shown. The difference is that puts are used instead of calls. This strategy assumes that the underlying stock's value is trending downward or trading in a narrow price range. The purpose in covering the put is to reduce risk of exercise and resulting loss, and at the same time, to reduce the cost of buying the long put. This strategy has a very limited risk. If the stock's price rises above original strike price, the loss is limited to the net cost between the long and short put positions; and if the stock's price falls below the short put's strike price, exercise can be offset by the long put. (This means that instead of being required to buy 100 shares of stock, you would simply exercise your long put, so that you would pick up 5 points of profit, the difference between the long 60 put and the short 55 put.)

These strategies—covering long options with shorter term short positions—work best when your estimate of likely price movement in the stock is correct. This, of course, is true for any market strategy you employ. The call strategy works best when the market price of the underlying stock rises over time, and the put strategy is preferable when the price declines. The wisdom of using the strategy is based on your ability to read intermediate-term volatility trends accurately. The strategies make long positions in options more practical than the purely speculative approach, but profitability is not ensured. The overall purpose of the long option strategy is to maximize the opportunity while identifying worst-case outcomes and setting up the strategies so that you will not lose or so that losses are minimal. In the case of calls, you may want to exercise the call to acquire stock far below market value; in the case of puts, you can insure existing long stock positions while mitigating the cost of carrying that insurance.

Coordinating Strategies with Portfolio Goals

Your ultimate purpose in using options should be to augment or protect your conservative goals. If your goals are best served by simply buying stock and not using options for any purpose, then that is the policy that should overrule all other possibilities. However, some option strategies are compelling enough that they cannot be rejected without further study.

The conservative strategies worth considering must be coordinated with a broader overall strategy. The following basic conservative option strategies are explained in greater detail in chapters 4, 5, and 6:

1. *Using long puts to insure long stock positions.* Your conservative position in stocks, held for the long term, should not be affected by short-term price uncertainties. If we accept the precepts of both the Dow theory and the random-walk hypothesis, we realize that short-term price movement is not reliable as an indicator of longer term trends. As a conservative investor, you have probably based your portfolio decisions on fundamental indicators, and you monitor financial reports as they are released to spot emerging and changing trends. In theory, you can simply ignore short-term price movement without concern for temporary market volatility. In practice, marketwide price gyrations are unsettling; they raise questions even among conservative investors. (See Chapter 4.)

   The strategically timed purchase of puts can work as a timing mechanism at what you consider to be market tops. You want to continue holding stock as a long-term investment, so you are not inclined to take profits; but you are also concerned about losing paper profits in the short term, even though that concern is contradicted by your long-term investment goals. Buying puts makes sense for two reasons. First, if you are correct and the stock is overpriced at the moment, the long put will be profitable and those profits will offset the unavoidable price correction. Second, the fundamental indicators for the stock may change at the same time that the price gyration is occurring; in fact, the unexpected volatility may foreshadow weakness in the fundamentals. The change could also affect your opinion of the stock as a safe long-term investment, in which case you may want to dispose of shares. If the stock's market value is depressed by the time you decide to dispose of shares, you will have to sell at a loss off the high. However, if you bought puts for insurance at or near the price peak, you now have a choice. You can sell the put and realize a short-term profit while holding onto shares, or you can exercise the put and dispose of stock at the higher exercise price. In this man-

ner, you achieve two goals. First, you preserve your paper profits by selling at or near the price peak (the fixed put strike price). Second, you accomplish disposal of shares when your opinion of the company has changed.

In this example, the use of puts for insurance was perfectly in line with your conservative goals. We can never assume that conservative means we pick a portfolio and stay with it, no matter how the fundamentals change. On the contrary, you are probably continually monitoring financial strength, and you make changes in your portfolio to ensure that your fundamental standards are matched in the mix of your portfolio. Changes in price may precede a change in financial strength or operating results, so price changes may be reliable indicators for using puts to insure paper profits.

2. *Covered call writing against long stock positions.* The best-known conservative options strategy is the traditional covered call. In this strategy, you write one call for every 100 shares owned. It is appropriate when the call, if exercised, would produce a capital gain in the stock that you would be happy to realize. In other words, if you are not willing to have stock exercised, then you should not write the covered call. Assuming that you would accept exercise as one possible outcome, you can use techniques such as rolling out of one call and into another to maximize income. The properly selected covered call strategy produces consistent current income. In exchange for writing covered calls, you risk losing out on increased market value; when stock prices rise above strike price and calls are exercised, your shares can be called away. However, when you compare that risk to the regular and dependable creation of current income in a conservative market risk profile, it is apparent that covered call writing will beat market averages without increasing market risks. Covered call writing also discounts your basis in stock, so your profit cushion is further protected. (See Chapter 5.)

   The traditional covered call strategy makes sense and fits well with your conservative risk profile when all of the required elements are present: You would accept exercise if it occurs; exer-

cise would produce a good return on your investment; and overall, the strategy will produce short-term profits while enabling you to retain your long-term portfolio. In those instances where stock is called away, you can replace it with a different stock or use long calls for contingent purchase planning (see 3, below).

3. *Options for contingent purchase plans.* Of the three basic conservative option strategies, contingent purchase plans are the most complex. The various methods you can employ are good matches in a conservative portfolio as long as the overall standards are maintained and given priority. One common trap for options traders is to become intrigued with the potential profitability of a particular strategy and to lose sight of the more important portfolio goals. Contingent purchase is conservative because it provides alternatives to buying stock at a fixed price or, when price trends do not continue, to limiting losses with the use of long options. Those losses are limited in two ways. First, you can never lose more than the long premium you pay. Second, when employing LEAPS options, you can cover the long-call position with short sales as long as the short calls expire earlier and are high-strike price contracts. Contingent purchase is equally interesting when using short puts in place of long calls, and the most advanced strategy involves selling covered calls and uncovered puts at the same time. In Chapter 6, a detailed example of this more complex strategy demonstrates why this is a conservative strategy and how it consistently produces extra current income in your portfolio. (See Chapter 6.)

Option and Stock Volatility: The Central Element of Risk

The whole question of risk is central to the options decision and to maintaining the conservative structure and theme in your portfolio. The selection of options can be directly related to price volatility as one measurement of risk, perhaps the most important.

When you pick stocks, you decide whether to follow fundamental or technical indicators, or a combination of both. Conservative investors tend to lean toward the fundamentals, so you probably prefer financial statements to charts and price trends. However, with options, you face a different criterion for judging safety. Because options have no tangible value of their own, there are no fundamentals specifically related to options. The stock fundamentals are crucial for picking stocks, especially if you plan to write covered calls. However, for options, you need to compare volatility to determine safety and risk levels.

An option's premium level is one of many technical indicators for the volatility levels of stocks. The more volatile the stock's price, the greater the risk to buying the stock; and the more risk in the stock, the greater the profit potential (and risk) in the option. Several features contribute to volatility in options, including time until expiration, proximity of stock market price to strike price, and to some extent, the volatility of the market as a whole (as measured by index movements).

Critical Analysis of Volatility

As a conservative standard, you must balance the volatility of the stock and option (as a measurement of risk levels) against premium income potential in the option (as a measurement of opportunity for profits). The two sides of the question—risk and opportunity—are related, of course, and cannot be reviewed separately. Options traders often are mistakenly attracted to higher premium options for covered call writing. Beginning with the standard of investing conservatively, it is a mistake to seek high-premium options to sell, and then buy stock primarily to cover calls. This approach programs in high-risk portfolio selection.

It would be simple if option valuation could be fixed by formula. Logically, it would seem that premium levels should be fixed by the various factors involved. Time value *should* decline at a predictable rate as expiration nears; intrinsic value is, by definition, also predictable based on movement in the stock's price; and proximity of current stock value to strike price of the option *should* affect valuation in a predictable manner. But these theoretical price standards for options are only starting points. Options do often sell at or near their calculated value levels,

but the real buying and selling opportunities in options can be found as well. The variation occurs because the market is chaotic. Options traders, like all investors, affect prices by anticipating future volatility, and that is manifested in the volume of activity in particular options. Some events, such as current earnings reports or new announcements, could cause higher volatility. The term implied is a substitute for *anticipated*, and aberrations in option pricing are indeed caused by options traders' anticipation of future profit potential.

Free 20-Minute Delayed Quotes

Professional options traders employ many formulas to spot implied volatility and to select advantageously priced contracts. However, the selection does not have to be that difficult. If you study options on a comparative basis, you can pick higher than average premium levels with little trouble. For example, the CBOE (Chicago Board Options Exchange) Web site provides free option listings with 20-minute delay, so you can check various option listings side by side. For example, you can limit your search to (a) stocks you already own, (b) stocks with current market price within 5 points below option strike price, or (c) stocks with 6 months until expiration. These criteria provide comparable options, and the return on each is easy to calculate. Divide option premium by the current market value of the stock. (Don't use your original basis in the stock, because your basis in various issues will be different, making the comparison less valid.)

Valuable Resource

The CBOE website offers many free features for option trading, including listings for all options and LEAPS contracts. Check *http://www.cboe.com/home/* for more information.

The point is that you do not have to involve complex formula studies or become well versed in the technical side of options. The process is similar to picking stocks on the basis of high/low pricing, dividend yield, and trading range. When these analyses are performed comparatively, you can spot bargains easily.

The Black-Scholes Model

Professional options traders, who use sophisticated methods for more speculative trading, are likely to use advanced volatility measurements such as the well-known Black-Scholes formula. For most investors, Black-Scholes is too complex to be of value; a more practical approach is simple modeling based on current option premium and time to expiration, evaluated with an understanding of the proximity between strike price and current value of the stock.

The Black-Scholes model was introduced in 1973 in a paper published in *Journal of Political Economy*, titled "The Pricing of Options and Corporate Liabilities." At that time, options were fairly recent devices in the stock market, and the theory was devised to identify the theoretical value of options based on stock price, strike price, volatility, time to expiration, and short-term interest rates.

Finding the fair value of options for your purposes does not necessarily require a complex level of analysis. You can simply review options on stocks you already own and keep comparative analysis simple. Selecting stocks for covered call writing should be based on several initial assumptions. First, you must be willing to accept exercise as one of the possible outcomes. Exercise, if it does occur, creates a capital gain in the stock, and the rate of return on both stock and option justifies the covered call position. If you meet all of these tests with stocks in your portfolio, comparing current option prices in the same price and time range is a reliable method for seeking value.

You should also question whether it is necessary to find high-priced options. The rate of return on options could be high enough to justify covered call writing, especially if you are working with stock that has appreciated since your original purchase price. For example, if you bought stock at $34 per share and you're thinking of selling 35 options, the capital gains margin is minimal; after trading costs, it will probably be a net loss with such a close margin. But if you bought stock at $34 per share and current market value is $74, selling a 75 call would create substantial profits. If exercised, you will earn a gross capital gain of $4,100 in addition to dividend income and option premium. This outcome is always possible with appreciated stock, so as long as the stock's funda-

mentals continue to work for you, writing covered calls is a winning idea. You will make a good return whether the option is exercised or not.

Identifying Your Market Opportunities

Considering the potential for gain with appreciated stock, covered call writing can be a way to utilize paper profits to create additional income. In this situation, you do not need to seek high volatility in option premium; the potential return can work well for you even when implied volatility is low or nonexistent. As a *general rule*, you should establish a minimum return in order to justify covered call writing. To meet that standard, you may need to adjust both strike price and expiration. For example, you might decide to write covered calls only if and when you can earn an annualized return of 10 percent or better.

Another factor to consider is the level of time value involved. The listed option is likely to have a lifespan of 8 months at the most, but if you study LEAPS calls as candidates for the covered call equation, you find that time value is far higher when expiration is 24 to 36 months out. You can sell calls between 5 and 10 points higher than current market value and earn significant returns. If the stock's price rises to strike price or above, you can roll out of the position to avoid exercise. You can accept exercise and earn current income from call premium, or you can close the short options at a profit due to reduced time value premium. Include LEAPS options in your study. These are also listed at the CBOE site: go to "Delayed option quotes" from the home page and enter the stock symbol; all options and LEAPS options are shown. LEAPS vastly increase the profit potential because time value is significantly higher for long-term LEAPS contracts.

Table 2–1 shows a comparison all 10 stocks in our model portfolio. The premium levels available for options expiring in 3-month, 15-month, and 27-month increments are summarized. In each instance, the call selected is the closest out-of-the-money call based on current strike price. The option premium is divided by current stock price to arrive at the initial yield.

This comparison between three different calls makes the point that the longer the call has to go until expiration, the higher the *apparent* rate of

Table 2–1 Comparative Call Yields*

			Premium		
Stock	**Price**	**Strike Price**	**3-Month**	**15-Month**	**27-Month**
Clorox	$55.91	60	0.50	2.85	5.10
%			*0.9%*	*5.1%*	*9.1%*
annualized %			*3.6%*	*4.1%*	*4.0%*
Coca-Cola	$38.90	40	0.85	2.55	4.00
%			*2.2%*	*6.6%*	*10.3%*
annualized %			*8.8%*	*5.3%*	*4.6%*
Exxon Mobil	$48.70	50	1.00	3.10	4.50
%			*2.1%*	*6.4%*	*9.2%*
annualized %			*8.4%*	*5.1%*	*4.1%*
Fannie Mae	$67.65	70	2.60	6.20	8.30
%			*3.8%*	*9.2%*	*12.3%*
annualized %			*15.2%*	*7.4%*	*5.5%*
Federal Express	$87.78	90	2.50	8.20	12.30
%			*2.8%*	*9.3%*	*14.0%*
annualized %			*11.2%*	*7.4%*	*6.2%*
General Dynamics	$100.01	100	3.80	9.90	13.90
%			*3.8%*	*9.9%*	*13.9%*
annualized %			*15.2%*	*7.9%*	*6.2%*
J.C. Penney	$38.20	40	1.20	3.90	5.70
%			*3.1%*	*10.2%*	*14.9%*
annualized %			*12.4%*	*8.2%*	*6.6%*
Pepsi-Cola	$48.48	50	0.85	2.90	4.30
%			*1.8%*	*6.0%*	*8.9%*
annualized %			*7.2%*	*4.8%*	*4.0%*
Washington Mutual	$38.43	40	0.70	2.55	3.10
%			*1.8%*	*6.6%*	*8.1%*
annualized %			*7.2%*	*5.3%*	*3.6%*
Xerox	$14.32	15	0.45	1.70	2.55
%			*3.1%*	*11.9%*	*17.8%*
annualized %			*12.4%*	*9.5%*	*7.9%*

* Values as of October 22, 2004, closing compared to calls expiring in January, 2005, 2006, and 2007.

Source: CBOE at *http://www.cboe.com/home*.

return. To make the analysis accurate, however, we must annualize these returns—reflect them as a 1-year period in each case. Because we are dealing with 3-month, 15-month, and 27-month options, the outcome changes dramatically upon annualizing. For example, referring to the J.C. Penney calls,

3-month option:	$(3.1\% \div 3) \times 12 = 12.4\%$
15-month option:	$(10.2\% \div 15) \times 12 = 8.2\%$
27-month option:	$(14.9\% \div 27) \times 12 = 6.6\%$

This exercise demonstrates that the shorter term sale is far more profitable than the longer term. Annualizing in this case assumes that the options are held to the day of expiration, which makes the comparison valid among the three choices. In practice, exercise could occur at any time the option is in the money, and the longer term options expand the exposure for a longer period of time. The shorter term call in this example is desirable not only because annualized return is higher, but also because there is a shorter term of exercise risk.

In writing options, you also face a reinvestment risk. You may earn 12.4 percent on an annualized basis with a 3-month call, but it is not always possible to repeat that experience every 3 months. So, while a study of current annualized returns is instructive when comparing two or more option choices, it does not mean that you will be able to continue that trend throughout an entire year.

However, as long as one annualized return is more favorable than another, the analysis on an annualized basis is important—as long as you accept the possibility that shares of stock may be called away. In this example, a seemingly modest 3.1 percent return (J.C. Penney) actually would yield 12.4 percent on an annualized basis. The validity of the strategy assumes that (a) you are willing to accept exercise as one possible outcome, (b) your basis in stock is far lower than current price levels, and (c) you like the rate of return that one or more of these options provides. The obvious offset between time and rate of return has to be considered; if you sell a shorter term option, its time value declines more rapidly, and it can be closed or allowed to expire, to be replaced with another call, perhaps even with a higher strike price. Longer term

options take longer for time value to decline, and the longer period also represents more exposure to the risk of exercise. If the stock rises substantially within the option period, you must accept exercise or roll out of open short positions.

You also need to be careful to not fall into the trap of overlooking lower priced stocks. Referring again to Table 2–1, five of the stocks yield double-digit returns for the 3-month calls. As exercise approaches, time value falls away with accelerating speed, and these are the most attractive annualized returns on the chart. One of those is Xerox, which shows only 0.45 ($45.00) for the 3-month option. However, when annualized, this option represents a 12.4 percent return. So, even though Xerox is selling currently at only $14.32 per share, its annualized return is impressive. It yields the same as J.C. Penney, in fact, which sells for close to three times more per share. Employing this strategy with 100 shares of J.C. Penney and one option, or with 300 shares of Xerox and three options, would produce approximately the same outcome.

This study reveals that it makes more sense to seek shorter term covered calls because (a) time value dissipates more rapidly as expiration nears, (b) the exposure to exercise is less than for longer term calls, and (c) annualized yield is greater, so you can sell subsequent calls more often using faster expiration cycles.

While we do not consider capital gains as part of this analysis, you must be aware of the spread between your original cost and the call's strike price. This is essential in judging whether or not the covered call strategy makes sense. Since exercise is one of the possible outcomes, you cannot ignore that possibility. The potential for exercise if you had purchased J.C. Penney at $10 per share would be viewed differently than if you had purchased it at $35 per share.

Limiting Your Strategies to Conservative Plays

Remember the basic premise for conservative options trading: the covered call strategy should be used only on stocks with sound fundamentals that you bought for their value, not used simply to write options

with high implied volatility. You may view exercise as part of a plan to reinvest proceeds in stock with equal growth potential and strong fundamentals. However, if you can hold calls until expiration without threat of exercise, a new covered call can then be written. The process can be repeated indefinitely, while you continue receiving dividends and avoiding exercise—hopefully while the stock's market value rises over time. That scenario—the existence of strong fundamental value in the stock, long-term growth, dividend income, and repetitive covered call writes—maximizes the covered call strategy.

Option volatility—for all the detailed and technical study that goes into it—is not necessarily the sole determining point for selection of options for conservative strategies. It is important, but more weight should be given to overall rates of return in various scenarios: exercise, expiration, and close of the short position. It is that overall return—based on your original basis in the stock—that provides the greatest flexibility. Remember, too, that out of respect for limitations you impose on yourself as a conservative investor, it may be preferable to select options and stocks with average price levels and to avoid high volatility altogether. If we accept the theory that high price volatility translates to higher market risk, it is ill advised to consider writing covered calls at all. If risk levels of the stock have increased, it could signal the need for reevaluation of the stock itself. Should you sell that stock and find an alternative issue with safer volatility levels? You may be better off respecting the conservative stock standards based on fundamental analysis, writing options with "typical" pricing, and staying away from stocks and options with higher than average volatility.

The idea of avoiding stocks and options with higher-than-average implied volatility makes sense in your conservative portfolio. If you restrict your activity to long stock positions, you monitor your portfolio constantly. If and when the fundamentals change, you replace your hold position with a sell. Not only should that standard be retained, but the implied volatility in option premium can be a red flag, enabling you to check other indicators to decide whether you want to keep your long stock position.

Identifying Quality of Earnings

The last word in picking options should always go back to the concept that quality of earnings mandates the quantifications of a stock.[1] The fundamentals apply only to the stock because options have no tangible value. So, when option implied volatility changes from the norm, it happens for a reason. It is a symptom and perhaps a signal that fundamental strength (the quality of earnings) of the stock itself have changed as well. Anticipation is the spark of the stock market, and more decisions are made in anticipation of future risk, profit, and other change than on any known fundamentals. In adhering to your conservative standards, then, highly volatile option premium may be a more cautionary sign than is a covered call opportunity.

Trading Costs in the Option Analysis

Risk analysis often involves small margins, and it is easy to overlook all of the elements that go into that margin of profit. Trading costs are especially troublesome when you deal in single-option trades. The per-contract cost is relatively high. We prefer using single-option examples throughout this book to keep those examples clear, but in practice, the trading costs affect your likely profits on both sides of the transaction. Trading fees vary widely, so you must shop around. You may discover that the brokerage you have been using to execute stock trades is not necessarily the best-priced for option trades.

The problem with multiple-contract trades is the increased risk exposure. It does not make sense to involve 10 options just so that the per-contract trading price is lower. Is it practical to increase risk 10 times by using that many options? It might be in some situations, but reducing trading costs should not be the primary criterion for employing multiple option contracts. The determining factor is potential return

[1] *Quality of earnings* refers to the fundamental strength of the corporation and to its long-term growth potential. A high quality of earnings translates to greater prospects for long-term growth and fewer unpleasant earnings surprises. One definition of this term is "The amount of earnings attributable to higher sales or lower costs rather than artificial profits created by accounting anomalies such as inflation of inventory." (www.investopedia.com)

and risk level compared to the ultimate conservative goals in your portfolio. For example, let's say you own 1,000 shares of stock. You might decide to write covered calls on as much as 300 shares, but you don't want to write calls on all 1,000 shares; in the event of exercise, you'd profit from option premium income, but you may also like to keep the remaining 700 shares. In this case, it would not make sense to write 10 calls just because you own 1,000 shares. Yes, trading costs would be lower, but it may also violate your risk standards. In this case, you would not be willing to have all of your shares called away, so you decide to write calls on 30 percent of your holdings. The trading costs are only one factor to consider; your desire to retain the other 70 percent of your portfolio is more important. If all 10 calls were exercised and 1,000 shares were called away, you would regret the decision even though it worked out profitably.

Calculating the Net Profit or Loss

Based on the trading costs of the service you end up using, you must calculate that cost into your profit outcome. For example, based on the number of options you trade, let's say that your trading costs are a quarter point on either side of the transaction. You have to deduct a half point from estimated profit levels (or add a half point to target closing price levels) to cover the cost of trading—a quarter point to open a position and a quarter point to close.

In considering capital gains upon exercise, you have to also include the trading cost of having stock called away. So, if your selected covered call's strike price is too close to your original basis in the stock, you could make no profit (or even suffer a loss) if and when the call is exercised. There is no value in programming a net loss into a covered call position; it only makes sense in the conservative portfolio when the net outcome is going to be profitable overall, based on your original cost of the stock, dividend income, and call premium. Again, while we do not consider capital gains as part of the return on an options strategy, the *level* of gain (or loss) will certainly affect your decision to open a short option against stock you own. If your basis in stock is 30 points below the call's strike price, then exercise will result in 30 points of profit; but

if your basis in stock is equal to the strike price, there will be no capital gain upon exercise. This reality should affect the decision to enter a covered call position.

Tax Rules for Options: An Overview

Tax rules for options are, for the most part, the same for options as for other investment activity. Dividend income is taxed at the top rate of 15 percent from years 2003 and forward. Capital gains are either long-term or short-term, and the tax rates for long-term gains are lower, also at 15 percent.

Some very important exceptions apply to taxes on option trades. The most complex relate to writing in-the-money calls. These rules are explained in detail in Chapter 5. Otherwise, the following tax rules apply:

1. *Short-term capital gains.* If you hold an investment for less than 12 months, you are taxed on profits as short-term. The federal tax rate can be as high as 35 percent.
2. *Long-term capital gains.* If you own stock for 12 months or more, your maximum rate is 15 percent.
3. *Wash sales.* The "wash sale rule" prevents you from taking a loss at the end of the tax year by selling stock and then repurchasing the same stock immediately. So, if you sell stock and repurchase it within 30 days, it is treated as a wash sale. You are not allowed to claim a loss.
4. *Capital gains for unexercised long options.* If you buy an option, it is taxed like other investments. The gain is taxed as short-term if the option is held less than 12 months and taxed as long-term if it is held 1 year or more.
5. *Exercised long options.* If you exercise your option, the amount you paid in premium is not separate: it is taken into basis in stock. For a call, your cost is added to the basis in the stock; for a put you exercise, your option cost lowers the gain on stock when you sell.

6. *Short calls.* You pay tax not when you sell the call, but when it is closed (through expiration or a closing purchase). All profits on short calls are short-term even when your holding period was longer than 12 months. If your short call is exercised, your premium adjusts your basis in the stock.

7. *Taxes on short puts.* You pay tax when the short put is closed. If that occurs by way of a closing purchase order or expiration, it is a short-term gain or loss. If the short put is closed through exercise, your premium adjusts your basis in the stock.

Federal tax rules for option trades are exceptionally complex, and you will probably need an experienced tax advisor to help complete your tax return. Make certain that your advisor understands the federal rules. As explained in Chapter 5, the calculation of taxes for in-the-money short sales can be quite complex. In some cases, long-term capital gains on stocks can be reverted to short-term status as a consequence of selling an in-the-money call.

The Importance of Professional Advice and Tax Planning

With the potential tax consequences in mind, you need to consult with an experienced tax professional before writing calls, to ensure that you don't create higher tax liabilities. Be sure that you know the tax rules of a particular strategy before you proceed.

One possible planning strategy is the intentional creation of short-term profits. This is a way to close out positions with option premium and capital gains combined, without regard to tax consequences. This works when you have a carryover loss to absorb. The annual limitation on deduction of net losses is $3,000. Many investors have far greater losses, with little hope of ever using the entire loss. But when you have such a loss carryover, you can apply it against current-year gains. That changes the entire planning question. You may welcome profitable short-term profits as long as they are offset by the carryover. It enables you to take profits this year and free up capital without having to pay as much as 35 percent in taxes.

In any case, consult with your tax professional to ensure that you know the benefits and consequences of each type of trade in advance. The basics of options can be quite straightforward—until you begin studying the tax rules.

For a detailed explanation of option tax rules, order or download a free copy of the CBOE booklet, "Taxes and Investing" from *http://www.cboe.com/LearnCenter/Workbench/pdfs/TaxesandInvesting.pdf*

The next chapter provides an overview of risk assessment in terms of return calculations and explains rolling strategies when you write covered calls.

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3

OPTIONS IN CONTEXT

Option risks affect how we proceed; perceptions, sometimes false, inhibit us from taking full advantage of the conservative potential of options. This chapter provides valuable details about designing conservative short positions, special margin requirements for option strategies, and calculating option returns on a comparative basis.

Any investment strategy—from plain to exotic—contains specific attributes and can be defined in terms of risk, rates of return, and specific strategies for various market conditions. Options are probably the most flexible investment products available. They can be used alone, in combination with other options, or as hedge devices to protect other positions. Options can help you to exploit market price swings, and they can be utilized in very speculative or in very conservative ways.

Identifying the conservative applications you can use makes options a tool within your long-term portfolio and requires that you view options trading in at least two classifications. First, the primary options trader is someone who uses options as the main vehicle for producing profits. The trader is willing to take higher risks and uses long positions mainly as coverage to reduce option risks or, at the very least, may choose stocks due to their volatility and technical attributes more than for any fundamental strength. Second, the stock investor is likely to be conservative. This individual picks stocks as the primary means for putting together a portfolio and uses options to protect paper profits, provide downside protection, and augment current income. As long as options conform to the conservative standards in your portfolio, this is an appropriate series of strategies. You may want to view options not as a separate form of investing but as a method for enhancing and protecting your portfolio.

The Nature of Risk and Reward

Any assessment of an investment decision has to involve a study of risk and reward. Your conservative approach to investing is based on your sensitivity to risk as a primary means for all of your decisions. You are less likely than the typical investor to react to sudden market changes out of panic or greed; your view is long-term. Rather than watching

index-based and volume trends every day, you track a company's fundamentals. You base your decisions on earnings reports, capital strength, and operating trends. The stocks you currently hold will be sold if and when you determine that the fundamental strength of the company has changed or if you locate another company whose stock is a better candidate for long-term growth and safety.

When options are involved, the risk equation changes. You are likely not only to alter your investing profile to take options-based risks in some circumstances, but to use options to protect paper profits without selling or to reduce your basis in stock to create downside protection. The proper use of options can increase the conservative nature of your portfolio because some strategies protect existing positions against loss.

Using Volatility as the Primary Risk Measurement

The usual method for defining market risk of stocks involves price volatility. This is a starting point. The more erratic the price trend, the greater the risk and the more difficulty you will have in trying to forecast future price movement. When a stock's trading range is broad, it further complicates the picture; price volatility is a problem for stock investors because owning shares in a volatile company means valuation is on an unending roller coaster ride. It is easy to say that long-term investors should not be concerned with price volatility; but when living the experience, it can be unsettling to see a stock's value cut in half in a single trading session, double the following day, and then fall once again. It makes any form of portfolio planning difficult.

Price volatility in the stock naturally affects option premium value as well. The greater a stock's price volatility, the greater the volatility in option premium. This reality can be a trap for the inexperienced investor who may pick stocks solely to write covered calls. While initial premium income is high, those current yields may accompany depressed prices in the stock by the time the short calls expire. Covered call writing is not always a conservative strategy. The definition applies only when stock has been selected on a conservative basis as a starting point. You may need to accept lower premium levels and lower implied volatility in exchange for safer overall portfolio positions.

The interaction between risk and opportunity is a fact of life. The higher the risk, the higher potential returns, and the lower the risk, the lower those returns. However, with covered call writing, you can create an exception to the rule. Premised on the idea that you have first picked stocks that meet your conservative criteria, covered call writing is a potentially profitable method for augmenting short-term returns and overall profits, with no corresponding change in market risk. This is especially true when the stock's market value has grown since acquisition date. It is difficult to create enough of a yield when the stock's current market value is at approximately the same level today as it was at purchase, so the more price growth you see in the stock, the more profitable—and conservative—the covered call strategy. As long as the strike price of the calls would result in current income if and when exercised, you can create the certainty of profits in any of the three outcomes—exercise, expiration, and close of the position—while also gaining current income. The premium income you receive may be viewed as a means for taking paper profits without selling stock. Those profits reduce your basis, providing downside protection.

> **Example:** You are reviewing available options on Clorox (CLX). The market value of stock is currently at $55.91, so you are reviewing 55 and 60 options. Clearly, your selection of options will be based on your purchase price for the stock. If you pay $56 for shares, the 55 call is not as attractive as the 60. Upon exercise, you would experience a $1 capital loss on the 55 call, or a $4 gain on the 60 call. The selection of an appropriate covered call has to include a critical analysis of your basis in stock, which makes the point that if your original basis in stock is far below either option, then you must make comparisons based on exercise with the certainty of profits. A study of the current 27-month options reveals that the 55 option is available at $7.30 and the 60 goes for $5.10. Your selection of either one must consider the capital gain, even though that gain is now part of the option return.

Options Used to Mitigate Stock Investment Risk

With well-selected stocks, option premium is likely to be "in the zone" of expectation; in other words, the low risk of the conservatively picked stock reflects the same low risk in the risk (volatility) of the option. You gain the advantage, even when dealing with safe stocks and options, in three ways:

1. *You select longer term option writes.* The LEAPS call brings significant profit potential to the covered call strategy. You want to use out-of-the-money calls so that exercise can be avoided, because the purpose to covered call writing is to generate repetitive current profits; this is somewhat difficult with listed calls because time value is limited. But when you use LEAPS calls, premium levels often are high enough that the simple yield is more attractive than with traditional listed options. The reason is time. The greater the time left until expiration, the higher the time value. This does not mean you have to keep the short position open for the entire duration; it can be closed and replaced or rolled forward at any time, based on changing stock prices. It does mean you can acquire higher premium payments because time value premium on LEAPS calls is far higher than the premium on shorter term calls.

2. *The selection of covered writes is limited to stock that has appreciated.* It would be contrary to your goals to write covered calls with strike prices close to your original basis in the stock. Some of the best premium returns are found in calls whose current market value is close to the call's strike price. This maximizes short-call income; but the strategy makes sense only if and when your basis in the stock is well below that level. Remember, the covered call write is a means for taking profits and providing downside protection, but *without* necessarily selling the stock. The strategy solves the dilemma every stockholder faces: stock has appreciated and the temptation is to take profits, but you don't want the capital gain and you don't want to give up the long-term investment. Covered calls solve this problem, but they fit your risk profile only when exercise would

yield returns you consider worthy of the exposure. For example, if you acquire stock at $28 per share and sell a 30 call for 3, exercise produces a $500 profit before trading costs. That is an overall 17.9 percent return (3 points in the option and 2 points in the stock—a total of 5 points on stock acquired at $28 per share). Net return is less when you calculate trading costs. Now consider the return if stock has appreciated to $44 per share and you sell a 45 call for 3 ($300). Upon exercise, your pretrading cost return is 19 points (16 points on the stock and 3 points on the call), which is a 67.9 percent return. When the stock has appreciated, writing covered calls programs in those impressive profits. Few investors would complain about a 67.9 percent return without any increased market risk. This analysis, including both option and stock returns, is not necessarily the sole outcome for a covered write strategy. If exercise does not occur, you do not count stock profits. You consider option profits based on current stock prices only. For example, a $300 gain on stock currently valued at $28 per share is a 10.7 percent return; and when the stock is valued at $44 per share, the $300 profit represents a 6.8 percent return.

3. *Exercise is avoided with rolling techniques.* You want to repeat the cash profits from writing covered calls on appreciated stock. The best of all worlds is to keep a strong long-term growth stock while generating repetitive option profits. If the short call is exercised, you would gladly accept the high yields, but at the same time, you prefer to avoid exercise. The threat of exercise occurs when the market price of the stock is rising, so exercise avoidance is profitable on two levels. First, you can continue writing covered calls and gaining premium income. Second, your stock gains value as the price moves upward.

Using *rolling techniques* achieves this. These techniques involve closing a current option and replacing it with another. For example, if you write a covered call and the stock price moves close to (or above) the strike price, you avoid exercise by (a) closing the short call and (b) opening another call that expires later. The later expiring call can be at

the same strike price or higher. The objective in rolling forward (to a later expiration date) and up (to a higher strike price) is to avoid exercise *and* to do so without having to pay for the roll. You often can roll forward and up while also gaining additional net premium. In Chapter 5, "Options as Cash Generators," we explore the various rolling techniques to show how you can avoid exercise in the covered call strategy.

Another Kind of Volatility

As long as you employ appreciated stock, you can create consistent and low-risk profits with covered calls. Price volatility is not necessary for the strategy to work. In fact, if you accept the technical risk of high-volatility stocks, it violates your conservative standards, and covered call writing makes no sense either. Your first priority should be to buy and hold growth stocks and to replace those stocks only when the fundamentals have changed.

Price volatility is the starting point for identifying market risk, at least in the short term. However, a related test of safety in the stock is the level of *fundamental volatility*. This is the trend in reported revenue and earnings. If a company's operating results are somewhat predictable, showing similar growth patterns from one year to the next, it is a sign of low fundamental volatility. But if revenues and earnings change erratically from one year to the next, the high fundamental volatility translates to high risk on a fundamental level. Following are some observations concerning fundamental volatility as a measurement of risk:

1. You are likely to see a corresponding level of price volatility when fundamental volatility is present. In other words, stock price *is* related directly to revenue and earnings trends.
2. Fundamental volatility is as serious a measurement of safety as price volatility; in fact, because price volatility often is short-term in nature, it may be less serious than fundamental volatility (especially if the operating trends are chronically unpredictable).
3. Comparisons between price and fundamental volatility can be revealing. When they do not correspond, it may be due to non-

recurring price spikes. To make the comparison valid, study a long-term pricing chart; remove spikes if (a) they are atypical, (b) the price change is corrected immediately and prices return to previously established trading ranges, and (c) the adjusted trading range appears to correspond to fundamental volatility levels. This adjustment is statistically sensible and can confirm fundamental trends.

Market risk—the tendency for stock prices to rise and fall and the volatility those price levels demonstrate—is manageable in a number of ways involving options. The most obvious is writing covered calls to reduce basis and take paper profits. Timing covered calls for price peaks is the most advantageous. If you expect overbuying short-term trends to correct in the near future, writing a call can produce fast option profits; this is a form of profit taking that does not require you to sell shares.

Another way to manage market risk is to time option strategies for a stock's pricing trends. For example, when prices rise much more quickly than you expect, you may buy puts in anticipation of a reversal in that trend. Buying puts is normally considered speculative, but when you buy relatively cheap puts to protect stock profits, it is a form of insurance. A "cheap" put is one without a lot of time value and that is several points out of the money. For example, your stock has risen from the mid-30s to $50 per share; you expect a price retreat. The 3-month 45 put is available for 0.75 ($75). Considering the potential retreat of 10 points or more that you expect within the coming few weeks, buying insurance through the put makes more sense than selling the stock to take profits now. Your conservative sensibilities encourage you to ignore short-term price gyrations, but you are watching the market too, and you know that this price trend could be an advantage to you. Whether you sell a call or buy a put, you take advantage of that price trend and protect the short-term paper profits.

As yet another alternative, you do not have to take any action. You could listen to the conservative voice and decide to simply wait out the short-term trends, reminding yourself that the fundamentals of the company continue to indicate a hold policy. In fact, you may wait until the stock's volatility has settled down before even considering

using options in any way. You may return to the conservative policy of employing covered call writes on appreciated stock; that strategy might not be well suited to an environment in which the stock's price is changing rapidly—even though call premium may be attractive at the moment.

Lost Opportunity Risk and Options

If you do decide to write covered calls on appreciated stock—whether in high-volatility times or otherwise—handsome yields are a realistic possibility. There is no market risk involved when the various outcomes are considered. The only existing market risk—that the stock's price will decline—exists whether you write calls or not. In fact, writing calls reduces that risk by lowering your basis in the stock. There is another form of risk to consider, however: the lost opportunity risk. If the stock's price soars far above the strike price of the covered call, you may lose shares through exercise. Your stock may have to be sold at the fixed strike price when that strike price is below the current market value.

Is writing covered calls worth the lost opportunity risk? When you remember that your stocks tend to be conservative selections in the first place, how many of your issues are likely to soar in price? It certainly happens. But when you compare the certainty of short-term returns from writing covered calls to the risk of losing appreciated price in the stock, you realize that the consistency in writing covered calls produces higher overall profits. You will probably have calls exercised periodically, and you will wish you had waited so that you could have benefited from the higher stock price. But your portfolio profits will be higher from writing covered calls on appreciated stock than they will be from simply keeping your long positions without any options activity. The lost opportunity is the exception rather than the rule because, by definition, a conservative selection of stocks requires consistent price trends (low volatility) and less likelihood of sudden and unexpected price changes. You can further mitigate or even eliminate the risk of exercise using rolling techniques once you have shorted options.

Perceptions About Options

Not only do options have a place in your conservative strategy; properly employed, options can strengthen your portfolio and provide greater protection than well-selected stocks. Because prices tend to move in cycles, short-term and intermediate-term pricing may be erratic, and even the best-chosen stocks go through reversal and consolidation patterns.

One argument concerning long-term planning is that such changes in price are of no concern. As long as long-term fundamental signals continue to show strength, the conservative philosophy is to hold, accumulate, and wait out the market. This traditional approach observes correctly that short-term pricing is unpredictable as an indicator, a belief held by followers of both the Dow theory and the random-walk hypothesis. Short-term price movement is not useful for any sort of long-term predictive use. However, it remains possible to (a) protect paper profits and even take those profits without selling shares, (b) exploit market price overreactions, and (c) generate current returns—all without taking on added market risks. As previously noted, the lost opportunity risk associated with committing shares of stock to a fixed strike price should be evaluated along with the rates of return, the value of downside protection, and the yield diversification we achieve with the use of options in a conservative manner.

Finding the Conservative Context for Options Trading

Options *are* high-risk, exotic, specialized, and very complex products when used in certain ways. To some extent, the technician enjoys the complexity of the high-risk, high-return options strategy. This does not mean that you, as a conservative investor, have to shun options; you only have to use them in the proper context. An individual who watches a high-speed stock car race does not stop using the automobile because of the dangers of driving 200 miles per hour; instead, the observer understands that prudent speeds, obeying traffic laws, and driving defensively are conservative policies. Such policies prevent accidents and injuries.

The same comparison applies to options. They are intangible and often have the character of a market "side bet." Those who believe strongly in acquiring and holding equity (a highly conservative point of view) are likely to view options as belonging solely to the short-term thinking of the speculator. This does not have to be the case. A side bet using an intangible product like an option is not always a high-risk approach to the market. It comes down to a question of *how* you use options. It would be reckless to write uncovered calls or to place large amounts of capital in long option positions. Those strategies are inappropriate for you, so they are out of the question. But there does exist an intelligent context for using options within your conservative risk profile. It is limited. You are likely to write covered calls or buy puts for insurance as the primary strategies. As we move to Chapter 6, "Alternatives to Stock Purchase," Chapter 7, "Option Strategies in Down Markets," and Chapter 8, "Combination Conservative Techniques," some more advanced variations of options are introduced—but all within the conservative game plan.

It is a mistake to make a blanket statement. For example, "Speculating in option long positions is always high risk" is an unfair characterization. Not only are you likely to use puts to protect paper profits; there are specific market conditions in which using calls simply makes sense, even with a conservative risk profile. For example, at those times when the "market" (as measured by the Dow Jones Industrial Average index, for example) falls by several hundred points, several changes occur in the market, all short-term. The most important is investor emotion. Everyone is fearful of further price drops. As a consequence, the idea of picking up cheap shares is appealing, but most people do not take that opportunity.

Strategic Timing and Short-Term Price Changes

Consider the possibilities at such times. Most of your capital may be tied up in long stock positions that would produce losses if sold when market prices are low. You recognize that this is the time to buy more stock, but you are uncertain, and you do not have capital available to make a bold move even if you wanted to. This is the perfect opportunity—using

a limited amount of capital, of course—to buy cheap calls. You know that sharp market drops usually rebound very quickly. You also recognize the stocks whose fundamental strength supports the probability of a healthy return to the normal trading range. So, picking the bargains is not difficult; the decision to put money into the market at these moments is the difficult part.

In this scenario, even a conservative investor may use long calls to take advantage of the temporary depression in stock prices. The point is this: being conservative does not mean that you have the same attitude in all market conditions. Flexibility is an essential tool in your portfolio management arsenal. When opportunities present themselves, it is prudent to take them. If you lack the capital to buy shares, or you are fearful of further price declines, options present the perfect compromise. You can limit your risk by investing only a small amount of capital; and the timing can work to your advantage given the likely price patterns in big-number changes.

This does not suggest that you should speculate in long calls under any circumstances. But every conservative investor has survived through big price swings and seen the results—a big drop followed by a few days of uncertainty and then a rapid return to previous levels. Just as sudden price declines can be exploited with the selective purchase of calls, sudden price rallies invariably lead to corrections, a time when you can use calls to (a) protect paper profits and (b) speculate in the price correction itself. Even if you do not own stock, when you observe a big run-up in a stock's price and you conclude the price trend is an overreaction, buying puts can be a well-timed strategy.

In addition to unexpected stock price movements, investors are concerned about what happens to open option positions when stocks are split. Does it change the ratio between stock and option? No. When a stock splits, options are split in the same manner. For example, in a 2-for-1 split, you end up with twice as many shares at half the previous share value; you double the number of options, and the strike price is cut in half. If a stock is split and you have open options with strike prices of 45, you end up with twice as many options, each with strike prices of 22.50. A stock split keeps the values the same; only the numbers change. The same rule is applied to all open option contracts in that situation.

Short Positions, Naked or Covered

The concept of speculating on long calls or puts is contrary to the generally understood definition of *conservative*. As shown in the preceding discussion, there may be moments when you want to use long calls or long puts to take advantage of price changes. It is appropriate, given the timing, and may conform to your conservative standards. For example, if you bought stock and currently have a large paper loss, buying calls is one way to average down your basis. If you can acquire additional shares of stock at a strike price below your original basis, it could bring the collective value up high enough to eliminate those paper losses. This is the opposite side of the coin in which you would buy puts to protect paper profits. If the stock were to decline in value, you could sell the puts, creating a profit to offset stock losses; or you could exercise the puts and sell shares of stock at a price higher than current market value.

Some strategies involving short calls and puts may also conform to your conservative risk profile based on prevailing market conditions and your portfolio positions. The basic covered calls strategy is the most obvious example. When you sell a call, you are taking paper profits and reducing your basis in the stock; you expose yourself to the possibility of losing future price gains in exchange for the certainty of premium income today.

The Uncovered Call—A Violation of the Conservative Theme, Usually

Is it ever justified to sell uncovered calls? In the conservative philosophy, it is not. Uncovered calls have to be viewed as one of the highest risk strategies possible. Chapter 6 contains an example of one situation in which writing uncovered calls can work for a conservative portfolio: the ratio write. In this strategy, more calls are written than shares owned. For example, you may write six short calls when you own 500 shares of stock. With the proper structuring of ratio writes, you minimize risks and produce profits with short calls; the plan works in some situations. The risks are simply too great, and the strategy is not a good fit in your conservative portfolio without modification.

One exception involves topping off a ratio write with one long call. In effect, this eliminates the uncovered portion of the ratio write. For example, if you own 300 shares, full coverage involves selling three calls. If you sell four calls, you have a ratio write. This can also be viewed as the combination of three covered calls and one uncovered call. However, you can further modify this position by purchasing a single call with a higher strike price. In effect, this creates a different kind of combination: a covered call strategy on 300 shares accompanied by a spread (a strategy in which the benefits of one side of the position are offset by the risk in the other). As long as the modified ratio write can be accomplished with a net credit (money coming in rather than going out), the risk is limited. The difference in strike prices between the fourth short call and the long call is a risk if and when the stock moves about the highest short call strike price. Chapter 6 examines this modified strategy in greater detail.

Short calls are related to ownership of stock, so exercise risk is easily controlled. Short puts are a different matter. There are many instances in which writing puts makes sense. Because puts cannot be covered in the same way as calls, it is easy to overlook the potential of writing uncovered puts. The risks of short puts are far more limited than those of short calls, because the potential decline in value is finite. An initial analysis makes it clear that a stock can decline only to the value of zero, so it is easy to limit short puts to low-priced shares. But that standard is not always necessary. The real likely decline in value is somewhere higher than zero.

A Stock's Likely Lowest Theoretical Price Level

Tangible book value per share is assumed to be a corporation's liquidation value, or the net value of all assets if the company simply went out of business and paid off stockholders. It is more likely that companies will cease to exist through merger or acquisition, and at a price somewhere at or above tangible book value. Does the worst-case liquidation value of the company also provide a reliable low market price level for the stock? In practice, your true support level may have little or nothing to do with the fundamental and tangible value of the corporation's assets. Some technicians prefer to identify a chart-based price-support

level, but that is also unreliable; the history of trading patterns in any given stock is the history of support and resistance levels being broken through and new trading patterns established. In evaluating the likely bottom for a stock, you may want to rely partly on fundamental and partly on technical indicators. However, your analysis should be based on the original criteria you employed when selecting the stock. Remembering the rule *that option activity should be restricted to options on stocks that you have prequalified on a conservative standard*, consider what, in your opinion, is a realistic bottom price range. With this analysis in hand, compare the difference between strike price and the probably lowest price level to the premium you receive upon selling the put. If the gap between a particular strike price and lowest likely price level is 3 points and you can sell a put for 5 points, then even given your perceived worst-case scenario for the stock, you will be ahead. This risk-free description, the worst case, allows for the possibility that the stock would be put to you upon exercise at a price above current market value. So, if the market value of shares were to fall below the put's strike price, you would be required to buy inflated-value stock.

Establishing the lowest likely price range may not be easy; it is a matter of opinion. A study of recent price trends may help, but determining the level is far from an exact science. This is why comparisons between price trends and tangible book value per share are useful. If you are uncertain about the reliability of price-support level, then tangible book value per share may provide a more comfortable "drop-dead price" and fundamental support level. This is especially true for the dedicated fundamental analyst. Because tangible book value per share is a fundamental indicator, it may be viewed as more reliable than the technical concept of price support level for judging risk.

Short Put Risks—Not as Drastic as Short Call Risks

The true risk to writing short puts is the difference between current market value and strike price, minus the premium you received for selling the put. This brings us to the conservative standard for selling uncovered puts: if the premium discounts the risk level to a price that you consider a *fair* price for the stock, then it is conservative to sell uncovered puts—but only if you are willing to buy shares at that price.

Once the short put is assigned, you can simply hold the shares and await a price rebound or recapture the paper loss through writing covered calls. The point is, in some situations, you may want to sell uncovered puts even though you are a conservative investor.

Consider the case in which prices of the stock have fallen as part of a marketwide price decline. You are fairly certain that prices will rebound in the near future; but current price levels are bargains given the company's fundamentals, earnings per share, dividend history, and tangible book value per share. In this situation, you may not want to buy shares outright, so you have two choices involving options. You can speculate in calls, expecting to profit from the price rebound, but that requires an outlay of money. Or you can sell uncovered puts for which you receive a premium. It is always better to have cash coming in than going out, but in exchange for the credit, you also accept the risk of exercise. However, if you are confident that prices will rise in the near future, selling uncovered puts presents less risk than in other circumstances. For example, when prices for the stock have risen sharply, selling puts is a reckless and ill-timed decision, just as buying calls is. We expect prices to act in a particular way, and it is reliable to time option decisions when we can recognize overbought and oversold conditions. Those conditions present opportunities for the timing of option trades, and uncovered puts can be structured to present great opportunity with relatively little risk.

The well-understood correlation between risk and opportunity is the *normal* situation. However, changes in a stock's market value may signal that a short-term correction is imminent. To average out your basis or to protect paper profits, you can use long or short calls at such moments. This is not the same thing as contrarian speculation, a strategy in which the speculator seeks out long shots offering great profit potential—and the likelihood of large losses. The wise timing strategy that suits your conservative standards involves careful timing of option trades with price aberrations in the stock. Such a strategy is considered conservative when you have qualified the fundamental strength of the company and when you would be happy to buy shares at the strike price.

Margin Requirements and Trading Restrictions

There are two areas in which option investors have to live with special rules: taxes and trading rules. The tax rules are covered later; a more immediate concern involves the special rules that apply once you move beyond the status of stockholder and begin to make actual option trades.

The first rule to be aware of involves the very basic qualifications to trade. You are required to complete a questionnaire and to advise your brokerage firm that, in fact, you know enough about options and their risks to enter into trades. The brokerage firm is required to establish your qualifications. So, you probably could not begin trading tomorrow for the first time. Because options can involve considerable risks, you have to go through a special screening process by the brokerage firm.

The second restriction is intended to limit the volume of trading undertaken by investors with limited capital. The Securities and Exchange Commission (SEC) defines a *pattern day trader* as any individual who makes four or more day trades within five business days. A *day trade* is opening and closing a position within a single day. Once you make the fourth day trade within a five-day period, you are required to maintain at least $25,000 equity in your account (in cash and securities). For many options traders, the restriction certainly applies. So, unless you can limit activity to three or fewer, you will be treated as a pattern day trader.

Other Margin Rules

All investors must be concerned with the initial margin (the amount of value required at the time a position is opened) and with maintenance margin requirements (additional margin that is required if and when prices change in the securities involved).

Options traders must be aware of these margin requirements. The strategies involving options may look good on paper but, given margin requirements, limited capital could make combinations of positions impractical. Table 3–1 gives an overview of the basic margin requirements related to options trading.

Table 3–1 Margin Requirements, Option Trades

TYPE OF TRADE	INITIAL MARGIN	MAINTENANCE
Long call or put	100% of cost.	Same as initial.
Short uncovered call	Proceeds received plus 20% of the underlying stock market value (when out of the money) plus additional margin when stock market value exceeds the call's strike price.	Additional margin if stock's market value exceeds strike price and continues upward; potentially unlimited.
Short uncovered put	Proceeds received plus 20% of the underlying stock market value (when out of the money) plus additional margin when stock market value falls below the call's strike price.	Additional margin if stock's market value falls below strike price and continues downward; limited to the range of price down to zero.
Covered call	Standard stock margin requirement (50% of cost of the stock) plus 100% of option value when in the money.	100% of stock purchase price.

The margin rules become much more complex for advanced trading strategies and combinations. To see a complete summary of a typical broker's margin requirements, check the Interactive Brokers Web site at *www.interactivebrokers.com* and follow links for (a) trading to (b) margin, and then to (c) US options.

Given the limitation on pattern day trading and the capital requirements, it would be very difficult for an investor to become active in options without placing substantial capital at risk. With options, it is realistic to believe that the threshold of four trades would be crossed quickly and easily within a few days, at least occasionally; it is the nature of option trading to execute a number of trades in a short period of time because market conditions present immediate opportunities.

Return Calculations—Seeking Valid Comparisons

Margin limitations certainly inhibit investor activity if only a small amount of capital is available. An equally complex problem is the calculation of returns from option activity. In attempting to measure and compare option trades—whether employing timing strategies or the safer and more reliable covered call—you face a problem. How do you measure your profits? Consider the problem of the covered call trade. You have three possible outcomes: exercise, expiration, or close of the position. In the first instance, you combine a capital gain with profits from selling a covered call; in the second two, you realize a level of profit, but you still own the stock. So, comparing possible returns cannot be done on a like-kind basis.

We have to look at potential returns as possible scenarios and judge the covered call if any of the three outcomes occur. Comparative return analysis is a wise move, and as a conservative investor, you want to know the best-case and worst-case range of outcomes before proceeding; but remember that the time a position is open and the actual outcome make comparisons elusive. The purpose in return analysis has to be to judge the strategy in all of its outcome permutations, and not to arrive at comparable outcomes.

The *return if exercised* is calculated as a percentage of the stock's value at the time the strategy is entered into. For example, if you were to write a 45 call at the time the stock was at $43 per share and you received premium of 7 ($700), the return if exercised would be 16.3 percent (7 ÷ 43). Your capital gain on stock would depend on your basis in that

stock and would be calculated separately. As long as you purchased the stock at a price below the short call's strike price, you can ensure a high capital gain in the event of exercise.

Limiting our discussion to the option-only return allows us to compare the various option outcomes. While return if exercised (also termed *if called rate of return)* appears to be the best possible return on a short strategy, it is not always the case. To make return comparisons truly valid, they have to be viewed on an annualized basis. When you consider the possibility of a short call simply expiring worthless (or being closed at a profit), you can repeat the strategy over and over. The ability to sell covered calls repeatedly turns stock into a combined long-term growth instrument and current cash cow. The combined annual income from dividends and call premiums can make nonexercised returns far more advantageous than the exercised rate of return.

To begin analyzing various options and their potential returns, we use a side-by-side comparison between stocks, and for each stock, we present potential outcome (exercise, expiration, or close). Table 3–2 summarizes the market data for the companies in our model portfolio.

In these examples, companies are shown with selected options at the money or at the next increment above. We included the option premium as a percentage of the current stock price. This is a good starting point because you may want to limit your study to covered calls that will yield a minimum return of some level. Because all options in this example expire 27 months from the study date, the percentages shown are comparable. If we were using dissimilar expiration periods, we would also need to annualize these returns.

The likely return you can expect to earn on a particular option depends on the premium's relationship to current price and may also include dividend yield on the stock. Clearly, the calculation of option returns has to also consider the ramifications of exercise. While we do not complicate our analysis by including this factor, it is clear that difference will occur. For example, the General Dynamics option is at the money, so exercise would include no capital gain above the value as of the analysis date. The Clorox call is more than 4 points above current share price, so in the event of exercise, you would keep the premium *and* earn a capital gain.

Table 3–2 Market Data for Covered Call Writing: Comparisons

			27-Month Calls**		
Name of Company	**Stock Symbol**	**Share Price***	**Strike**	**Premium**	**%**
Clorox Company	CLX	$55.91	60	5.10	9.1
Coca-Cola	KO	38.90	40	4.00	10.3
Exxon Mobil	XOM	48.70	50	4.50	9.2
Fannie Mae	FNM	67.65	70	8.30	12.3
Federal Express	FDX	87.78	90	12.30	14.0
General Dynamics	GD	100.01	100	9.90	9.9
J.C. Penney	JCP	38.20	40	5.70	14.9
Pepsico (Pepsi-Cola)	PEP	48.48	50	4.30	8.9
Washington Mutual	WM	38.43	40	3.10	8.1
Xerox	XRX	14.32	15	2.55	17.8

* Closing stock prices as of October 22, 2004.

** Current option premium value bid at the close, October 22, 2004; source: Chicago Board Options Exchange, *http://quote.cboe.com/QuoteTable.asp*.

A second factor to remember is the dividend yield. For example, Federal Express (which, in our example, yields 14.0 percent from option premium) pays only 0.3 percent in annual dividend as of the analysis date. However, Washington Mutual yields only 8.1 percent from option premium but pays annual dividend yielding 4.7 percent.

The consideration of capital gains upon exercise, and dividends, are not included in the comparison between call premiums. However, in the selection and comparison between stocks, and in the selection of a strike price, you must also consider which stocks would yield overall higher returns through covered calls. This is especially true in the case of dividends. The

CBOE includes dividends in overall return. Investors may actually determine which stocks to buy based on fundamental analysis *and* on the dividend yield, so dividends cannot be ignored altogether.

For example, let's assume that you had prequalified both Federal Express and Washington Mutual as stocks you would like to own and that the decision is based on the combination of (a) dividend yield and (b) 27-month option premium available through writing covered calls. If we annualize the 27-month returns on each company, we get the annualized option yield (divide return by 27, and then multiply by 12); we then add current dividend yield to find the overall potential:

	Option Premium Return			
Stock	**27-Month**	**Annualized**	**Dividend Yield**	**Total Return**
Federal Express	14.0%	6.2%	0.3%	6.5%
Washington Mutual	8.1	3.6	4.7	8.3

This calculation demonstrates that it is not reliable to simply compare potential returns on calls. You have to also consider dividend yield, especially if you are going to select one stock over another as the stock to buy. This also assumes that all other analyses are equal and that you would be happy to own either stock. When you add in the dividend yield to the annualized return, the relative outcome changes completely.

All of the options shown in Table 3–2 are at or out of the money, so the entire premium is time value. This simplifies the analysis. In fact, as a conservative standard, you may set a rule for yourself concerning covered calls: consider *only* those options that are at or out of the money. This standard makes sense for two reasons. First, writing covered calls is a method for trading on time value. The speculative nature of writing in-the-money calls—which may also invite exercise at any time—contradicts

your conservative policies. Second, writing in-the-money calls may jeopardize the long-term capital gains status of stock in the event of exercise and, in situations where you have owned stock for less than one year, may also toll the time counting toward achieving long-term status. Chapter 5 explains tax rules for covered call writing in more detail. The point here is that restricting your activity to time value premium trades makes sense under the definition of conservative investing.

With the information in hand from Table 3–2, we can compare outcomes in the event of exercise, expiration, and close. To ensure those comparisons are realistic, we also annualize potential returns.

In the case of closing a position, the return depends on timing as well as price. For example, if you close out short calls when their value decreases by one-half, then your yield before calculating trading costs is 50 percent. You then want to annualize that. If you hold the position open for 6 months, the annualized yield is 100 percent; and if you hold the short option open for 18 months, the yield is 33 1⁄3% (50% ÷ 18 × 12).

We make no further calculations to compare the "if-closed" calculation, since actual returns depend on the level at which you decide to close and the total number of months positions are left open. "If-exercised" and "if-expired" comparisons, however, are necessary.

Return If Exercised

We assume that exercise occurs at the very last day of the option's life. While exercise could occur at any time the call is in the money, we cannot accurately compare the yield unless we make such a broad assumption. Dividend yield would vary based on the time the option is left open; we assume that dividend yield is more properly treated as stock-specific and not as part of the comparative option return analysis, so we exclude it in our comparative analysis. If you decide which stocks to purchase based on dividend yield, then it becomes quite important. However, in the following example, we assume that you already own the model portfolio, and we exclude dividends from our calculation. Return if exercised is shown in Table 3–3, including annualized yield.

Table 3–3 Return If Exercised: Total Return, 27-Month Options

Name of Company	Stock Symbol	Stock Price*	Exercise Price	Option Premium	Yield	Annualized Yield**
Clorox Company	CLX	$55.91	60	5.10	9.1%	4.0%
Coca-Cola	KO	38.90	40	4.00	10.3	4.6
Exxon Mobil	XOM	48.70	50	4.50	9.2	4.1
Fannie Mae	FNM	67.65	70	8.30	12.3	5.5
Federal Express	FDX	87.78	90	12.30	14.0	6.2
General Dynamics	GD	100.01	100	9.90	9.9	4.4
J.C. Penney	JCP	38.20	40	5.70	14.9	6.6
Pepsico (Pepsi-Cola)	PEP	48.48	50	4.30	8.9	4.0
Washington Mutual	WM	38.43	40	3.10	8.1	3.6
Xerox	XRX	14.32	15	2.55	17.8	7.9

(1) Closing stock price at the time the position is opened, October 22, 2004.

(2) To annualize returns, the holding period must be adjusted to reflect the return that would have been realized if the stock had been held for 1 year. Overall return [12 ÷ 27] = annualized yield.

Annualizing yield is important in the side-by-side analysis. We tend to allow ourselves to be deceived by the numbers without looking at the percentages. For example, you may reject Xerox because the potential 27-month premium is only 2.55 ($255) in comparison to the 12.30 ($1,230) you could earn on Federal Express over the same period. However, the annualized yield tells the real story. Return on Xerox is 7.9 percent, compared to only 6.2 percent on Federal Express.

Stock price can also be deceiving. You may compare the Xerox price of $14.32 per share to the Federal Express price of $87.78 and draw conclusions about the potential for returns based on those price differences. However, ownership of 600 shares of Xerox is approximately equivalent to ownership of 100 shares of Federal Express in terms of capital required. Even so, the annualized yield from writing covered calls is greater in the case of Xerox.

These calculations present outcomes for the stocks being studied on a consistent basis. All comparisons involve 27-month LEAPS calls, so annualizing the returns reflects the comparative annual outcome. To continue evaluating the portfolio-wide returns in these cases, you need to also track dividend income and growth in the stock's market value. However, for option-specific returns, the results shown in Table 3–3 are accurate.

Using the alternative method of adding in dividends for the companies, we would change the outcomes on the basis shown in Table 3–4 (dividend information was obtained from each company's Web site).

Table 3–4 Alternative Method of Adding Dividends

Company	Dividend (Annual)	Dividend Yield	Annualized Option Yield	Total Yield
Clorox Company	$1.08	1.9%	4.0%	5.9%
Coca-Cola	1.00	2.6	4.6	7.2
Exxon Mobil	1.08	2.2	4.1	6.3
Fannie Mae	2.08	3.1	5.5	8.6
Federal Express	0.28	0.3	6.2	6.5
General Dynamics	1.44	1.4	4.4	5.8
J.C. Penney	0.50	1.3	6.6	7.9
Pepsico (Pepsi-Cola)	0.92	1.9	4.0	5.9
Washington Mutual	1.80	4.7	3.6	8.3
Xerox	0.20	1.4	7.9	9.3

Dividend yield was calculated by dividing annual dividends paid, by the price of stock at the time the option strategy was entered. While this does *not* reflect the true dividend yield you would actually earn (that would depend on the price of stock at the time of purchase), this secondary analysis does provide valuable information. It shows how the

annualized option return plus dividend yield would result in each case. Because the total yield using this method changes the total yield calculated in the previous method (making Xerox the most profitable stock based on option premium and dividend yield), it may be more accurate to consider dividend yield as part of the return if exercised.

We cannot ignore the fact that dividend yield affects the overall profitability and may also influence which stocks you would use for the covered call strategy. The most sensible approach perhaps is to make calculations both with and without dividend yield, and then compare outcomes.

Return If Expired

Comparing return if exercised, to return if expired, is useful to the extent that it shows the result of two possible outcomes. However, it is not accurate to compare the two outcomes to decide which is preferable. From the conservative point of view, the covered call strategy is sensible only if any of the possible outcomes would be justified; but consider the problem of trying to compare exercise to expiration. Upon exercise, your stock is called away, and you then have a taxable capital gain. In the case of expiration, you continue to own stock. You are free to repeat the covered call strategy after expiration. This means your yield can recur repeatedly as long as exercise never happens, so a true overall comparison is not really possible. Given the potential for repetitive returns from the covered call strategy, the rate of turnover becomes important. The more often you can replace a current covered call with another, the higher your premium income. For this reason, if the stock is far enough out of the money so that the short call is worth very little, closing it and writing a replacement call with more time until expiration could be more profitable than waiting out expiration on the current call. Rather than setting a specific level for closing the position, the determining factor should rest with a combination of premium value and time remaining. Thus, you must compare outcome scenarios when the attributes are so different. We want to use a basis for realistic comparison, so the purpose in these calculations is to ensure that we know the possible outcomes.

It is valid to compare the potential return to the stock's current value. You must own the stock to enter the covered call strategy as a requirement under your conservative risk profile. Comparing yield to your original cost makes it outdated, because there is no relationship between today's covered call strike price and your original purchase price. The validity of comparing expiration returns to today's price rests with the assumption that you would decide to select one or more of these covered calls based on (a) proximity between strike price of the call and today's market price, (b) related premium levels, and (c) time until expiration. The major difference between the two potential outcomes (exercise and expiration) is whether or not you continue to own the stock at the end of the strategy. This is where capital gains and dividend yield become important. The greater the distance between original cost and option strike price, the greater the capital gain; so in comparing return if exercised between two or more stocks, you must consider this as part of the comparison. The higher the annual dividend yield, the more value in keeping the stock; this also affects whether or not to select a stock for covered call writing. You may select one stock over another primarily because combined premium and dividend yield are higher than an alterative. You may also avoid using a particular stock for writing calls because of higher-than-average dividend yield (as in the case of Washington Mutual), based on your not wanting to risk high-yielding shares being called away. Referring again to overall return, you might decide to write calls on Xerox, with an overall 9.3 percent return but very low dividend yield. In that way, you protect your position in Washington Mutual, with its far higher dividend yield.

Dividend yield has to be an important component in the selection of stocks for covered call writing, whether you currently own the stock or are considering purchasing shares in the future. You may pursue high-yielding stocks to increase returns, or you may avoid writing covered calls so that dividend yield can be preserved.

It may be difficult to make completely reliable comparisons between return if exercised and return if expired. First, you may decide to close a short option position well before expiration and write a replacement call, which increases the annualized return, substantially in some cases. If you do hold the position until expiration, you can repeat the experience indefinitely. In comparison, when the short call is exercised, your stock is

called away; you can continue to write covered calls only by investing funds in new shares of stock and waiting out market appreciation.

Expiration may be the worst-case scenario if it yields the lower return compared to closing or having stock called away. But you have control. You do not need to keep option positions open until expiration. By comparing if-expired returns to the alternative of closing positions today and replacing them with richer premium short calls, consider the following:

1. The net yield, on an annualized basis, of closing the call. That is the difference between the original sales premium and the current closing purchase premium, net of transaction expenses, calculated on an annualized basis.
2. The comparative yield on a new short call, given longer time to expiration, higher time value premium, and proximity between strike price and current market value.
3. The increase, if any, in the strike price level. If the stock's market value is higher today than when you sold the original call, consider selling calls with higher strike prices. This increases your capital gain in the event of exercise, yet keeps your position out of the money and maintains your conservative standard for covered call writing.

With these variables in mind, worst case is difficult to quantify. Because the comparison is not entirely valid between stocks, it is not accurate to assign a preference of one outcome over another. All of the factors—including exercise, dividend yield, and capital gains—have to be considered as part of your analysis. The original cost of stock, proximity between cost and strike price, and proximity between current value and strike price all affect your decision, and those factors may vary considerably between stocks.

Long-Term Goals as a Guiding Force

Return comparisons, of course, are not the only forms of analysis needed to select an appropriate options strategy. Your long-term goals are the guiding force that ultimately determines whether or not a strategy

makes sense. So, if you want to keep shares of stock and are willing to give up current returns from writing covered calls, that is a clear goal. In that situation, covered calls are inappropriate. However, if you see covered call writing as a means for (a) taking paper profits without selling stock, (b) providing downside protection through reducing your basis in stock, and (c) enhancing current income beyond dividends, then a covered-call-writing program can help you manage your portfolio, exploit temporary market price changes, and overcome the worry about paper profits and losses.

Working within a conservative framework is not always an absolute or easily defined criterion for how to invest or what products to select. Your level of conservatism changes with market circumstances. The various options strategies enable you to take advantage of market high points without disposing of stock you prefer to keep. Degrees of conservatism are possible and may not be fixed. It may be considered conservative to use options at market extremes as long as large amounts of capital are not risked or exercise of short positions produces an undesirable outcome. That is an individual decision, and no universal standard can identify whether or not it is appropriate.

Current circumstances affect how you invest, and they should. As explained in Chapter 7, it is not conservative to invest in the same manner in every situation. You need strategies for managing your portfolios in down markets as well as in up markets; and options in their various configurations are powerful tools for protecting your long-term positions and for identifying and taking profit opportunities without compromising your goals.

There is a tendency to classify specific options strategies universally, so taking long positions is *always* high-risk, and writing covered positions is *always* safe. Neither of these statements is true, of course. For example, writing covered calls is ill-advised when the stock price is depressed, especially if the current price of an underlying stock is lower than your basis. If you think prices are going to climb in the future to reverse the downtrend, then timing of the covered call write would be poor. The best time is during high market volatility when the stock's price has run up and, in your opinion, is temporarily higher than its normal trading range. Not only will higher strike prices be available,

but the implied volatility in the option could also make it a profitable covered call opportunity.

A more subtle variation of risk involves how you utilize cash. For example, when you receive option premium, where can you invest it? If you hope to continue earning a rate of return you think of as a minimum in your portfolio, you may feel compelled to invest cash receipts in some way. Dividends can be reinvested automatically if companies whose stock you own offer dividend reinvestment plans (DRIPs), in which partial shares of stock can be acquired automatically in place of dividend cash payments. This makes sense because it creates a compound rate of return on dividend income. However, it is not as easy to create the same automatic compound returns when you sell options. Some choices include the following:

1. Place funds received for selling options in well-selected mutual funds. Select reinvestment of all income so that your money continues earning compound rates.
2. Group covered call sales to create enough funds to acquire shares in another company that you want to buy; or buy shares and write calls at the same time, paying the net debit required for both transactions. Make sure the company is on your list of stocks that meet your fundamental requirements, remembering to ensure that conservative risk rules apply. This action, combined with dividend reinvestment and the potential for additional option writing, puts premium income back to work as quickly as possible.
3. Invest premium income in other investments, satisfy margin requirements, or add funds to your personal cash reserve. Premium income can be used to augment a cash reserve as circumstances change, so you do not have to dispose of other assets; premium income can also serve as a source for the cash safety net.

Exercise as a Desirable Outcome

One context of options that is often ignored is the desirability of exercise in some circumstances. Exercise is usually avoided as part of an overall strategic approach based on your wanting to enhance current income

while doing all you can to keep well-selected, long-term growth stocks. In the covered call strategy, exercise is most likely when the stock's price is rising, so escaping exercise provides more capital gains in the stock, to be realized later. Avoiding exercise by rolling out of positions is usually a practical method for managing covered call positions; even if exercise does occur in the future, it is preferable at a higher strike price. There are circumstances in which you will welcome exercise:

1. *Writing deep in-the-money calls, even with tax consequences in mind.* If you have a substantial carryover loss to bring forward, you are limited to a maximum of $3,000 per year in capital losses you can claim. When your carryover is far above that level, you will not be concerned about the loss of long-term status you suffer when writing deep in-the-money covered calls. In fact, in that situation, your covered-call-writing strategy could be designed to invite exercise. Since deep in-the-money calls consist mostly of intrinsic value, changes in the stock's market value are matched dollar for dollar by changes in the call's premium. Covered calls provide complete downside protection to the extent of intrinsic value in this case; for example, if your covered call contains 20 points of intrinsic value, you receive the entire premium when you write the call; and the price drops for each point loss in the stock or rises with each point gained in the stock. The call can be closed for a purchase price below the original sale level if stock prices drop, so your lost points in the stock can be recovered in the changed option premium. This strategy works only when two conditions are present: (1) you have substantial carryover loss and don't care about losing long-term treatment for covered call transactions, and (2) your basis in the stock is lower than the strike price or lower than the strike price minus call premium. (For example, if you bought stock at $35 per share and it is now worth $60, you may decide to sell a 30 call. That will bring you 30 points of intrinsic value plus whatever time value premium is available. It is entirely possible when stock has appreciated to this extent to receive total call premium that *exceeds* your basis in the stock. That makes any outcome risk-free; if you can take out not only your basis, but extra profits as well, you have no

net capital investment, but you still own long shares against a short call. So, following such a transaction, a decline in the stock price could produce a profit in the call due to changes in intrinsic value.

2. *Selling puts as a form of contingent purchase when the strike price makes sense.* If you are willing to buy stock at the short put strike price, minus the premium, then exercise makes sense. For example, stock is currently valued at $33 per share and you can get 4 points for the 30 put. Upon exercise, you would acquire shares at the fixed strike price of $30 per share; your basis would be $26 per share due to the $400 put premium you were paid. The ideal condition is to experience exercise *above* $26, meaning your net basis would be lower than market value (not counting trading fees).

3. *Accepting exercise when fundamental indicators have changed.* You may find yourself in the interesting position of owning stock with a short covered call, to also discover that you no longer want to own the stock. If the call is in the money, you can simply accept exercise in this situation and take your profit. If tax consequences are not important to you (e.g., if you have a large carryover loss), you could also roll *down* to a lower strike price, gain 5 points in additional profits, and accept the certainty of exercise. If you don't want to wait for the outcome but prefer to exercise more quickly, you can roll down with the same strike price; you can even execute an unusual *rollback*, replacing the original exercise price with one on an earlier date. Combined with a roll down, this creates net premium income while accepting exercise as an exit strategy on shares of stock. The acceptance of exercise in this case may be more practical than closing a covered option position and perhaps taking a loss on the transaction just so that you would be free to sell shares of stock. As with the case of a deep in-the-money call written originally, this decision could affect the tax status of your stock; it is most practical when you want to absorb a large carryover loss.

Inviting exercise is one method of dealing with ever-changing market conditions. As a conservative investor, you continually struggle with the problem of market volatility. Even when you believe stock is worth holding for the long term, how can you ensure that today's paper profits are not lost in future market price movements? Several conservative strategies can be used to accomplish these defensive goals. In Chapter 4, "Managing Profits and Losses," we examine the intersting use of calls to protect paper outfits.

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4

MANAGING PROFITS AND LOSSES

Everyone contends with short-term price fluctuations, and even the most conservative investor may be susceptible to profit taking. Options can be employed to protect profits and even to take those profits without selling stock. On the other side of the short-term price question, options can be used effectively to eliminate loss positions through rescue strategies.

The conservative risk profile discourages short-term decisions, and speculation is contrary to your sensible investing philosophy. Your general buy-hold-sell rule is, *buy* well selected high-quality stocks, *hold* for the long term, and *sell* only when the fundamentals change. This smart investing approach does not preclude protecting profits when price levels become volatile. You do not want to begin as a conservative and end up as a speculator. However, there are ways to take profits without selling stock and without increasing market risks. In some instances, taking market risks makes sense, even though it is not generally a wise move to make.

We begin by making distinctions between various investor profiles. As a general rule, a *conservative* investor is interested in preserving capital and, as a result, wants to avoid risks. In stock market terms, risk usually refers to volatility (technical risk) or weak financial position (fundamental risk). A *moderate* investor is willing to assume somewhat greater risks as long as the potential for higher profits is present as well. A speculator or aggressive investor seeks the highest possible returns—often short-term—and is willing to accept the highest levels of risk.

These terms are by no means black and white, nor are they permanent. A particular profile is likely to change as financial and individual circumstances change. With investing experience, any profile is going to evolve based on the positive or negative outcomes of past decisions. Current market conditions also affect a particular risk profile directly. Self-defining labels rarely apply to anyone in every respect. In the following discussions, we assume that your profile is *generally* conservative, even though that will not always apply. Our discussions are based on the assumption that, even while you may view yourself as conservative or moderate, you accept the premise that—under some circumstances—your risk profile is going to be more flexible than the label may imply.

The labels we use to define ourselves as investors are often challenged when we come to the question of when and how to take profits. Recalling that profit taking normally involves selling stock, it is contrary to your conservative profile to dispose of stock you would rather keep. But when you involve options, your choices expand significantly. Option strategies provide methods for protecting paper profits as they exist today, making smart moves when market conditions change, and taking profits without needing to sell stock.

Your Conservative Dilemma

A conservative policy is intended to protect your investments from loss. By selecting long-term quality companies, you eliminate the volatility that threatens your portfolio's value, and you set the goal of building equity over many years. Even so, you have to contend with ever-changing market conditions and the prospect of needing to modify your mix of stocks. The most readily available information is short-term by nature, so you have to continually ensure that your portfolio-based buy-hold-sell decisions are made using *valid* information.

Short-term indicators can be very distracting. Momentary volatility in issues you own, especially when price spikes are part of marketwide volatility, can be very distracting. Without gaining independent confirmation of apparent changes in trends, it is easy to make mistakes. For example, you may decide to sell stock to avoid further price declines when it is not necessary, or you may buy additional shares when prices surge, only to realize later that a correction was virtually certain. Reacting to short-term indicators and trends is human nature, but it can adversely affect the value of your conservative portfolio.

The ongoing conflict between short-term market trends and your long-term mindset is efficiently managed with options. Used in the proper context—for managing price volatility and not as a primary and speculative change in policy—options help smooth out the price volatility that characterizes the market while protecting profits. Ask yourself these questions:

1. How often are paper profits one-time opportunities?
2. With high-quality stocks, do you still consider long-term growth potential likely?
3. Have you sold stocks prematurely, fearing the loss of profits?

Deciding How to Establish Your Policies

Most investors can relate to all of these questions because they have a familiar ring. If you have observed trends over time, you know that the price gyrations occurring this week and this month have a short-term aspect and a long-term aspect. You are keenly aware of what occurs from one day to the next, and you see daily reactions to political and business news, to earnings reports, to rumors of interest rate hikes, and to an unending number of other reasons for prices to rise or fall. But in the long-term context, short-term price changes and the daily reasons for daily price volatility really have nothing to do with long-term value. Conservative investing emphasizes fundamental corporate strength—competitive position, excellence of management, diversification, healthy capitalization, consistent dividend record, and so on—and is based on faith in long-term fundamental indicators. With this in mind, it seems most logical to invest in high-quality stocks, monitor the fundamentals, and ignore short-term trends altogether.

Even the most ardent fundamental investor may not want to take this approach exclusively. Profit taking is tempting. There is a way to take profits without selling stock. Some forms of trading can be made with little or no market risk. In Chapter 5, "Options as Cash Generators," we demonstrate how covered call writing using appreciated stock achieves this end. The well-timed purchase of puts protects profits for only limited capital risk and also provides the choice of selling stock at a fixed price (in the event of a rapid price decline) or closing the long put and taking the profits.

Selling stock when its price demonstrates short-term change may be contrary to your conservative strategy. However, rapid price movement may also signal a change in the attributes of the company. If the fundamentals have changed and that manifests itself in the very price move-

ment you experience in the short term, the long-put strategy gives you a way out should you decide to exercise. So, using this strategy does not contradict the conservative rule. In fact, the insurance aspect is conservative, and the contingency of providing a profitable exit strategy is both conservative and prudent.

Managing Profits with Options

The very real problem of "managing" profits is often ignored by investors. (It may seem odd to refer to the "management" of profits because the usual thinking is, you either sell to take profits or leave them intact; but in fact, management is precisely what you want to do, even when your primary emphasis is on long-term growth.)

The traditional advice to buy long-term stocks and ignore short-term volatility is generally good advice. But ironically, it may also be irresponsible to simply leave it at that. Your on-going portfolio management involves many chores, mostly centered on monitoring fundamental indicators. If and when corporate strength, competitive position, dividend payments, earnings trends, capitalization, and other fundamentals change, you may decide to sell shares and redirect a portion of your capital elsewhere. This is basic and sensible.

Basing Decisions on the Fundamentals

Conservative portfolio management is based on the fundamentals. Short-term price volatility—a technical indicator—can also be an early warning of emerging changes in the fundamentals. If volatility is a symptom of other problems—notably, of changes in fundamental strength—then watching prices carefully is a smart suggestion. It is not reliable, however; most market theories agree that short-term movement cannot be used as a predictive tool. When price volatility does appear, it is worth checking. It may serve as a signal of some kind, so seeking confirmation in the fundamentals just makes sense.

If price volatility is related to a serious decline in fundamental strength, it may help identify a change far earlier than do traditional methods.

Price volatility does not consistently provide early signals; much of the short-term volatility represents marketwide short-term trends, overreaction to news and events, or buying and selling trends among institutional investors that have little or nothing to do with the stock's long-term growth potential. So, to the extent that you pay attention to daily or weekly price trends, it remains important to keep that indicator in context.

The traditional advice given to conservative investors wanting to ensure safety is to diversify their portfolios. While diversification is a basic and sensible idea, it does nothing to contend with short-term price volatility. Even with the best diversification, you still experience price surges and declines; you still want to take profits or buy more stock at depressed prices; and you must resist the temptation to react to short-term trends for all the wrong reasons. Diversification protects you against specific risks, but it does nothing to ensure that you will not have to live through price volatility.

Yet another expansion of the diversified portfolio is to adopt a model for *asset allocation*. Under this variation, you "allocate" portions of your capital in different areas: stocks, mutual funds, real estate, cash reserves, precious metals, and so on. Asset allocation makes sense for the same reasons that diversification does, but it does not protect your portfolio from short-term volatility.

Allocation may not be adequate to protect capital. Simply moving money around among different markets provides safety to your capital, but it does not protect you from all forms of market risk. The portion of your net worth that is invested in the stock market is subject to short-term market risk, no matter how strong the long-term growth of your stocks. By the same argument, the short-term values in real estate, precious metals, and other allocated investments are vulnerable to short-term market risk as well. The most conservative investor contends with market risk continually. Even those who stay out of the market cannot avoid loss altogether; the gradual loss of buying power resulting from inflation, and the lost opportunity risk of being out of all markets, combine to form a more serious problem than short-term volatility.

The Reality of Risk

You cannot avoid all forms of risk. You can simply ignore short-term trends and adopt the traditional conservative plan: monitor well-selected stocks and sell only if and when the fundamentals change. Otherwise, ignore all short-term price volatility and wait out the market. Or you can recognize the potential of short-term price volatility as a possible signal worth confirming through an examination of the fundamentals, and even take advantage of price movement, using options to limit exposure to additional risk, smooth out price volatility, and take profits without selling shares of stock.

The two methods of protecting profits with options are buying puts and selling covered calls. Each of the attributes of these strategies is worth comparing. Table 4–1 summarizes the features of the long put and the short call.

Table 4–1 Options to Protect Paper Profits: A Comparison

Buying Puts	**Selling Calls**
A form of insurance on long stock holdings.	Contingent sale in the event of exercise.
Stock price decline is offset by increased put premium value.	Stock price decline is offset by reduced call premium value.
Price offset is unlimited as long as the put exists.	Price offset is limited to premium received in sale of call.
You pay to acquire the put.	You are paid for selling the call.
Time value declines may offset your in-the-money gains.	Time value decline is profitable in the short position.

The decision to use long puts or short calls rests with your long-term opinions about long or short positions. If you view long puts as strictly working to provide insurance, it is conservative to protect profits without risking stock positions. In comparison, covered call writing presents

the possibility of exercise in exchange for money flowing in rather than out and for providing a reduction in your basis, thus programmed higher profits in the event of exercise. This downside protection makes short calls more attractive in most respects. But picking one or the other is a matter of preference and, to some extent, it depends on what you originally paid for stock. If your basis is vastly appreciated, you may be happy in the event of exercise, so the short call makes sense. However, if you view covered calls as inappropriate because you do not want to have shares called away, then the long put may be the best method for protecting your profits.

Overcoming the Profit-Taking Problem

The debate about whether or not it is *conservative* to use options depends on the timing and motives behind the decision. Of course, buying options purely to speculate would be inconsistent with your conservative goals.

As a starting point in this discussion, we must identify the lowest likely price level for the stock. Support is a technical term, of course, and most conservative investors do not use support and resistance as decision-making tools. However, an understanding of support level within your conservative risk profile helps you to coordinate option strategies that enable profit taking without needing to sell stock.

At any given time, you probably have a fair idea of the support level for stock, based on recent historical price trends. This support level, a technical tool, is by no means reliable or appropriate in your conservative, fundamentally based methodology. However, when you use options to identify short-term risk (as an avenue to identifying how and when to use options for taking profits, for example), it is also important to identify support level. The technical definition of support—the lowest price at which stock is *likely* to trade within the current price range—is the most reliable definition for the discussion that follows.

Realizing Profits Without Selling Stock

The premise is that, as a conservative investor, you do not want to take profits just because the current price of stock is higher than your basis; at the same time, it would certainly be desirable to take those profits without selling stock. Given this premise, a few guidelines are valuable within your portfolio strategy:

1. It is appropriate to use long puts to protect existing portfolio positions. The long put, as insurance, represents a limited risk and ensures that current profitable prices are protected.

2. It is also appropriate to use long calls only as a form of *contingent purchase*, when long-term options (LEAPS) are available and when the purpose is to reserve the possibility of exercising those calls to purchase shares of stock. (See Chapter 6, "Alternatives to Stock Purchase," for more in-depth discussions of this strategy.)

3. Long calls are further useful if and when prices of stocks you currently own have fallen rapidly due to marketwide price declines; this presents a buying opportunity, but you may be unwilling to purchase additional shares as a means of exploiting the temporary condition. Calls can be exercised to acquire additional shares to reduce your overall basis in the stock. This is a conservative strategy only if and when you want to acquire additional shares of the stock.

4. Short puts are useful as a form of contingent purchase (you have shares put to you at the strike price if and when exercised) only when you would be pleased to purchase shares at the net price (strike price reduced by put premium you receive). In this situation, risk level should be thought of as the difference between strike price and price-support level, minus the net premium you receive for selling puts. Remember, support level is by no means an absolute value. You may employ certain fundamental tests such as profit and dividend history, tangible book value per share, and other indicators to find what you consider the stock's support level. To find the net risk associated with

short-put strategies, calculate the price level of exercise-adjusted price (strike price less support level), and reduce this price by the benefit of the net premium you receive. The net risk is defined as follows:

$$[S - L] - [P - T] = R$$

S = strike price of short put

L = support level

P = premium received

T = transaction costs

R = net risk level

5. Short puts can be used in place of long calls when prices of stock you own have declined and you expect near-term prices to rise. This assumes you are willing to acquire shares at the strike price if the put is ultimately exercised, based on the criteria in point 4 above.

When is the decision to employ options speculative, and when is it a valid conservative strategy? One consideration is whether or not you already have a position in the stock. As long as your purpose in using options is to protect profits, exploit price spikes, or average down your cost of stock, your conservative standards are compatible with using options in a variety of ways. If you use options to time market price movement in stocks you do not own, it in only appropriate for contingent purchase strategies, qualified by the preceding conditions. Otherwise, using options just as a means for profiting in stocks you do not own is speculative.

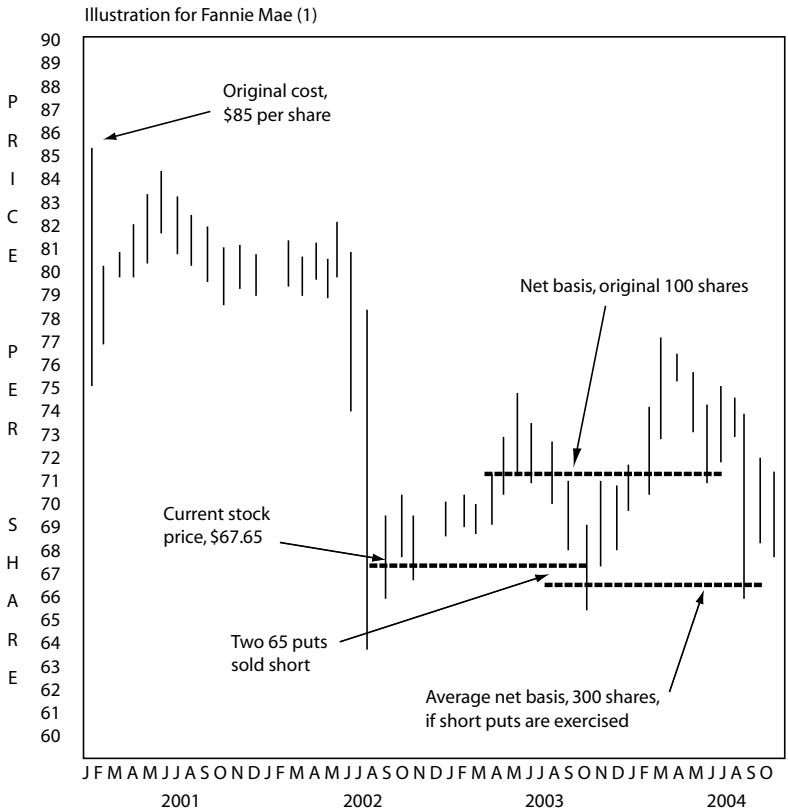
Further Defining Your Personal Investing Standards

Is it even necessary to protect profits, average down your basis, or exploit obvious market price spikes? The answer depends on your position, timing, and degree of advantage or disadvantage to a particular strategy. For example, if you own stock you want to hold for the long term, but a large correction recently occurred, how long will it take to get back to your original basis? It could take many months and, naturally, the concern is that it could take years. Meanwhile, capital is tied up in a paper loss position.

In this situation, options can be useful for managing and even reversing the loss, erasing it and restoring a basic nearer to current market value. You can use short puts based on several assumptions. The first assumption is that the stock has reached its low and is going to begin rising; if your timing is correct, selling puts produces income but the puts will expire worthless. That premium income reduces your basis in stock. Let's look at an example based on actual historical market information for one of the stocks in our model portfolio: In January 2001, you purchased 100 shares of the Fannie Mae. At that time, you paid $85 per share. Twenty-one months later, on October 22, 2004, share value closed at $67.65 per share. You sold a 65 put and received a premium of 6.80 ($680). This reduced your basis in stock to $78.20.

Because the short put could be exercised if the stock's price continued to decline below the put's strike price, that strike price (net of put premium) has to be considered in the context of the continued long-term strength of the company. It has to qualify as a long-term hold. Let's modify our example: you originally bought 100 shares at $85 and 21 months later, market value was $67.65. You sold *two* 40 puts at $6.80 and received 13.60. This reduced your basis in the stock to $71.40 per share (without calculating trading costs: $85.00 minus $13.60). The strategy works as long as you would be happy to increase your basis by an additional 200 shares of Fannie Mae. In the event of exercise, your average basis in the stock would be $67.13 per share, as shown below. This compares favorably to the current market price of stock as of the sample close: $67.65. The average basis in stock is calculated by adding together the net cost of all 300 shares, including reduction in basis from put premium:

Original cost, 100 shares	$85.00
Minus premium for selling 2 puts	–13.60
Net basis, original 100 shares	$71.40
Plus basis, 200 shares @ $65 per share	130.00
Net basis, all 300 shares	$201.40
Average ($201.40 ÷ 3)	$67.13



(1) Fannie Mae illustration based on historical prices and closing price of stock and put premium values as of October 22, 2004

Figure 4–1 Short put rescue strategy.

This series of transactions is summarized in Figure 4–1.

When a Rescue Strategy Is Appropriate

This rescue strategy is appropriate only when (a) fundamental strength continues to qualify the stock as a long-term growth investment, (b) you have capital available to purchase 200 more shares, and (c) you are willing to have that amount invested in a single stock. The historical drop in price levels in Fannie Mae is a problem; however, if the fundamental value of this stock has not changed and you want to continue to

hold shares, this rescue strategy helps reduce basis *and* acquire more shares.

If current market value were to rebound above the $70 per share level, you could sell the 200 shares acquired via short puts. Your *average* basis is $67.13, so a sale of 200 shares at $70 would result in a capital gain of $574 before transaction costs. But in reality, your original basis of the 200 shares would be $85 per share on 100 shares and $65 per share on the second 100 shares, plus a 4.40-point short-term gain on the put premium:

Capital loss, original 100 shares ($85 – $65)	$–2,000
Capital gain, second 100 shares ($70 – $65)	+500
Profit from selling two puts @ 6.80	+1,360
Net profit or loss	$–140

The precise timing of gain recognition and the question of short-term versus long term varies on these three components. The point to be remembered, however, is that with a current market value in the stock of $67.65 per share, this series of transactions reduces the basis in the 100-share position from $85 to $67.13, with a net $140 loss for tax purposes. In reality, you continue to own 100 shares with a basis of $67.13, and your $420 loss can be claimed this year on your tax return. Considering the dramatic two-year drop in market value of this stock, the rescue strategy worked well. You ended up with 100 shares with dramatically reduced market value and a small net loss reported, offset by a paper profit. This is what makes the strategy both practical and profitable when market value has declined in the stock.

Reverting to a Secondary Strategy

A second possible strategy following the acquisition of stock through exercised short puts is to revert to a covered call strategy. Given the same circumstances as in the preceding example, you started out with 100 shares you purchased at $85 per share. Average basis has been

reduced to $67.13 per share on 300 shares, and the stock's current market value is at $67.65 per share. Since your original position was limited to 100 shares, you may be willing to have 200 shares called away at a profit. So, among various covered call strategies, you could write two calls, each with strike prices of 70. In the event of exercise, 200 shares would be sold at 5 points higher than your current basis, so your capital gain would be $1,000. In addition, you would keep the premium income from selling the calls. The 27-month 70 calls were valued at 8.30 each, so this strategy would produce additional profits through covered calls of $1,660 for two covered calls.

The outcome of this strategy is positive from all angles:

1. You end up with 100 shares, but your basis is reduced from $85 to $67.13.
2. You earn premium from writing two short puts *and* two short calls, all of which is yours to keep.
3. You have a capital gain on the 200 shares acquired and then called away.
4. You come out of the series of transactions with 100 shares of stock, which is unencumbered and can be held for long-term growth (but at 17.87 points lower basis than originally) *or* to provide coverage for additional short call positions.

The series of transactions detailed above resulted in an important net change. You began and ended the position with 100 shares of stock, but your basis was reduced by 17.87 points. Your *realized* net capital gains create a small loss, along with a reduced basis in stock. In this example, you did not need to sell your original 100 shares, but were able to employ a combination of short puts and short calls to recover from the market decline. The *risk* in this situation was managed through the use of options trades. The positions are justified as long as you have prequalified the company, as always; the point is that options can be used effectively to adjust basis, manage volatility, and protect profits. In either outcome in the preceding example, the put premium you receive reduced the basis in stock so it was a sound fit for your conservative portfolio.

If the puts in the preceding example were not exercised, you could have waited out expiration, or you could have closed them prior to expiration. Once they were expired, you would have been free to write subsequent short puts. However, if the price of stock had rebounded during the life of the put, you would not have needed or wanted to repeat the short put strategy. If the puts' value declined, you could have entered a closing purchase transaction. The net difference between your original sale and later purchase would have all been profit and, once the puts were closed, you could replace the positions with new short puts, if desired.

The greatest problem with strategies like this is the complexity of the transaction. To execute a series of trades involving short puts and short calls, changes in basis and the number of shares owned, some conservative investors are understandably discouraged. It may require confidence and skill to deal with the specific details. For example, if you want to write short puts, your broker requires that you have funds on deposit to pay for stock in the event of exercise: the cost of stock plus transaction fees, minus premium earned from the short sale. Considering that the purpose in this transaction is to manage a decline in market value and to turn it into a profitable position, it is worth overcoming the initial learning curve. However, you also should ensure that before you enter the short positions, you fully understand the potential consequences, as well as the benefits, in every possible outcome.

Managing the Inertia Problem

For some conservative investors, the problem is not mastering the complexities of option trading; in fact, some may be quite comfortable with options and the various strategic possibilities they offer. A greater problem may be inertia.

When market prices move quickly, the natural tendency is to close out positions to cut further losses, or to become overcautious and fail to act when the timing is right. The panic reaction is untypical of conservative investors. You know the stock is a viable long-term hold, so you are unlikely to panic if prices drop out. You know that this temporary situation will turn around at some point in the future. Inertia, on the other

hand, is more difficult to deal with. When prices fall unexpectedly, taking decisive action is a struggle between two forces: the desire to make smart, well-timed moves and the fear that the entire market and its conditions have changed and a more defensive posture is justified. In hindsight, everyone knows that inertia is just another word for lost opportunity; but it is very difficult to act when the opportunity exists.

Inertia Management

Some suggestions for dealing with the inertia problem:

1. *Set goals in advance.* With specific goals set in advance, you improve the clarity of your decisions. Sudden, even unexpected changes the market as a whole or in the profile of a particular stock prompt a specific and timely decision. Conservative investors are not concerned with daily price timing but do want to pay attention to fundamental changes. Price volatility often signals a change in the fundamentals, so your goals have to allow for the unexpected. For example, if your criteria for holding a stock require continued improvement in quarterly revenues, return on sales, capitalization ratios, increased dividend payments, and other useful indicators, what happens when one of those trends stops or turns around? If you decide in advance that you must sell shares at that point, take action. The goals should involve far more than questions of current price and profit and loss. As important as it is to your goals to make a profit, you also know that—from a conservative viewpoint —holding shares when risks have increased can be dangerous as well.

   In setting action goals, selling shares does not have to be the only possible decision. In reaction to changing news, you may decide, for example, to take other action. Increased price volatility may prompt you to sell if you can break even or make a profit, or to buy one put per 100 shares to provide downside price protection. A high market price condition along with changed fundamentals may prompt you to sell a covered call for limited downside protection or to sell and take profits, and then

move capital to another issue. Selling shares is not the only possible way to cut losses; options can help you to adopt a defensive position while also preserving your long-term holdings.

2. *Follow your own rules without exception.* Prearranged goals give you comfort and clarity, and programmed reactions offset emotions. The emotional block to taking decisive action is a common flaw in the market, and you can overcome this flaw by operating from the base of your own rules. Once your rules are set and analyzed critically, follow them without fail, even if your instinct tells you to wait and see, or to take a different action. When prices become volatile, it is the worst time to lower your guard and speculate. The real test of conservatism is how you act when prices are volatile and there is more to lose.

3. *Develop two-part strategies.* What if prices rise? What if prices continue to fall? Plan your actions based on worst-case scenarios. You have a particular course of action if and when prices rise in volatile times and a different course of action when stock prices fall. Remember, volatility itself is what changes your risk level, and you must identify an action plan. If the volatility is temporary, you can use options to smooth out the rough ride while expanding possible secondary actions if you later decide the fundamentals have also changed. If that changed volatility is permanent, seek an exit strategy. If you can sell at a profit and the fundamentals have changed, take action immediately. If not, you may have to accept a loss, or you may be able to use options to protect yourself against further losses and to provide opportunities for developing a profitable situation in the near future.

4. *Consider closing positions when risk attributes have changed.* Volatility is often more than cyclical market change; it may also be a symptom of a change in the stock's fundamental profile, indicating the need for further investigation. When your stock has been trading in a narrow price range and suddenly breaks out and behaves erratically, you must determine why. Is the volatility occurring throughout the market? Is current news

causing the change, and if so, do you expect the price range to return to normal levels? Does the volatility follow recent earnings reports, and is there anything in the operating results that you should act upon? If fundamental conditions have changed, then you may want to revisit your assumptions concerning the company; you may conclude that attributes have changed and that you need to sell that stock.

It may be worth redefining your investment policies on a conservative theme. It is not realistic to expect to *always* make profitable decisions; but you do expect that by selecting stocks wisely, your portfolio will perform better than market averages. While options can certainly help in this goal, it may be more prudent to sell shares that have become less safe. Your capital may serve you better elsewhere. The *conservative* theme of your portfolio should not dictate profit levels, but your actions. By following those themes, you avoid the common problem investors face: ending up with a portfolio of stocks acquired above current market value. Inexperienced investors tend to take profits whenever they are available, so by selection, they end up with a portfolio full of underperforming stocks. This is contrary to any investor's goals. Because you are a conservative investor, it is important to know not only when to take profits, but also when to take losses.

Taxes and Profits

The various strategies you employ to either protect paper profits or minimize paper losses may be profitable or not, depending on your tax status. If a profitable or breakeven situation is calculated on a pretax basis, it may end up at a net loss after tax liabilities are calculated.

To assess strategic decisions with tax liabilities in mind, several points have to be included in your analysis:

1. *Carryover loss status.* As a planning tool, carryover losses are easily forgotten or ignored. Many investors have fairly large losses from past years that can be used to offset current-year gains. If your carryover loss is substantial, you may absorb that loss by taking gains this year that you might not have taken

otherwise. As inconvenient as carryover losses are, they provide a planning opportunity. For example, as long as you avoid the 30-day wash sale rule, large realized profits can be absorbed by carryover losses, and the current position can be replaced with a lower basis. However, if you use options to protect current value in stock, you could jeopardize the tax advantage. For example, if you own appreciated stock, you can sell shares this year to offset a carryover loss. If you wait 31 days or more, you can repurchase shares and establish the current price as your new basis. If you also sell puts or buy calls to protect your current basis in the event of a price decline, it may be treated as a related transaction: you may not be able to claim the loss on stock if you have opened option transactions as well. These so-called "offsetting positions" are complicated. If you sell in-the-money puts within the 30-day period—meaning the put is likely to be exercised—you may risk losing the right to claim a loss on the stock. The sale of stock and the exercise of the put (meaning a reacquisition of the same stock) could negate the sale under the wash sale rule.

To be on the safe side, a true sale of stock should occur without any use of options. Wait the 31 days and repurchase stock, or sell in-the-money puts at the strike price close to your sale price. When the put is exercised, reacquire the stock, discounted by the premium you received when you sold the put. Or, you can simply wait the 31 days and buy the stock without using options in the transaction.

2. *Your true effective tax rate.* When you calculate the tax effect of capital gains on stock or options, be sure to include both federal and state taxes. Your "true" effective rate is the combined rate of both. The effective rate is defined as taxes on any earnings you report within your effective tax bracket. For example, if your annual income places you in the 33 percent federal tax bracket, any *additional* reported income is taxed at that level. However, you may also be taxed by your state. For example, if your tax rate for state earnings is 8 percent, then your combined effective tax rate is 41 percent. You may need to make additional calculations. For example, while federal long-term

capital gains rates are fixed at a lower rate, your state may not provide any long-term gains provision.

The adjustment could be complex. In calculating a long-term gain, for example, you may need to reduce the federal rate from 33 percent to 15 percent but calculate the state tax based on the full rate assessed. At the same time, you may have a federal carryover loss, but no corresponding loss (or a different one) on the state level. To compare tax rules for each state, check the Web site *http://www.taxadmin.org/fta/rate/ind_inc.html.*

3. *The timing of your profits and losses.* Traditional tax planning involves preplanned timing of taxable gains and, equally important, of tax losses. You can time your profits and losses based on your tax status this year. However, your priority in timing of transactions should be set first on your conservative goals. Only when it makes no difference should the tax questions come into play. For example, if a sale this year would create a net loss, but you already have a large loss carryover, there is no tax advantage to selling shares before the end of the year. In this case, you could buy puts to protect your current value and wait until next year, when you may need the loss. If the tax advantage next year would be greater than the cost of buying the put, then it makes sense to employ this strategy.

   To the extent that you can plan profits and losses to offset one another, you can minimize your tax liability. Tax avoidance is legal, but it requires planning and consultation with your tax adviser. Profits and losses can be offset based on timing of profitable sales with disposal of loss-status assets. Profits can also be offset against carryover losses. In the past, stock profits and losses could be offset against nondeferred gains from selling a primary residence. Today, though, profits from selling your primary residence are tax-free up to $500,000 and cannot be deferred. This is a great advantage, but timing and coordination between residence sales and your investment portfolio provides no year-to-year planning advantage.

4. *Offsetting profits and losses in the same year.* One of the most effective planning devices is to simply match profits against

current-year losses. The outcome is to have no effect on your effective tax rate. If your rate is close to the point where additional income would push your taxes into the next bracket, preplanning makes sense. If you intend to take profits, it may be smart to also dispose of underperforming stock. You gain two advantages by coordinating the timing of these transactions. First, you shelter gains by offsetting them with investment losses. Second, you dispose of stocks that have not performed as you hoped. This is far more conservative than making decisions in isolation. You may experience subsequent year swings in your tax bracket and liability if you do not plan. For example, this year, you may sell several stocks and realize capital gains, which are taxed; and next year, you may sell several stocks that have lost value, creating a carryover loss of limited year-to-year value. By not planning ahead, you may create a problem for yourself. Not only do you face the possible jump in your tax bracket in the profitable year, but you may also create problems by placing your investment losses into a single year without offsetting gains. While all of your gains are taxed in the year reported, your maximum annual capital loss is $3,000. It makes no sense to create a carryover loss when, with some preplanning, you can time those losses so they can be used as offsets to reduce current-year tax liabilities.

5. *Unintended tax consequences.* The tax rules for options-related transactions are complex. For many individuals, the tax rules are too complicated even without options, so many people who simply buy and sell stocks, mutual funds, and real estate hire tax experts to help them comply with the law. When you add options to the mix, the complexity makes professional help more important than ever. Be sure your tax professional is completely knowledgeable in the area of tax rules for options. You must pay for the professional advice not only at tax season but throughout the year. The complexity of rules, notably for in-the-money covered calls, can have consequences, including the loss of long-term capital gain status on your stock portfolio. Consult with your expert before making trades so that you

understand the rules and know beforehand which types of trades can cause significant loss of tax advantage.

Options Used for Riding Out Volatility

Every investor has to contend with short-term price volatility. As a conservative investor, you focus on fundamental attributes of the company and use short-term indicators only to test your ongoing assumptions. If those assumptions change, then your hold strategy may become a sell. However, as long as you intend to continue holding stock, options can be valuable in riding out short-term volatility as an alternative to profit taking in the traditional manner. With options, you can minimize short-term losses and even take profits while continuing to own shares of stock.

In the next chapter, the intriguing possibilities of the covered call strategy, including the special tax rules that apply to short options strategies, are explored in depth.

5

OPTIONS AS CASH GENERATORS

Covered call writing is a conservative strategy. The key is in exploiting time value premium. For the strategy to make sense, your basis in stock must justify the short position, option premium must be adequate to justify the risk of exercise, and you must know the tax ramifications before you open short positions. Tax rules for short options are odd and complex, but they cannot be ignored.

The covered call is among the most attractive of *conservative* option strategies. It provides an impressive rate of return when properly structured, and it does not increase the most common forms of risk. In fact, market risk—your exposure to lost value in your stock—is *reduced* with the covered call strategy.

In this chapter, we explore the conservative possibilities of covered calls, starting with the underlying premise necessary to succeed with this strategy. We explore various outcome scenarios to form realistic judgments about when and if the covered call strategy makes sense. We perform our analysis with tax consequences in mind; for example, capital gains rules for covered call strategies affect the decision and the timing of these short positions.

One of the more intriguing strategies involving covered calls is the forward-and-up roll, a technique used to avoid exercise while increasing potential profits in the event of future exercise. This idea works best after a run-up in stock prices that occurs after entry into the covered call strategy. We also examine using covered calls as a means for intentionally generating a sale of stock and at the same time creating more profit than would be possible through a straight stock sale.

The Covered Call Concept

No strategy is completely risk-free, not even owning stock in well-managed, strongly capitalized companies. But in the case of a covered call, we seek to enhance our profits without incurring added *market risk*, and this is both practical and inevitable. For many investors, the *lost opportunity risk* is worth the additional income that covered call strategies generate. (Lost opportunity risk is discussed later in this chapter.)

A covered call strategy has two elements. First is the ownership of 100 shares of stock for each option to be covered; second is the short position

in the call option. If you own 100 shares, you sell one call to achieve the one-to-one "covered" status. The call grants the right to the buyer on the other side of the transaction to buy your 100 shares (to call them away) at the set strike price at any time from the date of sale until expiration. As long as the current price of stock is below the strike price, the call should not be exercised.

> **Example:** You own 100 shares of Pepsi. The current price is $48.48. If you consider covered calls with strike prices of 50, 55, and 60, these positions are not exercised unless the market value of the stock rises above those strike price levels before the call expires.

Who Makes the Decision?

When you enter a covered call position, you are *selling* the call against stock you own. This means you give the right to exercise to the buyer, and that decision is entirely in the buyer's hands. You are allowed to keep the cash you receive upon selling the short call, whether the call is exercised or simply expires. You also continue to receive dividends during the period you are short on the call. The big question comes down to this: Is it worthwhile to risk having 100 shares of stock called away if and when the stock's price moves above the call's strike price?

To answer that all-important question, we analyze the transaction itself, review the yield outcomes based on all possible stock price movements, and analyze the after-tax yield from the covered call as well as potential capital gains on the called-away stock.

The *advantage* to selling covered calls is that it produces instant cash. You are paid for selling the call. For example, if you can achieve an immediate 10 percent return on your stock by selling a call, is it worthwhile? The answer, of course, depends on your original purchase prices versus today's stock value as well as the potential call-away price. These elements determine your overall yield on the investment in the event of exercise.

The *disadvantage* to selling covered calls is that you tie up 100 shares for each call sold, and you cannot escape from the covered position with-

out closing out that short call. For example, if you sell a call and receive payment (the *premium*), and you later decide you do not want to continue in that position, you have to buy the call to close. (Remember, the initial transaction was a sale; to close that out, you next need to buy the call with a *closing purchase transaction*.)

You should close the position under one of two circumstances. First, if the value of the short call has declined since the time the position was opened, you can pay the current price and close out the position. The net difference (the original sales price minus the closing purchase price, net of trading expense) will be a capital gain, which is taxable in the year the position is closed. Second, you should close the position if the value of stock has moved upward beyond the strike price. In this situation, you face the possibility of exercise, which can happen at any time when the call is in the money (current market price of stock is higher than the strike price of the call). When the stock's price moves above strike price, the net premium value of the short call may be *lower* than it was when you sold it. This is true because the call's time value declines as exercise date comes closer. In this situation, it is prudent to buy and avoid exercise while still realizing a net gain on the call transaction. Incidentally, once you close out the covered call position, you are free to repeat the transaction, using calls with higher strike prices and later expiration dates.

If the stock's price moves above strike price so that your short call is in the money, the call's value may also have increased. You can still avoid exercise without taking a net loss, using a technique called rolling (replacement of one call with another). This strategy is explained in detail later in this chapter.

Examples: Ten Stocks and Covered Calls

To illustrate how the basic covered call strategy works, we examine the 10 companies in our model portfolio, sharing three common attributes:

1. Both listed options and long-term options (LEAPS) are available on the stocks.
2. All of these stocks are assumed to have current market value *above* the original basis. (There is no justification for engaging

in covered calls for stocks whose market value is lower than the basis; the conservative strategy works only when the stocks have appreciated in value since the time of purchase.)

3. All stocks show current moderate price volatility levels. (If volatility in a stock is high, so is market risk; if it is too low, option premiums also are low, and the strategy may not be justified.)

These stocks' attributes are summarized in Table 5–1.

Table 5–1 Sample Stocks for Covered Calls

Name of company	Symbol	Current Price*	Dividend Yield
Clorox	CLX	$55.91	1.9%
Coca-Cola	KO	38.90	2.6
Exxon Mobil	XOM	48.70	2.2
Fannie Mae	FNM	67.65	3.1
Federal Express	FDX	87.78	0.3
General Dynamics	GD	100.01	1.4
J.C. Penney	JCP	38.20	1.3
Pepsico	PEP	48.48	1.9
Washington Mutual	WM	38.43	4.7
Xerox	XRX	14.32	1.4

* Values shown reflect closing prices, October 22, 2004.

Working within Pre-Established Standards

The covered call strategy works at specific strike price levels, so we proceed on the premise that stocks you own share all of these attributes as well. If they do not, the covered call strategy will not conform to your conservative standards. The first step is to select strike prices that are (a) at or out of the money and (b) higher than your original basis in the stock.

In Table 5–1, note that Washington Mutual reports the highest dividend yield of 4.7 percent. Because we base our conservative covered call strategy on stock attributes, the high current yield is attractive; while we may not consider dividend yield for stocks currently owned, the yield may affect the decision to purchase particular company stock given that fundamental indicators are otherwise equal. If you owned all 10 of these stocks in your portfolio, you would expect to also experience a varying range of potential profits from covered call strategies. By the same logic, you might also own other stocks whose option premiums would not meet your expectations. Referring again to Table 5–1, you may decide to *avoid* writing covered calls of Washington Mutual specifically because of the high dividend yield. It may be preferable to ensure that you retain these high-yielding shares and reserve covered call writing for the lowest yielding stocks on the list, notably Federal Express (yielding only 0.3%), J.C. Penney (1.3%), General Dynamics (1.4%), or Xerox (1.4%).

We next analyze a series of options in comparative form. If you compare options with different expiration terms, you should annualize the return. In our case, we use LEAPS calls, all of which expire in 27 months. A summary of call option values expiring in 27 months is shown in Table 5–2.

Calculating the Gain Comparatively

Let's review how these values must be read. In the case of the Pepsi options, we see that the 27-month option with strike price of 40 is currently worth 5.70 ($570). So, if you sold this option today, you would receive $570 (minus trading fees) as premium for the sale.

If you sold the 50 option (one having a strike price of $50 per share), you would be paid 2.30 ($230) per option. We can perform a very fast return calculation based on the difference between today's value and strike price to see what you would gain if each call were exercised. Upon exercise, your 100 shares of stock would be called away at the strike price: in the first instance, $50 per share, and in the second, $55 per share. The following calculations are based on *today's* price, however, and not on what you actually paid for the stock. Based on the current price, if the short call

Table 5–2 Covered Call Premiums, 27 Months Until Expiration

Name of Company	Symbol	Current Price	27-Month Strike	Call Options Premium
Clorox	CLX	$ 55.91	55	$ 7.30
			60	5.10
			70	2.30
Coca-Cola	KO	$ 38.90	40	$ 4.00
			45	2.15
			50	1.15
Exxon Mobil	XOM	$ 48.70	50	$ 4.50
			55	2.70
			60	1.60
Fannie Mae	FNM	$ 67.65	70	$ 8.30
			80	4.80
			90	2.45
Federal Express	FDX	$ 87.78	90	$12.30
			95	10.10
			100	8.10
General Dynamics	GD	$100.01	100	$13.90
			110	9.60
			120	6.40
J.C. Penney	JCP	38.20	40	$ 5.70
			50	2.50
			60	1.00
Pepsico	PEP	48.48	50	$ 4.30
			55	2.30
			60	1.15
Washington Mutual	WM	$38.43	40	$ 3.10
			45	1.65
			50	0.80
Xerox	XRX	14.32	15	$ 2.55
			17.50	1.60
			20	0.90

Closing prices as of October 22, 2004, and option bid values for January 2007 calls as of closing on October 22, 2004.

were exercised in the month of expiration, you would gain (excluding dividend income and not allowing for taxes) the following:

07 JAN 50 **January 2007 expiration; strike price 50**	
Sale of stock	$5,000
Less current value	–4,848
Stock profit	$ 152
Return	3.1%
Call premium	430
Option yield	8.9%*
07 JAN 55 **January 2007 expiration; strike price 55**	
Sale of stock	$5,500
Less current value	–4,848
Stock profit	$ 652
Return	13.4%
Call premium	230
Option yield	4.7%**

* $430 ÷ $4,848 = 8.9%

** $230 ÷ $4,848 = 4.7%

We show the stock *and* option profits to make an important point: while you do not include the stock's capital gain as a means for picking one covered call over another, the return if exercised varies based on strike price. In this example, the lower strike price of 50 produces a higher option gain but lower stock capital gain, and the higher strike price of 55 produces a lower option gain but a greater capital gain. The 50 strike

price example produces a 12.0 percent overall gain, and the 55 strike price produces an 18.1 percent overall gain. So, while you should not mix the two potential outcomes, the selection of one strike price over another is essential if you expect to make valid outcomes based on various scenarios. In the example, the higher strike price produces a more desirable outcome, even though the option premium return is lower.

If we annualize[1] these rates of return—again, based only on stock sale and option premium—we must adjust the reported gain to show the yield based on a 12-month holding period:

07 JAN 50 **January 2007 expiration; strike price 50**	
Stock gain	(3.1% ÷ 27) 12 = 1.4%
Option premium	(8.9% ÷ 27) 12 = 4.0%
07 JAN 55 **January 2007 expiration; strike price 55**	
Stock gain	(13.4% ÷ 27) 12 = 6.0%
Option premium	(4.7% ÷ 27) 12 = 2.1%

This example demonstrates that in comparing two different options, we arrive at a rate of return based on stock gains and another separate return based on option premium. We do not want to combine these because it remains important to compare option outcomes if exercised and if expired, excluding any capital gains on stock. The point relates only to the selection of strike price based on various exercise outcomes and demonstrates that overall returns are substantially different when stock profits are also considered.

1 Annualizing option returns is important because holding periods are likely to vary from a few weeks or months to several years. The basic annualization formula involves dividing the yield by the holding period (in months) and then multiplying the result by 12 (month); this produces the average annual yield.

As we observed before, this is a brief overview and is used only for comparative analysis. Actual comparisons should be based on your purchase price of stock, include a calculation of dividend income, and consider the overall tax liability as part of the calculation. More on taxation of covered call exercise is found later in this chapter.

Smart Conservative Ground Rules

All strategies have positive as well as negative aspects. The covered call strategy is conservative, assuming that you understand the transaction's specific attributes and that you are sure the numbers work in your favor. We must observe seven basic ground rules as we proceed through the analysis to ensure a truly *conservative* application of the covered call strategy:

1. *Your original purchase price has to justify the strategy.* The most conservative use of covered calls is found when you own stock that has appreciated in value. The lower your basis in comparison to today's market value of stock, the more flexibility you have in devising a conservative options strategy. In fact, the use of covered calls is a sensible way to protect a portion of your paper profits without needing to take those profits. For example, if you have a 30-point paper profit, selling a covered call and receiving a premium of 10 ($1,000) gives you 10 points of downside protection, or one-third of your total unrealized profit. If you sell a series of covered calls over time, it is even possible to take *all* of your profits out of the position without selling stock. For example, if you received a premium of 10 on three subsequent calls over a period of many months, with each one expiring and being replaced in turn, the entire 30 points of paper profits can be taken as capital gains.
2. *The premium value you will receive has to provide enough yield to justify the covered call exposure.* If you plan to use your stock as cover for a short option position, you must be able to justify it in terms of profit levels. Check returns from option premium on an annualized basis. So, if you own shares of many different

stocks, you will naturally seek out those option positions that yield the best returns. In comparing one option position to another, be aware of the rate of return and the time until expiration. A 5 percent return you earn in 6 months is far more profitable than a 10 percent return that takes 24 months. Also remember that you will not always keep the short position open all the way until expiration. You can close out short positions at any time. For example, one very profitable strategy is to sell a covered call, wait for the time value to decline, and then enter a buy-to-close order, realizing the net difference as a profit. After the position is closed, you can open another covered call using the same stock, but with more time value and profit potential.

3. *You are willing to accept exercise as one of the possible outcomes.* In every covered call position, you have to accept the possibility that your 100 shares of stock will be called away. In fact, some investors are drawn to options with the original idea of accepting exercise and selling shares, only to realize that repetitive covered call selling may be more profitable. If you do not want exercise under any circumstances, you should not write covered calls. However, for many investors, covered call writing is a smart alternative to simply selling shares. Keeping shares of stock and the associated dividend income and selling calls to realize short-term profits is one effective way to achieve current returns.

The idea that you must be willing to accept exercise is not a problem if, in fact, exercise produces capital gains in addition to option returns. The risk in such a transaction is that the covered call could be exercised and you would be required to sell your 100 shares of stock. But a risk that comes with a return is one that most investors gladly accept—assuming that it is structured to produce profits if and when the short call is exercised.

1. *You are aware of the tax consequences in the event of exercise.* If you trade in options without considering the effect on your stock positions, taxation is easy to understand. If you sell a call and it expires worthless, your gain is treated as short-term regardless of how long it was held. So, tax treatment of LEAPS options is different than for most other investments.

(Incidentally, less conservative investors who go long on options may have either short- or long-term gains or losses, depending on the usual holding period rules.) However, for covered calls, the tax rules are very complex, as explained later in this chapter. For now, the point is that you must understand how capital gains rules apply to a particular strategy and consider the tax consequences as part of your overall return calculation.

2. *The primary risk to the covered call strategy is possible loss of future market gains if and when stock prices exceed the call's strike price*. This lost opportunity risk should be understood before you enter into any covered call strategy.

   Example: You purchased stock at $35 per share. Today, it is valued at $40. You sell a covered call expiring in 1 year and receive a premium of $300. The strike price is $45 per share. If the stock rises above $45, your stock will be called away. At the time you enter the transaction, you justify the decision based on your purchase price, which is $10 per share below the strike price. Furthermore, strike price is 5 points higher than today's stock value, so the entire premium represents time value. Finally, the $300 premium is extra income equal to 8.6 percent of your original purchase price. This analysis makes sense; however, let's say the stock's market value soars to $60 per share and your stock is called away at the strike price of $45 per share. Your lost opportunity cost for this transaction is $1,200, the difference between market value of stock and strike price of the call.

   In this example, the lost opportunity arises from the stock's market value climbing 15 points above the call's strike price. In the analysis of a covered call strategy, you have two risk factors to consider. You know (given the example) that you can create consistent high returns with no increase in market risk. You also know that for stocks you own that have appreciated in value since you purchased shares, this scenario can be repeated many times unless a particular call is exercised. In exchange for consistent high returns, you must look at the other side: in

some cases, a stock's market value rises above strike price, and you may lose the potential profits had you not entered into the covered call strategy. That is the lost opportunity.

Here is the essential question: Are you willing to give up the consistent higher-than-average returns on all stocks on which you can write covered calls in exchange for the lost opportunity that might occur? You need to assess lost opportunity risk in the context of your conservative portfolio, considering your willingness to accept possible exercise, dividend yield comparisons between stocks, proximity of striking prices to current market value, and the amount of profit in the current position based on original purchase price. The stocks you own today should have a good chance of growing in market value gradually over time. Lost opportunity risk cannot be ignored; but that risk may be less significant in the conservative portfolio.

Lost opportunity risk can be mitigated using a secondary covered call strategy, rolling forward and up, discussed later in this chapter. The point here is that even though stock prices may rise more quickly than you expect in some cases, the lost opportunity risk is not absolute. You can (a) close option positions to avoid lost opportunity risk; (b) avoid risk by employing covered calls on only a portion of your holdings (for example, covering 100 shares when you own 500 shares, so only 20 percent of your holdings in a particular stock are even exposed to the lost opportunity risk); and (c) employ rolling techniques to escape the lost opportunity risk or to mitigate the future lost opportunity you might experience when stock prices rise even further.

Lost opportunity is a "delightful problem" for conservative investors. It is an opportunity to accept exercise at ensured high-yield levels; it allows you to roll out of one position and replace it with another to increase profits even more; and if you have employed covered calls on only a portion of your holdings, it means the balance of shares on that company continue to appreciate in value. Many investors would be quite pleased to face a lost opportunity under these circumstances.

3. *The covered call strategy commits the capital invested in stock for as long as the short call remains open.* Because a conservative strategy requires that your long stock position is maintained as an offset to the short call, your shares are committed until the short position is closed. You escape this commitment when you buy to close the call, when the call is exercised, or when the call expires. If you plan to keep the covered call position open until expiration many months in the future, for example, this means that you cannot sell shares until the call is closed or canceled. (You can sell shares, of course, but that would transform the highly conservative covered call strategy into a high-risk uncovered call strategy.)

   Is it worthwhile to keep shares committed? As a conservative investor, a basic assumption made here is that you own shares of a particular company as a long-term investment and would not want to sell. The alternative to the covered calls strategy is to take no action, but simply to continue your hold strategy in the stock. Covered call writing does not change this basic strategy; it only employs the stock to enhance profits via option premium. So, yes, assuming your portfolio strategy does not change, it *is* worthwhile to keep shares committed.

   A second point to remember is that even though your shares are committed or tied up relative to the short call, you will continue receiving dividends as long as you own your shares. So, if part of your conservative strategy is to invest in high-yielding stocks, the covered call does not change this strategy. If you are also using a dividend reinvestment program to achieve compound returns on your dividend income, this will also continue to occur. So, remaining committed to keeping the stock is consistent with your existing conservative strategy.

4. Most important of all, your primary portfolio strategy has to remain the same, seeking long-term investment in the stock of properly selected companies, not in selecting stocks based only on potential covered call returns. One danger in using options to enhance profits is that it could change your entire

investment strategy. As a conservative investor, your first rule should be that, no matter what, the proper selection of companies based on fundamental strength and growth prospects must remain the primary means of stock selection and the primary deciding factor for any decision to buy, hold or sell shares.

Example: You have built a strong portfolio of stocks with growing dividend payment history and with a consistent long-term growth record. However, in looking through the options listings, you discover that some other stocks have options yielding much higher premium levels than your stocks. You sell your holdings and replace them with stocks on which higher yields can be achieved with covered call writing.

This is a big mistake. One essential rule in the options market is that higher risk stocks (defined by the primary market risk factor—volatility) exhibit a correspondingly higher volatility in option time value premium. As a consequence, if you concentrate on stock selection with option premium as your primary criterion, then you will be replacing a conservative portfolio with a high-risk portfolio.

A Conservative Approach

Proceeding from the ground rules for covered call writing, the next step is to determine exactly what makes elements of the strategy advantageous. As a conservative investor, what are the primary attributes you need to enter a profitable conservative strategy? There are three: appreciated value in the stock, time value premium, and downside protection.

Element 1: Appreciated value in the stock. As long as the current value is higher than your basis, you have great profit flexibility in entering a covered call strategy. By this, we mean that with those paper profits, you can build in a greater certainty of profits. For example, consider how different the return scenario looks in the two following examples:

Example 1: Covered calls without substantial appreciated value in the stock. You purchased Exxon Mobil stock at $46 per share; today, shares are worth $48.70. You sell a January 2006 (15-month) $50 strike call and receive a premium of $4.40. If exercised, total return on stock and on option transactions (without adjusting for trading costs, annualization, or taxes) would be

Capital gain, $5,000 strike price less $4,600 basis = $400

Capital gain = 8.7% (before annualizing)

Option premium = $440

Option return = *$440, or 9.0%* ($440 ÷ $4,870)

Example 2: Covered calls with substantial appreciated value in the stock. You purchased Exxon Mobil stock at $36 per share; today, shares are worth $48.70. You sell a January 2006 call with a strike price of $50 and receive a premium of $4.40. If exercised, total return on stock and on option transactions (without adjusting for trading costs, annualization, or taxes) would be

Capital gain, $5,000 strike price less $3,600 basis = $1,400

Capital gain = 38.9% (before annualizing)

Option premium = $440

Option return = *$440, or 9.0%* ($440 ÷ $4,870)

Clearly, the greater appreciation from higher capital gains enhances the overall return from combined capital gains and option premium. The conservative covered call strategy requires that the scenario produce such returns if the call were exercised. However, it is also important to remember that in comparing option-specific outcomes, we do not consider the capital gain as a part of the total return. The example above illustrates that exercise produces higher profits for appreciated stock

than for stock that has not appreciated. It simply makes the point that you should prefer to use appreciated stock in covered call strategies.

Exercise is one of the possible outcomes, and we cannot just ignore the potential capital gain. That may even be desirable. However, the majority of covered call writers would prefer to gain option profits without going through exercise so that they can repeat the strategy many times. You can avoid exercise in a number of ways; however, if you look at exercise as a worst-case outcome, then you will want to ensure before entering the position that it is justified by the level of profitability upon exercise.

Element 2: Time value premium. The key to successful covered call writing is in the time value premium. To review, every option's premium contains two parts. *Intrinsic value* is the value of in-the-money points. For example, if strike price of the call is $40 and the current market value of stock is $43, the call contains 3 points of intrinsic value. *Time value* is any premium above intrinsic value. If the call is at the money or out of the money, there is no intrinsic value. For example, if the stock is valued today at $43 and the 40 call premium value is 5 ($500), it contains 3 points of intrinsic value and 2 points of time value. If the stock value is at or below $40 per share, a call with a 40 strike price consists entirely of time value premium.

Time works *for* the seller and *against* the buyer. Buying options can be highly speculative because the buyer has to hope not only that the stock rises enough to create intrinsic value prior to expiration but that the growth in price also rises far enough to offset lost time value. Because time value evaporates as expiration approaches, this is very difficult to achieve. For example, a buyer may purchase a 40 call and pay $500 (5 points) when the stock is valued at $39 per share. In this situation, the premium is all time value. That stock must rise to at least $45 per share *just to break even* by expiration. (The buyer paid 5 points for time value.) Even before considering the cost of trading on both sides of the transaction, the buyer must experience considerable growth in the stock's market value to create a profit.

In comparison, time value from the seller's point of view is an advantage. Knowing that time value declines no matter how the stock's price moves by expiration, the time value premium is a cushion. In the circumstances

described above, imagine the advantage the seller enjoys even when the stock's market value rises. For example, let's say the seller *sells* the $40 call at 5 when the stock is at $39 per share. By expiration, the stock is at $43. This is not enough for the buyer to profit; the 3 points of intrinsic value are still 2 points lower than the premium the buyer paid. However, the seller has a different point of view. As expiration approaches, the concern is that the call will be exercised for the 3 points in the money. The seller can close the position by buying the call to close. Before considering trading costs, the profit is $200. The call was sold for $500 and then purchased for $300. The seller makes a profit, whereas the buyer cannot in the same circumstances. (Sellers can also roll out of this position; more on this later in the chapter.)

With traditional listed options, the lifespan is generally as short as 8 months. While time value is an important part of the seller's equation, greater time value profit potential is found in the LEAPS calls. The LEAPS option has a life span up to 36 months, so option time value is substantially higher. For example, a comparison of various options on Federal Express calls with stock at $87.78 and strike price at 90 (based on closing prices, October 22, 2004, when stock was valued at $87.78 per share) demonstrates the point:

Expiration Month	Option Value	Return	Annualized Return
January 2007	$12.30	14.0%	6.2%
January 2006	$ 8.20	9.3	7.4
January 2005	$ 2.50	2.8	11.2
November 2004	$ 0.85	1.0	12.0

This example shows that the longer period produces a higher yield in time value premium. In the example above, we are dealing strictly with time value. The stock's price is below the $90-per-share strike price level, so *all* premium is time value for the 90 call. The longer you are willing to keep your long stock positions exposed with a short call cover, the greater the time value premium; but as the example also

shows, the yield on an annualized basis tends to be higher for shorter term options.

Element 3: Downside protection. Every investor whose stock has appreciated in value worries about losing the paper profits, so profit taking is more likely as paper profits increase. Well-disciplined conservative strategy tells us that we should not give in to the temptation to speculate on short-term price movements, that is, by taking profits. However, as the old adage tells us, "Wall Street climbs a wall of worry."

Selling covered calls against appreciated stocks is one way to offset your personal wall of worry. The premium you receive from selling covered calls is, in a sense, a way of taking profits without giving up ownership of shares. Those profits are yours to keep in the event of expiration or exercise; and if you close the position by buying the short call, the difference between sell and buy price represents profit or loss. In any of these events, you continue owning stock and receiving dividends.

The net premium you earn from selling calls can be viewed in another way: as downside protection. For example, if your original basis in stock is $40.00 per share and you sell a call for a premium of 4 ($400), that is a 10 percent reduction in your basis. Your adjusted basis in stock is $36 per share, not $40. Viewing covered calls in this way, you achieve a broader range of profit margin, meaning more downside protection. The more premium you receive from selling calls over time, the higher your downside protection.

Tax Ramifications of Covered Calls

Calculating returns without also figuring out the after-tax outcome is not realistic. Not only must you consider a tax liability, you also need to be aware that the tax rules can drastically affect your tax rate on capital gains. The current rules for federal taxes on option trades are more complex than for most forms of investing. For conservative investors, a crucial point to remember is that selling out-of-the-money calls is the least complicated strategy, for two reasons. First, the entire premium consists of time value. Second, the tax rules are simple as long as you restrict your trades to out-of-the-money positions so there is no effect

on the calculation of short-term or long-term capital gains holding periods. However, once you sell an in-the-money call, the whole question gets much more complicated. Here is a rundown of the tax rules governing options:

1. *Rules for option buyers*. If you buy options, the profit or loss can either be long-term or short-term depending on how long you own the long option. The net amount is reported on Schedule D in the year of sale. If the transaction is completed within 1 year or less, it is taxed as a short-term capital gain or loss. If the total holding period was longer than 1 year, it is treated as a long-term gain or loss.

2. *Rules for option sellers*. The rules for option sellers are quite different. The payment you receive at the time of sale is not taxed at that point. The tax "event" occurs when the position is closed or canceled. If you sell an option in one year and it is closed in the next, the tax is not calculated until the latter year. A "close" involves expiration of the contract, exercise, or a closing buy transaction.

One important exception to the general rule governing short-term and long-term tax rates is that if you keep a short call until expiration, it is treated as a short-term gain or loss, no matter how long the position was open. For example, you may sell a covered LEAPS call that does not expire for 3 years. Upon expiration, the gain is considered short-term. If you close out the position with a buy order prior to expiration, it is treated as short-term if it was open for 1 year or less, or as long-term if the holding period went more than a year.

If the call is exercised and your stock is called away, the gain is figured including the premium you received from sale of the call along with the gain on stock. For example, if your capital gain was $2,400 and you received $830 for the option, *all* of the gain—$3,230—is treated in the same manner. That treatment depends on the holding period of the stock and whether or not the call is defined under IRS rules as a "qualified" covered call. Nonqualified covered calls affect the calculation of the long-term gain holding period. As long as the option you sell is at the money or out of the money, the holding period for your stock is not

affected or stopped. If the call is in the money and it meets the definition of qualified, the holding period is suspended. If it is nonqualified, the holding period is done away with and, for the purposes of calculating gain, the time limit begins anew.

> **Example:** You own stock currently valued at $75 per share. You sell covered call options with an $80 strike price. There is no effect on the calculation of the stock's holding period, because the position is out of the money; the holding period for the stock's eventual capital gain calculation continues to run. If you purchased the stock more than 1 year ago, you already qualify for long-term capital gains treatment if and when the call is exercised. If your holding period is less than a year, the time continues to run without interruption.

> **Example:** You own stock currently valued at $75 per share. You sell a covered call in the money (below the current value of the stock). In this case, the status of long-term or short-term gain is determined by the rules for qualification for the call. If the call does qualify, the holding period of stock is suspended as long as the call position is open. If the call does *not* meet the test of qualification, then your stock's holding period is eliminated entirely and starts over. So, if you have owned stock for less than a full year, selling an in-the-money call, even if qualified, is unwise; the time limit stops running as long as the call is open, and if the call is nonqualified, you lose any time already accumulated toward the 1-year long-term holding period.

A qualified covered call must have more than 30 days until expiration. In-the-money calls with fewer than 30 days to expiration are not qualified. For calls with expiration occurring more than 30 days, qualification depends on the stock's closing price and on option strike price level. This is where the calculation becomes complicated. Based on the previous day's closing price of stock at the time the call is sold, it is necessary to calculate the lowest qualified strike price. (Remember, as long as the call is out of the money, there is no need to qualify its status. There is no effect on calculation of holding periods.)

Six Levels of Separation (of Your Money) for Taxes

The following applies only to in-the-money covered calls. There are six separate levels of calculation:

1. *The previous day's closing stock price is $25 or less and the option has more than 30 days to go until expiration.* A qualified covered call must be no lower than one strike price *below* the closing stock price, but no qualified call is counted if the strike price is less than 85 percent of the stock price. This is somewhat mind-boggling, and the average investor has to wonder how such limitations were arrived at, what they are meant to achieve or prevent, and why the calculation has to be so complex. The purpose in limiting qualification is to apply special rules for "offsetting positions" in which risks are reduced so that tax benefits and deferrals are minimized. The qualification price ranges of calls in this classification are summarized in Table 5–3.
2. *The previous day's closing stock price is between $25.01 and $60.00, and the option has more than 30 days until expiration*. A qualified covered call must be no lower than one strike price below the previous day's closing stock price.
3. *The previous day's closing stock price is between $60.01 and $150, and the option expires in 31 to 90 days*. A qualified covered call must be no lower than one strike price below the previous day's closing stock price, but not more than $10 in the money.
4. *The previous day's closing stock price is between $60.01 and $150, and the option expires beyond 90 days*. A qualified covered call must be no lower than one strike price below the previous day's closing stock price, but not more than $10 in the money.
5. *The previous day's closing stock price is greater than $150 per share and the option will expire between 31 and 90 days*. A qualified covered call must be no lower than one strike price below the previous day's closing stock price.
6. *The previous day's closing stock price is greater than $150 per share, and the option expires beyond 90 days*. A qualified covered

Table 5–3 Qualified Covered Calls for Stock Prices of $25 or Below

Stock Closing Price	85%	Qualified Calls Price Range*
$25	21.25	21.25–24.75
24	20.40	20.50–23.75
23	19.55	19.75–22.75
22	18.70	18.75–21.75
21	17.85	18.00–20.75
$20	17.00	17.00–19.75
19	16.15	16.25–18.75
18	15.30	15.50–17.75
17	14.45	14.50–16.76
16	13.60	13.75–15.75
$15	12.75	12.75–14.75
14	11.90	12.00–13.75
13	11.05	11.25–12.75
12	10.20	10.25–11.75
11	9.35	9.50–10.75
10	8.50	8.50–9.75
$9	7.65	7.75–8.75
8	6.80	7.00–7.75
7	5.95	6.00–6.75
6	5.10	5.25–5.75
5	4.25	4.25–4.75
$4	3.40	3.50–3.75
3	2.55	2.75 only
2	1.70	1.75 only
1	0.85	1.00 only

* This range assumes that calls are traded in increments of $0.25.

call must be no lower than two strike prices below the previous day's closing stock price.

The tax rules for writing in-the-money covered calls are clearly complex and potentially costly in terms of tax consequences. Since the long-term gain period can be suspended (for qualified calls) or even eliminated and started over (for nonqualified calls), most conservative investors find no justification in writing in-the-money calls. However, even beyond tax considerations, the question of a call's status dictates that out-of-the-money covered calls make sense. Your advantage as a seller is found in time value premium.

In conclusion, the conservative investor should seek out-of-the-money covered calls exclusively. This simplifies the tax calculations and conforms to the commonsense standards defining a conservative strategy. One exception to this general rule is that if you have large carryover losses, you may not be concerned with taxation of current-year capital gains. Because annual capital losses are limited to $3,000 maximum, a large carryover loss may be used to absorb current-year gains. So, even if you lose long-term capital gains status for exercised stock, that large carryover loss presents a planning advantage; you can engage in in-the-money covered call writing without worrying about long-term or short-term restrictions.

Rolling Forward and Up—Exercise Avoidance

The complexities of the tax rules are easily avoided by utilizing only out-of-the-money covered calls. For conservative investors, this makes good sense even without considering how federal taxes affect the strategy. It can and does affect planning if you intend to create a forced sale using deep in-the-money calls ("deep" means more than 5 points below strike price). Under the definitions in the tax rules, that would convert all stock sales to short-term because the options would be nonqualified.

Rather than *seeking* forced exercise, most conservative investor prefer to keep ownership of the stock and use options to maximize short-term income, hopefully in a repetitive fashion. So, exercise avoidance is a far more attractive strategy for most people. In some instances, a stock's

trading range remains narrow enough that option profits can be achieved with little effort or lost opportunity risk; relatively low price volatility means there is little chance of exercise. However, a stock's price can exceed the strike price, which makes it a viable conservative strategy to avoid exercise.

Since covered call writers have to accept the possibility of exercise, why avoid it? While exercise is a very real possibility, it is often preferable to keep well-selected stocks in the portfolio and to take steps to (a) avoid having it called away, (b) be able to continue writing subsequent calls, and (c) in the event of exercise, maximize income from the transaction. All of this requires employing the *rolling* technique.

The Types of Rolls

In a roll, you close out a current open position and at the same time open a subsequent position that has one of three possible attributes:

1. A roll forward: The new covered call expires later than the old covered call but at the same strike price. Caution: If the stock price moves *above* this strike price, you risk converting your out-of-the-money covered call into an in-the-money call, so the entire tax picture of stock profits changes.
2. A roll up: The new covered call expires at the same time but at a higher strike price. With this strategy, expiration remains the same, but you "buy" another 5 points of profit in the event of exercise. The difference of 5 points may be only 2 or 3 points of cost, so if you expect the stock's price to continue rising, losing a few points in the exchange of one option for another is not a negative in every instance. For example, the net difference in buying out of the current position and opening the new one is 2 points, but you gain 5 points in the higher strike price.
3. A roll forward and up: The new covered call expires later than the old covered call *and* at a higher strike price. This is the most desirable rolling method. It is possible to execute a forward-and-up roll while still producing a net credit. This means more premium income as well as a higher potential exercise price. By

avoiding exercise, you gain more net income, *and* you also gain 5 points (assuming the calls are trading within 5-point increments, as most medium-range stock priced calls do). You give up more time in exchange.

Example: You originally sold a Federal Express call with a strike price of 90 and expiring in January, 27 months away. At that time, the stock was trading at $87.78 per share. You received $1,230 when you sold the covered call. Today, the stock has moved up to $92 per share, and you want to avoid exercise.

If you exchange the January 90 call for an April 90 call, you will receive a net premium because the later call has more time value. However, because the new call is in the money, either you will suspend the long-term capital gain term or, if the new option is nonqualified, the stock's status may return to a zero count, meaning long-term capital gain status will be lost. In the event of exercise within the term of the option remaining open, all gain is treated as short-term.

If you exchange the January 90 for a January 95 call, you gain the 5 points in the event of exercise, which would yield an additional $500. This move would not produce a credit, so you would have to spend money to roll up.

The most desirable strategy is to roll forward *and* up. For example, exchange the January 90 call for an April 95 call. This normally yields a net credit cash exchange, so you receive cash in the roll. At the same time, by closing out the original position, you create a current-year loss for tax purposes. (If you had the position open for a year or less, it is treated as a short-term loss, and if longer than a year, as a long-term loss). So, from a timing standpoint, you can create positive cash flow in one year accompanied with a tax loss and defer a gain until the following year by rolling to a different call.

The Exercise Acceptance Strategy

A final strategy worth mentioning is the *exercise acceptance* strategy. Most conservative investors are content to keep their long-term stocks and to use well-selected out-of-the-money calls to create additional profits along with downside protection. However, what if you would be happy to see your call exercised?

> **Example:** You bought shares of Federal Express at $72 per share 2 years ago. That stock has current market value of $87.78 per share. You would be happy to sell today and take a 15.78-point long-term capital gain. However, you could sell a covered call expiring in 27 months and gain even more. Today, the 27-month 90 calls sell for $1,230. If exercised, you could keep the $1,230 *and* earn capital gains.

Selling covered calls is a profitable alternative to simply owning stock. You can also force exercise by intentionally writing in-the-money calls. However, because this ensures the loss of long-term status of capital gains when exercise occurs, the strategy has to be studied on an after-tax basis. When you have a large carryover loss from previous years, it could be an effective way to create large option premium gains and absorb unused carryover. Your annual net-loss deduction is limited to $3,000, so if you have a $30,000 carryover, it would take 10 years to use it up. It is desirable to absorb that loss as soon as possible; so in this case, creating a large gain in stock and options by writing deep in-the-money covered calls (virtually ensuring exercise) would be beneficial because the loss of long-term status is sheltered by the carryover loss.

Remembering to Limit Yourself to Conservative Strategies

We consider covered calls a conservative strategy because no increased market risk is involved. The alternative, simply owning shares of stock, has an inherent market risk, and discounting the basis by generating call premium reduces the basis in stock, thus reducing the net market risk. Covered call writing does involve lost opportunity risk, but in reviewing likely scenarios for a number of stocks, we know that such

lost opportunities occur in a minority of cases, while consistent high returns from covered calls are certain.

In the next chapter, we explore interesting ways to use options as an alternative to the outright purchase of shares of stock. Contingent purchase strategies make options powerful tools, especially during volatile market periods.

6

ALTERNATIVES TO STOCK PURCHASE

Most investors start by looking for stocks they want to buy. But with options, there are many other ways—safer ways—to enter the market. Contingent purchase *using either long calls or short puts is a powerful weapon in your strategic arsenal. Options can also be rolled forward to avoid exercise or applied to recover paper loss positions. This chapter explores these ideas and demonstrates how the ratio write can be converted into a risk-free conservative strategy.*

Options open up a range of *contingent* strategies. Covered calls are interesting because they are the ultimate low-risk form of contingent sale. If and when exercised, the covered call is designed to produce current income consisting of both dividend income and call premium.

Contingent sale—represented by the covered call strategy—is the most conservative use of options. However, you can also use options to leverage capital in several forms of contingent purchase. As an alternative to buying shares of stock, you can either buy calls or sell puts with the intention of acquiring stock before expiration. This strategy is appropriate when the market is volatile or when marketwide prices fall significantly. You recognize the buying opportunity, yet you do not want to risk capital on stock that might continue to fall even more.

Because time is invariably an issue, LEAPS options are more likely to work in contingent strategies. The ability to leave positions open for as long as 3 years makes LEAPS well suited for this range of strategies, whereas traditional listed options do not survive long enough for contingency to mature. The risks are simply too great that the option's life will end before stock prices move adequately. This is especially true when you employ contingent strategies with long calls.

Leverage and Options

The contingent-purchase strategy is based on the assumption that a number of conditions exist at the moment:

1. *The market is volatile; prices are down.* The most likely market condition for contingent purchase is when prices have moved downward or are highly volatile. You want to be in the market but at you hesitate to take equity positions, fearing ongoing volatility.

The dilemma is a combination of (a) volatile conditions and (b) concern that you will lose opportunities if you don't act now.

2. *You have capital available to open option positions.* You must have capital available either to purchase calls or to leave on margin in the event that short puts are exercised. Looking to the future, if you do decide to exercise long-call positions, you need capital to complete your purchase as well. So, on the long side, you need to be able to buy calls—preferably in several different stocks—and later, to exercise. On the short side, you will be required to deposit funds to buy stock (equal to the purchase price minus put premium you earn or, on margin, a portion of the purchase price, often one-half). These requirements naturally limit the extent of contingent purchase in which you can afford to engage at any given time.

3. *You want to open contingent purchase positions in several stocks.* The importance of diversification as a conservative model cannot be overemphasized. The basic theory behind contingent purchase is that you do not know whether a particular stock will rise or fall in the future, so you select stocks that meet your fundamental criteria, and you open contingent purchase positions in that range of stocks. If you can afford to engage in contingent purchase on four or five stocks at the same time, you increase your chances that they will end up being profitable decisions. The essential starting point is that stocks you pick must be stocks you would want to purchase if you were simply buying shares. In any contingent-purchase strategy, you limit your activity to stocks that meet your conservative standards based on fundamental analysis.

4. *You believe that contingent purchase—given current circumstances—is an appropriate conservative strategy.* This strategy, like all market strategies, must be assessed in context and as part of a larger portfolio strategy. It is inadvisable to place *all* of your capital in options as part of a contingent-purchase strategy; your conservative portfolio should contain a foundation of strong growth stocks. Contingent purchase can be used to fix

the price of additional shares of stock you already own or to ensure your right to buy shares in new stocks if and when price movement goes in the right direction. But given market conditions and your personal rules for picking stocks, the underlying issues have to be appropriate. If you select stocks for contingent purchase based only on option pricing, you violate the basic rules for portfolio management. Conservative investing is always based on equity value of the stock, and options are considered only as a secondary possible strategic means for acquiring shares.

Applications of Contingent-Purchase Strategies

Contingent purchase is a way to fix the price of stock if and when you decide to buy shares (in the case of calls) or if stock is put to you (in the case of short puts). In either case, the basic rules remain:

1. You would be pleased to acquire stock at the indicated strike price.
2. You can afford to buy the stock.
3. You have performed fundamental analysis and found the company suitable.
4. The contingent-purchase strategy is appropriate, and you are comfortable with it as an alternative to simply buying shares at the current price.

Just as any options strategy is wrong when based solely on option premium levels, using contingent purchase without intending to buy stock is wrong as well. Contingent purchase is appropriate only if you intend to buy shares, and your purpose in employing the strategy should be to limit current risk and not to incur more risk. If you are following four stocks that meet your criteria, but you are not sure that all will increase in value, contingent purchase allows you to leverage capital and limit your risk exposure. Even if only some of those stocks increase in value, you can profit from the overall contingent-purchase strategy. By fixing

premium prices, you keep purchase as one possible outcome without undertaking excessive market risk. You may exercise long calls (or have short puts exercised), the options can expire worthless, or the positions can be closed before expiration.

Contingent-purchase strategies require watching so that you know when to act and when to wait. This does not mean you have to track prices on a daily basis, but frequent monitoring can help you to time subsequent decisions to maximize profits or to reduce undesired losses. Depending on the contingent strategy you employ, time may work for or against you. The use of LEAPS makes the range of contingent-purchase strategies realistic, and working with options lasting as long as 36 months gives you a lot of flexibility. In the market, 36 months is a very long time and a lot can occur in that period. If you look back over the last three years and review the changes in market conditions and prices of individual stocks, you will appreciate the potential of long-term contingent purchase investing.

Later in this chapter, we discuss how even a long position's cost can be mitigated with offsetting long-term short positions. Given the right circumstances, you may recapture the entire cost of the long position without incurring additional risk.

It is risk, when all else is considered, that ultimately determines whether or not you employ contingent-purchase strategies. No matter how profitable and safe a strategy seems to be, it has to work as a good fit for your conservative profile. This limits the kinds of strategies you will be willing to use. Option strategies come in all shares and sizes, and many are highly speculative.

If you pick options incorrectly or ignore the underlying risks, then using option strategies simply won't work for you. But the contingent-purchase strategies are sensible and conservative, assuming the following:

- The fundamentals of the underlying stock meet your standards.
- You consider the strike price a good price for the stock.
- The funds are available to open positions and, later, to exercise.

The Long-Call Contingent-Purchase Strategy

The first contingent strategy involves buying calls instead of stock. This would be a speculative move if the only purpose was to create profits in call premium. However, as long as your intention is to buy shares, this strategy fixes your future purchase price at the strike price. If you buy calls in several stocks and only some increase in value, you should exercise those calls only on profitable positions. Contingent purchase limits your capital risk. For example, if you spend $500 on call premium and the stock later falls 15 points, you can never lose more than your $500 investment. However, if you had bought 100 shares of stock, you would suffer a loss of $1,500. So, the primary advantage of the long-call contingent-purchase strategy is limitation of risk. Its primary risk is loss of value, notably time value.

If you buy LEAPS calls with a long time until expiration—which is essential in order for this to qualify as a conservative strategy—you pay for the time value. We demonstrate later in this chapter how you can mitigate the long-call cost. For now, the question of whether the contingent purchase is worthwhile is determined by (a) call premium, (b) strike price of the underlying stock, (c) time until expiration, and (d) your desire to fix the price for possible future purchase. One of the more difficult situations occurs when you know that the current price of stock is attractive, but you either cannot afford to buy or are concerned about short-term volatility. Buying LEAPS calls as a contingent-purchase strategy overcomes this dilemma.

Diversifying Exposure with Several Stocks in Play

The strategy should involve several different stocks. This diversifies your exposure in a long-option position, and the very reason you are considering contingent purchase is that you do not know what future price levels will be. So using several well-selected stocks make sense as part of a coordinated strategy.

Here is how a contingent-purchase program might work using long calls: we review our 10 model portfolio stocks. Table 6–1 summarizes these stocks with available LEAPS calls.

Table 6–1 Stocks for Contingent Purchase Using Long Calls

Name of Company	Symbol	Current Price*	January 2006 Calls			January 2007 Calls		
			1	2	3	1	2	3
Clorox	CLX	$55.91						
Strike prices 0/70/xx			2.85	—	xx	5.10	2.30	xx
Coca-Cola	KO	$ 38.90						
Strike prices 40/45/50			2.55	1.05	0.25	4.00	2.15	1.15
Exxon Mobil	XOM	$ 48.70						
Strike prices 50/55/60			3.10	1.45	0.60	4.50	2.70	1.60
Fannie Mae	FNM	$67.65						
Strike prices 70/75/80			6.20	4.30	2.85	8.30	—	4.80
Federal Express	FDX	$87.78						
Strike prices 90/95/100			8.20	5.90	—	12.30	10.10	8.10
General Dynamics	GD	$100.01						
Strike prices 100/110/120			9.90	5.60	2.95	13.90	9.60	6.40
J.C. Penney	JCP	$38.20						
Strike prices 40/45/50			3.90	2.15	—	5.70	—	2.50
Pepsi Cola	PEP	$48.48						
Strike prices 50/55/60			2.90	1.20	0.35	4.30	2.30	1.15
Washington Mutual	WM	$38.43						
Strike prices 40/45/50			2.55	1.10	0.40	3.10	1.65	0.80
Xerox	XRX	$14.32						
Strike prices 15/17.50/20			1.75	0.80	0.30	2.55	1.60	0.90

* Stock prices and option premium values based on closing prices as of October 22, 2004.

Source: Chicago Board of Exchange (CBOE).

The table lists a range of possible long calls. Two possible future dates are selected for all five stocks based on our October 22, 2004, review date: January 2006 (15 months in the future) and January 2007 (27 months out).

If you bought one call for each stock, the overall price would depend on the proximity between current market value and strike price. If you compare the three strike prices selected for each stock to current market

price, you can see how these values change. The first selection in each target expiration is at or near the money, and the second and third strike prices are farther out of the money. If you decided to buy one call for each stock given these differences, your total cost would be as follows:[1]

January 2006	
At or near the money	$4,390
One strike price increment up	2,455
Two strike price increments up	1,120
January 2007	
At or near the money	$6,375
One strike price increment up	4,140
Two strike price increments up	2,840

This cost summary shows how time value interacts with the proximity between current value and strike price. While you can vary the selection of calls for each stock, our illustration makes the point. To buy a single call for each of the five sample stocks, you would pay the amounts shown. The calls at or near the money have the greatest potential for price appreciation, so the premium costs are higher as well.

[1] Note: Not every call has an available listing on any given close, so we estimated some values in calculating these costs. We estimated the value of a January 2006 Clorox call at 1.00, although no such call was listed as available; and we calculated 0.50 value for a third call, although we only analyze two calls for Clorox. For 2007, we estimated a third-level Clorox call at 1.00. For Fannie Mae's 2007 call with 75 strike, we used 6.00 to approximate the value because no such call was listed on the close. We used 2.00 for the Federal Express 100 call expiring January 2006. Finally, we estimated two values for the J.C. Penney 45 calls that were not available on the close: 1.00 for the January 2006 call and 3.00 for the January 2007 call.

In order for the basic contingent-purchase strategy to be profitable, you need a net increase in market value equal to or greater than the investment level. For example, if you purchased a January 2006 call at 90 or Federal Express (costing 8.20), the stock would need to rise to $98.20 per share before your breakeven point (not counting transaction fees). You would need the stock's value to rise *above* that level to justify the long-call contingent-purchase strategy. While this is a disadvantage, you have a lot of time for the outcome to materialize—15 months for the 2006 calls or 27 months for the 2007 calls.

Reducing Contingent Purchase Risks

Contingent purchase risk can be reduced in a variety of ways. Here are three ideas:

1. *Use a higher strike price.* Table 6–1 shows three strike price levels. If you preferred the third increment over the first or second strike prices, your investment basis would be lower because there would be more points to go to expiration. Looking at the 2006 columns, you would spend $35 rather than $290 to buy the higher strike price Pepsi calls, for example.
2. *Invest in longer term calls.* For example, you gain a full year buying 2007 calls instead of 2006; in the case of Exxon Mobil, the added cost of the first-increment calls is $140, but the added time is significant.
3. *Reduce the cost of long calls by using short-call offsets.* The most effective way to cut risks and make contingent purchase a profitable strategy is to write short calls against your long-call positions. This secondary strategy is explained in the next section.

The Covered Long Call

The major risk involved with long-call contingent purchase is the same as for all long-call strategies: If expiration occurs before an adequate price increase occurs in the underlying stock, it is extremely difficult to make a profit in this manner. So, *risk* involves the same

problem as every other long-option strategy: time works against you. Even if the stock's market value rises, you still need to overcome the time value problem.

There is a way to achieve this. Assuming that some or all of the stocks in this example increase in value before expiration, you can employ a secondary strategy designed to recapture the premium cost of the long call. The basic strategy is to sell a call with a higher strike price and earlier expiration than the long positions. Does this work out?

Let's assume that you bought one of each of the closing strike price 27-month calls for the 10 model portfolio stocks and invested $6,375. You hope that during the next 27 months, the price will appreciate enough in these 10 stocks to make the contingent purchase a profitable strategy. At the same time, you would like to get back some or all of the $6,375 you invested in long LEAPS calls. To make this illustration comparable, let's assume that all 10 stocks were to increase between 5 and 10 points in the near future—not enough to ensure profitability on the long-call purchases, but enough to put the secondary strategy into effect. To estimate the future value of calls given the increased market value of the underlying stock, we review current premium values for calls 5 points above current value. For example, in the case of Pepsi Cola, where we are involved with a range of calls in the 50-strike price range, we review calls with current strike prices of 55. In the case of each stock, we can compare the long-call cost to current value of one price increment above those positions. This is summarized in Table 6–2.

In this table, we estimate future premium values based on two assumptions. First, the market value of each underlying stock will rise by 5 to 10 points, and second, the current premium values for calls with strike prices 10 points lower represent fair estimates of future premium value. For example, in the case of Pepsi, we estimate the value of the 55 short call by using the current 45 call's value.

Extrapolating Future Strike Prices

In making this comparison, we have to assume that the relative value of calls will remain about the same in the future as it is today. Because future strike prices of the short positions are higher than the corresponding

Table 6–2 Stocks for Short Sale Against Long LEAPS Positions*

Name of Company	Symbol	Current Price	January 2007	January 2006
Clorox 60 long call	CLX	$55.91	2.85	5.10
Clorox 70 short call			1.00	2.30
Coca-Cola 40 long call	KO	$38.90	2.55	4.00
Coca-Cola 45 short call			1.05	2.15
Exxon Mobil 50 long call	XOM	$48.70	3.10	4.50
Exxon Mobil 55 short call			4.50	2.70
Fannie Mae long call 70	FNM	$67.65	6.20	8.30
Fannie Mae short call 75			4.30	6.00
Federal Express 90 long call	FDX	$87.78	8.20	12.30
Federal Express 95 short call			5.90	10.10
General Dynamics 100 long call	GD	$100.01	9.90	13.90
General Dynamics 110 short call			5.60	9.60
J. C. Penney 40 long call	JCP	$38.20	3.90	5.70
J.C. Penney 45 short call			2.15	3.00
Pepsi Cola 50 long call	PEP	$48.48	2.90	4.30
Pepsi Cola 55 short call			1.20	2.30
Washington Mutual 40 long call	WM	$38.43	2.55	3.10
Washington Mutual 45 short call			1.10	1.65
Xerox 15 long call	XRX	$14.32	0.80	2.55
Xerox 17.50 short call			0.30	1.60
Total long position costs			42.95	63.75
Total short position profits			27.10	41.40

Note: Stock prices and option premium values based on closing prices as of October 22, 2004 (source: Chicago Board of Exchange, CBOE). Estimated short-call premium values are based on current premium of calls with strike prices 5 points below indicated levels; and assuming that underlying stock values were to rise five to 10 points.

original long positions, exercise is a no-risk outcome. If the short calls are exercised, they are offset by 5 points lower value in each of the long calls; those long calls could be surrendered to satisfy the call in each instance. For example, if you bought an Exxon 50 for $310 and later sold an Exxon 55, exercise would create a 5-point profit for you. You would use your long call to offset the exercised short call. The risk is eliminated because of the following:

- Each long position provides cover for the short positions.
- Exercise of short positions creates a profit of 5 points between the short and long positions.
- Expiration of short positions occurs 12 months prior to long positions; if the short calls expire, you end up with continuing long positions at a zero cost basis.

This illustration is based on the belief that the market value of these shares will grow within the next 27 months. Hopefully, if your stock selection skills are good, your contingent purchase experience can take the course shown in the example. When you enter into a contingent-purchase strategy at a time when marketwide prices are low, chances are better than average that this course of price change will occur. In the examples shown, the average spread for 15-month calls was 63 percent, meaning that—based on the belief that this ratio remains approximately the same—you could expect to recapture 63 percent of your long cost through writing short calls. (This may be affected to a degree because short calls have earlier expirations.) The ratio for 27-month calls was 65 percent, about the same.

The long-call contingent plan with short-call offset is an example of how your disadvantage can be turned to an advantage. When you are long in calls, you have a time disadvantage. Using higher strike price, shorter expiring calls flips the time value in your favor. You buy time value on the long side, but you sell it on the short side. Given the example in which market value of underlying shares has grown, this is a good method for making the strategy work well. You preserve the original locked-in strike price, but you recapture your long-premium investment.

The strategy assumes that the higher strike priced short calls will expire worthless. You risk exercise in this strategy, but that would produce a 5-point profit as long as you use the next increment of strike prices for the short positions. You can also roll forward to avoid or defer exercise. However, remember that this strategy remains conservative only as long as the short position does not expire later than the long position.

Using the Forward Roll Effectively

Rolling forward is attractive when the underlying stock's price is rising. The purpose in rolling is to avoid exercise; at the same time, the short positions cannot expire later than the long position. What should you do if and when exercise appears imminent?

For example, let's say you originally purchase a Coca-Cola 40 call expiring in 27 months and later sell a 45 call scheduled to expire 3 months earlier. Today, the stock's market price is 2 points above the short call's strike price. You could roll the short position forward 3 months to defer exercise; you could also roll forward and up to the next strike increment; that puts the call out of the money by 3 points and creates a situation in which both short and long calls expire at the same time. This is not desirable because you will probably want to exercise the long call *after* the short call has expired.

An alternative is to roll both long and short positions. Roll the short call forward and up to escape the in-the-money status; also roll the long position forward. By closing the current position and opening one with a later expiration, you will have to pay additional premium. However, as long as premium levels for the long and short positions offset one another within a close range, this adjustment is worthwhile. You replace the short-call strike price with a new short call 5 points higher. This avoids exercise or, in the event of exercise, creates a 5-point increase in future profit.

Another choice is to replace the current long position with a later expiring call and also increase to the next higher strike increment. Because this position is already in the money, you can probably buy the higher call at a reduced intrinsic value of 5 points. So, while you increase your future purchase price at exercise by 5 points, you save 5 points today by

replacing the existing long call with a higher strike price. The four choices in this situation, illustrated in Figure 6–1, are as follows:

1. Roll the short call forward to a later expiring position.
2. Roll the short call forward and up to the next strike increment.
3. Roll the short position forward and up, and roll the long position forward.
4. Roll both positions forward and up.

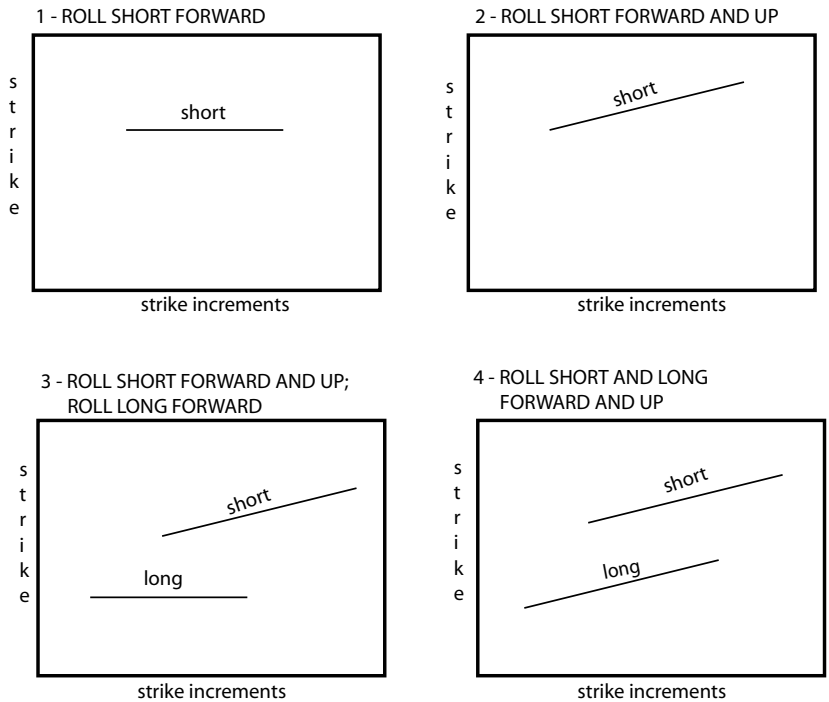


Figure 6–1 Rolling strategies, contingent purchase cover.

The viability of these rolling techniques depends on current option premium values. As a general rule, rolling forward produces higher income because you are "buying" more time. Rolling up is likely to offset that time advantage, especially when you move from in-the-money

to out-of-the-money status. The, In picking a rolling strategy, consider the net balance between credit or debit, compared to the advantages gained by avoiding exercise or changing strike price.

Short Puts and Contingent Purchase

You are not limited to long LEAPS calls to enter a contingent-purchase strategy. You can also use short puts. When you sell puts, you are required by your brokerage firm to have adequate funds on deposit to satisfy exercise of the put, if and when that occurs. The benefit of the put strategy is that money flows to you rather than away from you. Time value is also an advantage. You receive a premium for selling the put, and that premium value declines over time, even when the stock's value falls to in-the-money price levels. Time value may offset intrinsic value to a degree.

Using the same stocks as examples for reviewing long-call strategies, we can use puts to set up a short-position contingent purchase. We begin with a review of the strike price. If you would be happy to acquire shares at that price, based on the fundamentals, then the short-put is an excellent strategy. It can go in one of two possible directions. First, the stock does not move in the money, in which case you can later buy the puts to close at a profit or allow them to expire. Second, the stock's market value declines below strike price; in this event, you can either wait for exercise or roll forward and down to avoid or defer exercise. When you roll forward and down, you expose yourself to more time, but you reduce the basis in the event of later exercise by one strike price increment.

The Value of Selling Puts

Table 6–3 summarizes a series of puts below current market value for the 10 stocks in our model portfolio.

In the section concerning long calls, diversification was sensible because the long position was employed. In a strategy with short positions, the same rationale applies in the sense that you do not know

Table 6–3 Stocks for Contingent Purchase Using Short Puts

Name of Company	Symbol	Current Price*	January 2006 Puts			January 2007 Puts		
			1	2	3	1	2	3
Clorox	CLX	$55.91						
Strike prices 50/45/40			2.75	—	0.45	3.80	2.40	1.40
Coca-Cola	KO	$ 38.90						
Strike prices 35/30/25			1.55	0.50	0.10	—	1.20	—
Exxon Mobil	XOM	$ 48.70						
Strike prices 45/40/35			2.30	1.10	0.45	3.30	1.80	0.90
Fannie Mae	FNM	$67.65						
Strike prices 65/60/55			6.80	4.90	3.40	—	6.60	—
Federal Express	FDX	$87.78						
Strike prices 85/80/75			6.30	4.50	—	8.60	6.70	5.10
General Dynamics	GD	$100.01						
Strike prices 100/90/80			8.60	4.60	2.30	11.10	7.20	4.20
J.C. Penney	JCP	$38.20						
Strike prices 35/30/25			2.90	1.45	0.60	—	2.35	—
Pepsi Cola	PEP	$48.48						
Strike prices 45/40/35			2.10	0.95	0.40	3.00	1.70	0.85
Washington Mutual	WM	$38.43						
Strike prices 35/30/25			2.80	1.30	0.50	3.80	2.05	—
Xerox	XRX	$14.32						
Strike prices 12.50/10/7.50			1.00	0.50	0.20	1.45	0.75	0.35

* Stock prices and option premium values based on prices as of October 22, 2004.

Source: Chicago Board of Exchange (CBOE).

which stock will rise and which will fall in market value. At the same time, you probably would not prefer to acquire shares of all 10 stocks in our example if current market value declined below the indicated strike price levels. You can use the short-put contingent-purchase strategy on any single stock or on a combination of issues, depending on your willingness to leave funds on deposit and also based on the attractiveness of this strategy.

If you decided to short puts on all of these stocks, you could also vary the strike prices and expiration dates. In Table 6–3, we present 15-month and 27-month expirations to demonstrate how the time value in short puts can work to your advantage. While you would not have to select puts with the same expirations, we can judge this strategy by making comparisons. For example, if you restricted your analysis to the medium-level strike price, you would receive premiums totaling $2,080 (for the 15-month puts) or $3,275 (for the 27-month puts).[2] The net transaction would not involve receipt of those premiums, however. The net margin requirement would simply be reduced by those levels. In this sample mid-range strike price, the net purchase amounts are summarized in Table 6–4 on page 150.

These net payments would have to be made only if and when the puts were exercised. So, in determining whether it makes more sense to employ 15-month or 27-month puts, you need to realize—in this example, at least—that the difference between these two studies is very close.

The Value of Shorter Exposure Terms

Given the shorter time span of the 15-month mix of puts, it is preferable to employ these for several reasons:

1. *Less time is required for leaving funds on deposit.* The money you have to leave on deposit in the event of exercise—whether involving one stock or all five—will be committed a full year less if you use the shorter expiring options.
2. *Turnover profits are higher.* By using puts with closer expiration, you are free to repeat this strategy if and when the short puts expire. As a result, you can create more short-term profits or contingent purchase opportunities.
3. *Time value premium decline more rapidly.* Time value premium tends to evaporate with greater speed in the months prior to

[2] Because not all indicated strike prices reported availability, we estimated some values. For Clorox, we estimated a 1.00 premium for the January 45 put.

Table 6–4 Purchase Prices, Net of Short-Put Premium

Company	Put Strike Price*	Symbol	15-Month Exercise	27-Month Exercise
Clorox	45	CLX	$4,500	$4,500
Coca-Cola	30	KO	3,000	3,000
Exxon Mobil	40	XOM	4,000	4,000
Fannie Mae	60	FNM	6,000	6,000
Federal Express	80	FDX	8,000	8,000
General Dynamics	90	GD	9,000	9,000
J.C. Penney	30	JCP	3,000	3,000
Pepsi Cola	40	PEP	4,000	4,000
Washington Mutual	30	WM	3,000	3,000
Xerox	10	XRX	1,000	1,000
Total exercise cost			$45,500	$45,500
Less premiums received			–2,080	–3,275
Net purchase prices			$43,420	$42,225

* Stock prices and option premium values based on closing prices as of October 22, 2004.

Source: Chicago Board of Exchange (CBOE).

expiration than in preceding months. Thus, the 15-month puts lose time value much more rapidly than the 27-month puts within the coming 15 months. If you determine that it would be better to close and replace these short positions prior to expiration, it would be more profitable with the 15-month puts.

We return to the same question we ask for all strategies. Is it conservative? Does this strategy suit your risk profile, and would you be happy to acquire stock on the basis of exercised short puts? While stock values would be lower in the event of exercise, your basis would be discounted by the premium received. You would probably not wish to enter short contingent-purchase positions on a portfolio of 10 stocks all at the same time; this example simply illustrates the overall effect of doing so. The strategy is more applicable to most situations by looking at a single stock and calculating the likely outcomes based on its price movement.

For example, if you sold the January 2006 Federal Express 80 put, your premium income would be 4.5 points, so your basis in the stock upon exercise would be $75.50 (before calculating net trading costs). As long as the exercise occurred at a time when the stock's market value was between $75 and $80 per share, this contingent purchase would not create a paper loss. However, even when exercise does create a loss, you can employ rescue strategies to offset that loss.

Rescue Strategy Using Calls

Let's say you sell a put as part of your contingent-purchase strategy and the put is exercised. It creates a paper loss. What can you do to recover in this situation?

The solution depends on the point value of the net loss. In the preceding example, we showed how the Federal Express put exercise would not create a net loss if the stock's market value was between $75 and $80 per share. However, what if market value declined below that level?

The first strategy to employ is the roll forward and down to avoid or defer exercise. For example, once the Federal Express stock fell below strike price, you could replace the 80 put with a later expiring 75 put. Even so, if the stock were to continue to decline, it could eventually be exercised. Market prices may also fall suddenly, so you do not always have the opportunity to employ a rolling strategy. Exercise could occur without advance warning.

Rescue Strategy Based on Smart Stock Choices

When you end up with stock put to you above current market value and your basis still produces a net loss, you have three choices. First, you can simply wait out the market.

Second, you can sell a covered call to offset the paper loss. The danger in the covered call position is that it may be exercised. You do not want to set up a situation in which exercise would create an overall net loss, so premium level of the call has to be adequate to offset the paper loss, trading costs, and income tax on your gain. If that is not possible, then it makes no sense to write a call.

The third choice is to employ a combination of average-down strategies and short calls. This strategy assumes that you are willing to buy more shares of the stock. Remember, the underlying assumption for all of these conservative strategies is that (a) you have prequalified the stock, (b) your hold continues to apply, and (c) you would be happy to acquire more shares. For example, let's assume that your net basis in Federal Express is $75 per share and that current market value is about $70 per share. If you were to buy 200 more shares, your average basis would be $71.67 per share. What is the current value of the 75 calls, given various expiration dates? In our previous examples, we saw that Federal Express 15-month calls brought about 6 points of premium even when strike price was 7 points in the money (compare Table 6–1: Federal Express market value at $87.78, 15-month 95 call valued at 5.90).

In this example, with average cost of $71.67 per share, we may also assume we could locate a 75 call available for about 6 points in premium. So, if you bought an additional 200 shares at 70 on top of the current value of 75, average basis would change to $71.67 per share, and you could then sell three calls with strike price of 75, receiving about 6 points for each:

Total basis in stock, 300 shares @ 71.67	21,500
Less premium received, 3 calls @ 6	–1,800
New net basis (65.67 per share)	19,700

In the event of exercise, the 300 shares would be called away at $75 per share compared to your adjusted basis of $65.67 per share. Total profit before trading costs and taxes is $9.33 per share, or $2,799. This rescue strategy is illustrated in Figure 6–2

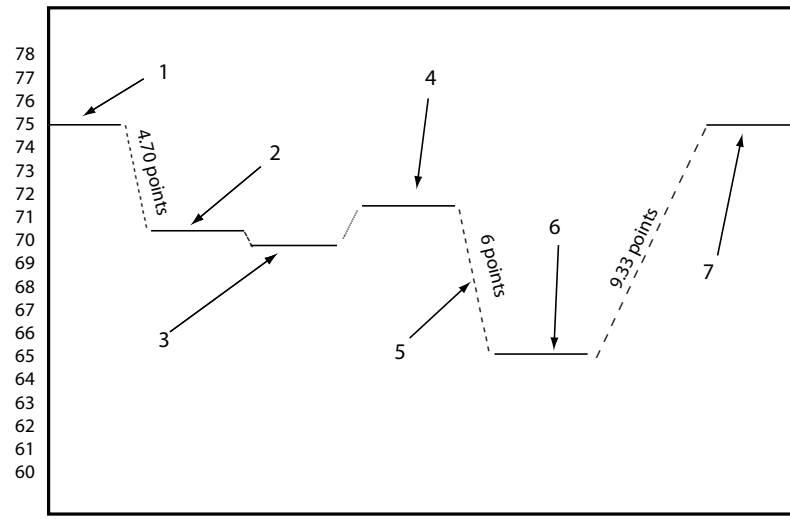


Figure 6–2 Rescue strategy, average down with covered calls.

The strategy has seven segments, as reflected in the figure:

1. The original put was exercised with a strike price of $75 per share.
2. The net basis in acquired shares was $70.30: strike price less $4.70 premium.
3. An additional 200 shares are purchase at $70 per share.
4. The new net basis is $71.67 per share.
5. Three 75 calls are sold at 6.
6. The new basis is $65.67 per share.
7. The calls are exercised at $75, creating a profit of $9.33 per share.

Programming a Profitable Result

Even though the sequence of events depicted in Figure 6–2 included a significant point decline in the stock, when the stock's price recovered and the last calls were exercised, the outcome was profitable. But what if the stock's price did not recover? The new basis (step 6) was $65.67 per share, but what if current market value remained at $60. In this situation, if the calls expired worthless—which would happen as long as market value remained below $70 per share—you would be free to sell the shares, simply hold for long-term appreciation, or use more option strategies.

There is a tendency to think about stocks in terms of current market value in relation to past market value. If a stock is at $79 per share and over time it falls to $60, the general opinion is that its value has fallen. So *value*—as defined in terms of market price—tends to be a relative idea. However, as the rescue strategy reveals, you can forget about relative value and use options to reduce your basis. This adjusts the perception that the stock has fallen from the original cost of $79 to $60; if you reduce your basis to $65.67 through various options strategies, the realistic gap is only 5.67 points, not 19 points. When combined with price averaging, the use of covered calls can turn a loss situation into a smaller paper gap or even into an overall profitable situation.

The Ratio Write—Before Adjusting to Make It Conservative

A somewhat less conservative strategy is the ratio write. However, risks can be eliminated so that the ratio write fits within the definition of conservative risk. First, an explanation of the unadjusted strategy: the ratio write is a method in which you partially cover your calls. For example, if you own 300 shares and you sell four calls, it is a 4-to-3 ratio write. You could view this as having three covered calls and one uncovered call, or as a 75 percent coverage ratio. The higher the number of shares, the lower the risk. For example, 400 shares with five uncovered calls is an approach with less risk than 300 shares with four uncovered calls.

The advantage of the ratio write is that it increases premium income with only moderate increase in risk. A variation on the ratio write is to

spread strike prices over a range. For example, if your basis in 400 shares of stock is $22 per share, and the stock is now worth $21, you may decide to write five calls; you could employ a combination of two calls with striking prices of $25 and three with later expiring strike prices of $30. The risk is relatively low for two reasons. First, all calls are out of the money, and the two upper-level strike prices are 9 points higher than the current market value. Second, two of the calls will expire sooner, and that eliminates all of the market risk for the remaining calls, also eliminating the uncovered portion of the ratio write. If the stock's price exceeded the strike price of 25, you could roll forward and up on any or all of these positions to avoid exercise.

In this example of the ratio write, the strategy could be rolled forward and up indefinitely to avoid exercise and to keep risks at a manageable level. Even if the 25 calls were exercised, the 30 calls could either be closed or rolled; so unless the stock's price soared quickly past the higher strike price, risk of exercise would not be immediate.

Converting the Ratio Write into a Conservative Strategy

Even with this logic, the ratio write continues to present risks that contradict your risk profile. The solution involves using a method for reducing worst-case risk by offsetting the exposed top-side uncovered call. That is achieved by going long on a higher strike price call to offset the uncovered position.

For example, consider once again the Federal Express range of options. Let's assume that you own 300 shares with an original basis of $80 per share; today's price is $87.78 per share. The month is October. You enter a ratio covered call position involving four calls, but you also buy an additional call, which essentially eliminates *all* of the ratio risk. The following represents using actual closing values as of October 22, 2004:

Sell two January 2005 90 calls @ 2.50	$500
Sell two April 2005 95 calls @ 2.15	430
Buy one April 2005 100 call $ 1.05	–105
Net credit	$825

In this situation, you have created a combination yielding 9.4 percent return in 6 months, which annualizes out at 18.8 percent. Half of the exposure lasts 3 months until January; the other half goes out 6 months, until next April. The exposed additional 100 shares are protected by the April 100 long call. In the worst-case scenario—all short positions exercised—you could use the long call to satisfy assignment of the fourth short call, costing you $500 (the difference between the 100 strike of the long call and the 95 strike of the unprotected short call). However, your overall cash credit is $825 on these positions, so you would still have a net of $325 to cover transaction costs. Remember, this is worst case; it assumes no rolling forward, and it also assumes that the stock's price rises above $95 per share prior to expiration. In addition, exercise would represent capital gains—assuming your basis of $80 per share—or a profit of $3,500 ($2,000 on two exercised 90 calls and $1,500 on one exercised call at 95). The overall outcome for exercise of all these positions, without counting dividend income, transaction costs, or taxes, would be as follows:

Capital gain, 200 shares with basis of $80, exercised at $90	$2,000
Capital gain, 100 shares with basis of $80, exercised at $95	1,500
Loss, uncovered 95 call versus long call at 100	–500
Net premium income received	825
Total gain before costs and taxes	$3,825

This worst-case analysis assumes rapid increase in the stock's price, necessitating the purchase of an "insurance call" at the top of the transaction. However, splitting the ratio between different expiration dates and strike prices provides a degree of protection in most situations. It may not be necessary to assume worst-case outcome and still remain within your risk profile range. You may consider this worst case because stock was called away, so the ratio write is appropriate based on the same rules for any form of covered calls: You have to be willing to accept exercise as one of

the possible outcomes. In the example, using the single long call at the top of the transaction eliminates the ratio-write risk entirely, while leaving you exposed to the net covered call exposure.

Ratio Writes for Rescue Strategies and Higher Current Returns

The ratio write is not only a useful rescue strategy for depressed stock; it may also serve as a powerful tool for creating higher returns from options with minimal risk, even when the price of the stock is below your original basis. However, to ensure the safety of your position, the split of expiration dates and strike prices is recommended.

Rescue Strategy Using Puts

You can create a rescue strategy with short puts in place of the purchase of additional shares. Given the previous example, refer to step 3: an additional 200 shares are purchase at $70 per share. Remembering that short puts can be used as a form of contingent purchase, an alternate rescue strategy can be employed to reduce average price and create additional downside protection through put premium income.

The rescue strategy is modified in this example. Let's say that you sold three 65 puts in this situation. This means that if the market value of the stock were to fall below $65 per share, you would risk exercise. Let's also assume that you could get about 5 points for each put, which would reduce your basis in the additional 200 shares down to $60 per share. Your average price on all 300 shares would then be $63.43 ($70.30 on 100 shares plus net $60 on an additional 200 shares).

The Risk of Continued Price Declines

The difference in this variety of the rescue is that the net basis remains about the same, but there is a further chance for price decline. This is why you should employ such a strategy only when acquisition of more shares

is desirable based on your fundamental analysis of the stock. If the additional two puts were exercised, you would revert to the original rescue strategy and write covered calls. However, using short puts allows you to create the lower net basis without necessarily having to acquire more shares. If the short puts expire, you create a reduced basis in the 100 shares by virtue of put premium. In that instance, you began with a basis of $70.30 and received $1,000 for the two puts. If the puts expired worthless, then your net basis in 100 shares would be $65.30. Stock would be above $65 per share at that point (we know this because the puts would not be exercised as long as stock value was at or above strike price).

The net outcome of this situation is that you have 100 shares at $65.30 net basis. The stock resides somewhere at or above that level, and you are free to sell, hold, or use as cover for additional option strategies. If we compare this outcome to the one summarized in Figure 6–2, profit can be substantial. That rescue assumed that the 65 calls were exercised, so market value would be higher than $65 per share. In the expired put version of the rescue strategy, you end up owning 100 shares with a net basis of $65.30, which is 10 points below the call strike price.

The advantage of having 300 shares is clear: profits would be three times those of the 100-share rescue. However, using short puts may be more conservative because you would not be required to buy shares unless prices decline below strike price. Given that average share prices are continually reduced through averaging down, the question becomes, Are you willing to buy more shares as market prices decline? As long as you believe that the stock's long-term value remains strong, this may be desirable; or you may conclude that, as strong an investment as it is, there is simply too much volatility. You would prefer, then, to create a situation in which the net basis is lower than current market value so you can sell shares at a profit.

Both varieties of the rescue strategy achieve this goal. Remember, this example began with an illustration of a stock that fell from the mid-80s down to $70 per share or lower. So, if you can reduce your basis to create a profitable outcome, the rescue strategies are valuable ways to manage your portfolio. The decision to use calls or puts depends on your attitude toward the company, available resources, and your willingness to wait out the stock's market trends.

Covered Calls for Contingent Sale

Looking beyond contingent purchase, we also have to consider contingent-sale strategies. The most conservative form of contingent sale is the covered call write. When you own 100 shares and you sell a call, you invite the possibility of exercise. One strategy—writing deep in-the-money calls to create exercise intentionally—makes sense, but *only* if you first consider the tax implications.

For example, using the previous example of Federal Express, with the stock at 87.78, current-month calls (based on October 2004) are available for 12.70 (November 75) or 7.90 (November 80). These are virtually all intrinsic value, so if you want to create exercise, it makes little difference which one you pick. Strike prices are approximately 5 points apart, but so are option premium levels. Every point of movement in stock price will be matched point-for-point in changes in option premium, so short-term changes in the stock could create immediate profit opportunities as an alternative to exercise.

Picking the Right Conditions for Forced Exercise

The strategy of creating a forced exercise as a form of contingent sale makes sense under two conditions. First, your original basis in the stock should be low enough that the exercise price would create a profit. For example, if you purchased the stock at $72 per share, selling the 75 call would combine a 3-point capital gain plus a 12.70-point profit on the call, with total return before trading costs and taxes of $1,570.

The second condition is an awareness of the tax rules. When you sell in-the-money covered calls, you may lose long-term status for taxing of capital gains. In the event of exercise, the entire transaction could be taxed at the short-term rate. For example, if you owned Federal Express for many years and your original basis was $20 per share, selling at a strike price of 75 would be a 55-point gain. The difference in long-term and short-term rates could be substantial, perhaps even offsetting the option premium with increased tax liability. However, if you have a significant capital loss carryover, current-year short-term gains will be absorbed by the carryover loss. In fact, creating current-year gains may

be a smart tax move, because annual loss limitations are only $3,000, and it could take many years to completely use up a capital loss carryover. For some unfortunate ex-stockholders of Enron, WorldCom, or any number of dotcom companies, the carryover loss may never be entirely absorbed unless future gains are realized to offset those losses from year to year.

One of the great advantages to covered call writing is the ability to use well-selected stock as cover for a string of covered call profits. This strategy—based on the fundamental value of the stocks in your portfolio—enables you to keep stock in most circumstances, while enhancing current income. This can work over many years if you write out-of-the-money calls, use high-dividend stocks, reinvest your short-term income, and avoid exercise. If stock is worth holding onto for the long term, it is worth avoiding exercise through a series of rolls forward and up. The forward roll increases the time value, while roll-up increases the strike price so that if exercise does occur later, you will increase your stock profit by that point spread as well.

The possible alternatives to outright stock purchase demonstrate how you can use options to leverage your capital, employ conservative techniques to offset time value risks, and put rescue strategies into effect when a stock's price moves downward. The covered long-LEAPS-call strategy even employs shorter expiring short calls to balance out long-position time value. All of these strategies make it possible to deal with volatile market conditions, improve your portfolio diversification, and lock in prices on a wide range of stocks that you might want to buy in the near future.

The next chapter expands on these concepts to show how options can be used to offset paper losses and to maximize conditions in down markets.

7

OPTION STRATEGIES IN DOWN MARKETS

Some options moves qualify as conservative strategies—as long as the purpose is to manage the portfolio rather than to simply speculate. You can use long puts or calls to manage price change, and short puts—with their limited risk—present great opportunities as long as they are used solely when you would be happy to acquire more shares of the underlying stock. This chapter provides a conservative context to these ideas, explains how to evaluate your stock positions when prices have fallen, and examines options strategies to reduce market risk.

The chronic problem every investor faces is the inevitability of cycles. The stock market experiences these cycles in a variety of ways. The severity and duration of a cycle determines the success of your program, if only because timing is so crucial. Even though you invest with the long term in mind, you prefer to adhere to the advice to buy low and sell high—instead of the other way around. Chapter 6, "Alternatives to Stock Purchase," showed how to devise a rescue strategy when stocks move in an unexpected direction as part of a contingent-purchase plan. In this chapter, we offer a variety of additional option strategies worth considering.

Thinking Outside the Market Box

What characterizes the "crowd mentality" of the market? Fear and greed often have more to do with decision making than does prudent or analytical, strategic thinking. While an academic approach—usually taken by someone with no money at risk—may dictate against fear and greed, it is far more difficult to ignore those emotional responses to market trends when you have capital at risk.

Knowing this, how can you proceed? How can you manage and resist fear and greed to avoid making the common mistakes? Investors often describe themselves as conservative, but they act irrationally when sudden and unexpected trends emerge. They may also say they base decisions on the fundamentals, but they watch index movements, short-term price trends, and other newsy but not especially useful forms of information. Valid fundamental data is less exciting than current-day price movement and far more difficult to convey in a 10-second television or radio news bite. As a consequence, the vast majority of news that investors receive through television and radio is useless. The print media are more useful to the extent that stories go into greater depth and may be more analytical. Coverage by the leading financial newspapers and

magazines is superior to television and radio media, primarily because the venue is more suited to the kind of fundamental and analytical information investors need.

Remembering the Fundamentals

The success of your conservative approach to investing is based partially on the quality of research and information you have available. You may use one or more of the dozens of free Internet Web sites and subscription services; print services, including newspapers and magazines; and stock market services. The amount of time and money you are willing to spend determines how information-based your decisions are; ultimately, going directly to a company's Web site and reviewing quarterly and annual financial statements is a fine starting point. This assumes that you can glean information from the financial information provided by corporations and their auditing firms. To a large extent, as long as you understand how to interpret the important indicators, you can make sound decisions.

A sensible way to narrow your field of investigation is to identify a few high-quality fundamental indicators and then investigate companies meeting your criteria. This is preferable to listening to analysts and Wall Street personalities, and then buying stocks they recommend, often without fundamental reasons for doing so.

If you want to act as a contrarian in the way you pick stocks, you have to first ask yourself if the market efficient. If so, does the *majority* tend to make sensible market decisions? In fact, the majority often does not make good decisions, so a contrarian approach to stock selection makes sense. It may be the ultimate contrarian approach to define yourself as a conservative investor and at the same time use options to manage market price swings.

The long-term conservative point of view is that taking a long stock position in well-chosen companies is the primary, and perhaps the only, method for investing success. However, this approach may not be conservative at all. If you entrust your portfolio to short-term price gyrations, you are at the mercy of a chaotic and ever-changing market. It makes more sense to view your portfolio in two segments. First, the

foundation of your conservative portfolio will always be defined with well-selected companies whose long-term value ultimately dictates where their stock prices will head. Attributes of such companies include consistent growth in dividend payments, strong and consistent capitalization, and competitive growth in revenues accompanied by consistent earnings. Second, you can manage market gyrations with the selective use of options, which is prudent and conservative as long as the purpose in using options is not speculative and as long as option richness does not dictate which stocks you hold or buy. Options are a secondary tool to help you manage market volatility, increase short-term profits, protect paper profits, and devise rescue strategies when your portfolio experiences paper losses. All of these goals are conservative.

Conservative Versus Speculative: Remembering the Difference

Timing is crucial in the use of options. A speculator is likely to devise strategies and select options based primarily on implied volatility and a perception of how stocks will react in the short term. However, because speculators leverage their capital in high-risk scenarios, they do not appreciate the long-term goals that you develop as your first priority. The use of options in the two instances—speculative and conservative—are vastly different. You use options successfully if you time strategies to take advantage of short-term price changes in stocks you own, to protect paper profits, or to average prices when your stock values have declined but you continue to believe those companies are quality investments.

Options can help you to overcome the short-term timing problem, enabling you to acquire more shares when prices are low. When prices are high, options are effective at protecting paper profits without having to sell shares. Using long puts, you can offset price decline by selling puts at a profit or by exercising them to actually sell shares at the market top. If you use covered calls, you can actually cash out your paper profits without selling stock. Such examples of options used to time price changes in your stock make the point that many conservative strategies can help you to build wealth in your portfolio while resisting the temptation to think conservatively but act speculatively.

The Long Put: The Overlooked Option

The tendency to favor long calls over long puts—a common phenomenon among speculators—arises from the tendency for investors to be optimistic. Realistically, we know that market values rise *and* fall, but those who speculate in long options invariably believe that a stock's price will begin rising immediately after they buy a call. It is relatively rare for speculators to consider buying puts in the belief that the stock will fall in value.

This generalization applies to most, but not all, speculators. However, because so much emphasis is placed on calls, long puts often are overlooked and at times undervalued as a result. Your conservative risk profile may present situations in which buying long puts not only makes sense, but conforms to your standards as well.

When the Stock's Price Rises

There are two scenarios worth considering. First, and most likely, is one in which a stock's price rises quickly. The temptation is to sell shares at the market top and take profits. This is a dilemma. You want to keep shares for the long term, but you also want to protect paper profits. If you don't want to sell shares, buying long puts is a sensible alternative. You do not need to spend a lot of money on long puts either. If you expect a correction within 2 to 2 months, you can probably find an out-of-the-money put for a relatively small premium with a 2- to 3-month expiration.

For example, assume that you purchased shares of various stocks and they have appreciated. We use the 10 stocks in our model portfolio to summarize available puts expiring in 27 months, as shown in Table 7–1.

In each case, the examples cover a range of current price strike prices from the closest increment to the stock's price, and two strike prices below that price. For example, Pepsi Cola is currently worth $48.48 per share, so we looked for puts with strike prices of 45, 40, and 35. If the Pepsi market value declines below those strike price levels between the current (October) date and expiration (27 months later), we can either sell the puts at a profit or exercise them. If we sell at a profit, we offset lost paper profits with a current option profit. If we exercise, we sell

Table 7–1 Long Puts to Protect Paper Profits

Name of Company*	Symbol	Current Price	27-Month Put Premium		
			1	2	3
Clorox	CLX	$55.91			
Strike prices 55/50/45			5.80	3.80	2.40
Coca-Cola	KO	$38.90			
Strike prices 35/30/25			—	1.20	—
Exxon Mobil	XOM	$48.70			
Strike prices 45/40/35			3.30	1.80	0.90
Fannie Mae	FNM	$67.65			
Strike prices 65/60/55			—	6.60	—
Federal Express	FDX	$87.78			
Strike prices 85/80/75			8.60	6.70	5.10
General Dynamics	GD	$100.01			
Strike prices 100/90/80			11.10	7.20	4.20
J.C. Penney	JCP	$38.20			
Strike prices 35/30/25			—	2.35	—
Pepsi Cola	PEP	$48.48			
Strike prices 45/40/35			3.00	1.70	0.85
Washington Mutual	WM	$38.43			
Strike prices 35/30/25			3.80	2.05	—
Xerox	XRX	$14.32			
Strike prices 12.50/10/7.50			1.45	0.75	0.35

* Stock prices and option premium values based on closing prices as of October 22, 2004. Source: Chicago Board of Exchange (CBOE).

Pepsi shares at the strike price. For example, if we purchase one 45 put per 100 shares and the stock falls to $39 per share, we can exercise before the expiration deadline and sell shares at $45 per share, the put strike price. That would produce a pretransaction cost profit of $3 per

share (6 points between market and strike values minus the cost of $3 per share).

As you can see, low-cost puts can be used to produce protect profits. You can employ long puts to protect paper profits and to provide yourself the choice between exercising and selling those puts if and when prices retreat. You can protect against price decline in the case of Pepsi stock below $45 per share for premium cost of $300 (or below $40 per share, at a cost of $170 per put; or below $35 per share, for only $85 per put).

If you have bought shares of stocks that tend to rise and fall on average with marketwide direction, a rapid price increase could create an overbought position in many, if not all, of your portfolio issues. So, the use of puts to protect paper profits is a prudent method for dealing with short-term price trends. Because the assumed market trend is short term, a 27-month protection period is a very long period in terms of market price trends. Rapid price spikes tend to correct within a very short timeframe, so if you have read the market correctly, this strategy—even given its limited life span—is both realistic and conservative. Shorter term options provide protection for shorter time periods, often with advantageous pricing. For example, compare the prices for Pepsi 45 puts at various expirations:[1]

Months to Expiration	Premium Cost
27	$300
15	210
6	100
3	50
2	25
1	20

1 Based on closing bid prices, October 22, 2004; source: CBOE delayed quotes, *www.cboe.com.*

You can see from this comparison that, depending on the amount of time you want to have the protection, the premium cost varies considerably. You can buy 27 months of downside protection for $300 or 2 months for only $25 (before transaction costs).

Balancing time and cost enables you to identify a practical means for managing short-term price fluctuation in your long stock positions. The alternative is to ignore short-term price gyrations and simply hold stocks for long-term appreciation. This is also a conservative approach. Because short-term price movement is often irrational and not caused by any fundamental changes in the companies themselves, you can either avoid management of short-term price changes or use options to exploit price spikes and to create the opportunity for additional profits without substantial capital risk.

The strategy of buying puts to insure paper profits (or even to provide a safe floor for your purchase price of shares) is a system for managing short-term volatility while continuing to execute the long-term conservative policies you have established in your portfolio. This is not mere speculation; it is a method for protecting current value at a relatively small cost, just as is purchasing fire and casualty insurance on your home even though the chances of a loss are slim. In the case of your portfolio, it is doubtful that properly selected stocks will experience large price declines, but when market prices rise too quickly, a short-term correction presents an opportunity to protect profits for relatively small cost.

When the Stock's Price Falls

In the second scenario, long puts are used when market prices fall rapidly. In this situation, you may recognize a buying opportunity on an intellectual level, but you also fear further declines. So, you use long puts to provide an immediate floor for stocks in your portfolio. In cases of extreme short-term volatility, you can combine long puts with long calls. Long puts protect your capital value in case of a further decline; at the same time, a price rebound would make the long calls profitable.

The two scenarios for using long puts—when your stock prices either rise or fall rapidly—are based on the premise that you want to protect

the long value of shares you own. This qualifies both strategic uses of long puts as conservative in nature. Speculators have no interest in protecting long stock value; in fact, the true speculator does not even own stock unless it serves as vehicle for executing some related strategy, such as covered call writing. Were you to play market price swings, you would be defined as a speculator. However, the strategies described here are designed to serve as insurance for your paper profits, reduction of further losses, or an opportunity to take paper profits if and when they materialize. The thoughtful selection of long puts makes sense in these extreme market positions. It can also make sense to buy puts for insurance. For example, if you buy shares and you want to guarantee that the market value will not fall below your net basis, using puts as insurance makes sense even when market prices are not especially volatile. It is conservative to insure long positions. A basic assumption is that your stocks will rise in value. Realistically, you also know that you could be wrong, at least in the short or intermediate term.

Short Puts: A Variety of Strategies

In a down market, you face the dilemma well known to all investors. You want to take advantage of buying opportunities, but you're not sure where the market is going. The conservative point of view should be to recognize down markets as the chance to pick up more shares of your favorite stocks. This not only represents a bargain; it is also a way to create new paper profits. When you buy cheap shares, you lower your overall basis in a stock, and that improves long-term as well as current income potential.

Given the fear factor in down markets, you may hesitate to put a lot of capital into shares. What if the market continues to fall? What if it takes months instead of days to recover? Anyone can look back over past pricing patterns and identify the obvious timing of purchases, but it is far more difficult to do in advance. This is where short puts are especially valuable. There is always the possibility that stock prices will fall and not recover. This danger exists whether you use options or not; it is a well-known investment risk. The value of using options is that strategies may exploit *temporary* price declines. When prices fall and remain

down, options reduce the losses (if you use short options) or provide the opportunity for recovery with limited additional cost (if you use long options). For many conservative investors facing possible losses, using options in short strategies is more appealing than going long, because at the very least, it involves receiving payment instead of spending more capital.

When you sell puts, you receive the premium payment. If the stock's market value falls below strike price, the put is exercised. You can avoid exercise by rolling forward and down; or you can accept exercise and have 100 shares put to you. However, in down markets, selling puts can be a valuable method for acquiring additional shares of stocks at a reduced price, thus reducing your basis in stock through the profits you earn from selling puts.

Conservative Ground Rules for Short Puts

Following are seven conservative ground rules for selling puts in down markets:

1. *Sell puts on stocks you already own.* Conservative standards state that you will buy and hold stock that meets your fundamental criteria. If those criteria continue to hold even when the stock's market value falls, then you may view selling puts as a sensible and conservative strategy. This gives you the potential to pick up more shares and lower your average basis as well as to increase current income.
2. *Select strike prices based on support level.* The stocks you select for writing puts, like all stocks, are likely to trade in a predictable price range. Conservative stocks normally have a fairly narrow trading range and strong support. But when marketwide price declines occur, your conservative stocks may spike downward temporarily.
3. *Sell puts that provide a minimal rate of return.* What rate of return will you earn on short puts if exercised? As a *general* rule (and not a universal one) you may want to look for puts that represent a 10 percent return on strike price. Identifying percentage helps you to

avoid a common problem: choosing a higher dollar amount without comparing rates of return. For example, let's say that you have two stocks on which you want to write puts, but you've decided to go with only one. Current market value of one stock is $40 and the other is $65. The $65 stock has options available at 5, and the $40 stock has puts at 4. The $500 premium on the first stock is higher than the $400 premium on the second. However, on a percentage basis, you would be wiser to pick the second stock and take the 10 percent return. This is a better return than the 7.7 percent return on the $65 stock. (This comparison assumes the same time to go until expiration, because annualized returns can also change the comparative picture.)

4. *Coordinate strike price and current market value.* In picking short puts, you want to gain the best possible premium, but you also want to avoid exercise. The farther out of the money, the better you avoid exercise, but the lower the premium will be. So, you may look for puts with strike prices between 3 and 7 points lower than current market value. Why this range? It is the most likely range for creating premium profits. If the strike price is any closer to the current market value, a relatively small decline in the stock will put you in the money and could lead to exercise. If strike price is farther out, you are less likely to generate adequate premium to justify the short position exposure.

5. *Pick expiration time based on your market perceptions.* How long should you leave yourself exposed in the short position? The longer until expiration, the greater the time value; the shorter that time, the lower the risk. The key is to compare those puts offering the desired 10 percent return with proximity between strike price and current market value. How long an exposure period is required? Is it worthwhile? How long do you estimate it will take for the market to rebound? The decision has to be based on your willingness to remain at risk.

6. *Pick exit levels and/or roll levels when you initiate the transaction.* You may set a rule for yourself. For example, you may decide that once the stock's market value declines to within one point of the strike price, you will roll forward and down to avoid

exercise. You may also decide that if and when the put's premium value declines to one-half its original value, you will close the position and take a profit, perhaps then replacing the short put with another. For example, if the stock's price rose while the short position was open, you may be able to sell a put with a higher strike price, generating additional premium profits.

7. *Plan out secondary strategies in the event of exercise.* What if the price of the stock falls below the strike price, and before you have the opportunity to roll out of the position, the put is exercised? In that case, you need a rescue strategy. One conservative choice would be to do nothing. If the put exercise reduces your overall basis, you will have more shares at a lower overall cost. Remember, as long as the fundamental value of the company is strong, this is a short-term situation and not a problem. In fact, it is a long-term advantage because your average price of shares has been reduced. Another secondary strategy may involve either selling additional puts or reverting to a covered call strategy. With more shares, you can write more covered calls. The basic rule is that if exercised, the covered call position must produce an overall net profit in the stock (after calculating the net basis due to average costs and further reduced by short-put and short-call premium). In that case, writing out-of-the-money calls (which are 100 percent time value) further reduces your net basis. Exercise can be subsequently avoided in a rising market by rolling forward and up.

An example shows how this strategy may work. Table 7–2 summarizes the annualized returns you would earn by writing several different puts on Federal Express. The annualized yield is calculated by first calculating the simple rate of return between option premium and strike price, then reflecting that return as if the position were open for 12 months.

Comparing Rates of Return for Dissimilar Strike Prices

The comparison between different strike prices and expiration dates is complex, even when the returns are annualized. When you consider the ramifications of different strike prices with the potential for exercise in

Table 7–2 Short-Put Annualized Rates of Return

Federal Express Expiration and Strike Prices*	(A) Premium	(B) Simple Return	(C) Months to Expiration	Annualized Return**
January 2005				
85	2.15	2.5%	3	10.0%
80	0.95	1.2	3	4.8
75	0.40	0.5	3	2.0
70	0.15	0.2	3	0.8
65	0.05	0.1	3	0.4
April 2005				
85	3.30	3.9%	6	7.8%
80	1.90	2.4	6	4.8
75	1.00	1.3	6	2.6
70	0.55	0.8	6	1.6
65	0.25	0.4	6	0.8
January 2006				
85	6.30	7.4%	15	5.9%
80	4.50	5.6	15	4.5
75	—	—	15	—
70	2.25	3.2	15	2.6
65	—	—	15	—
January 2007				
85	8.60	10.1%	27	4.5%
80	6.70	8.4	27	3.7
75	5.10	6.8	27	3.0
70	3.90	5.6	27	2.5
65	2.90	4.5	27	2.0

* Stock prices and option premium values based on prices as of October 22, 2004. Source: Chicago Board of Exchange (CBOE).

** The calculation to annualize involves the following two steps:
Divide premium (Col. A) by strike price to arrive at simple return (Col. B)
Annualize with the following formula to reflect return on a 12-month basis:
[col. B ÷ col. C] × 12

mind, it changes the comparison completely; for example, if the stock continued to decline, you would prefer to take exercise at the lowest possible strike price, given the desired rate of return. The comparison between returns at various strike prices provides a valuable analytical tool for making an informed, conservative decision. For example, with Federal Express at $87.78 per share, the exercise risk of an 85 strike is considerably greater than the same risk for an 80 put. The 3-month 85 put yields annualized 10.0 percent; the comparable 80 put yields 4.8 percent, but also contains 5 points less market risk (the difference between strikes of 85 and 80).

Table 7–2 can be useful in limiting risks and establishing your own standards for which puts to sell. The table demonstrates that spreading the risk out to longer expirations does increase the *dollar* amount of premium; but on an annualized return basis, shorter term options yield far better returns. Consider the case of the 80 puts. The 3-month option yields the same annualized rate as the 6-month option. Yield for 15 months is only slightly lower. In this comparison, the risk of the 3-month option is less because the exposure period is shorter. Thus, the turnover of short positions could be entered more frequently. This represents a lower risk for another reason: if the market value of the stock were to change in either direction in the next 3 months, you could select different options in future short strategies based on the desirability of maintaining a gap between current market price and strike price that meets your standards. In our example, we compare returns for strikes of 80, which is 7.78 points below current market value. So, for example, in selecting options with the short-put strategy in mind, you could limit your exposure to puts with strike prices between 5 and 10 points below current market value and with 3 to 6 months until expiration.

When you consider the alternative—buying shares at today's price to average down your basis—you immediately realize that selling the put is more profitable but requires less capital (limited to margin requirement minus premium).

When selecting short puts, plan an exit or roll strategy and also identify a rescue strategy in the event the stock declines in value. To address these two contingencies, you may sell the 80 put and decide that if and when the stock's market value declines to $79 per share or below, you

will roll forward and down—replacing the short put with a later expiring put. That would extend the proximity of market value and strike price, and build in a margin of safety. You will likely be able to roll forward and down at a credit (or perhaps at a small cost when trading expenses are considered). The value of rolling is not based on the exchange of premium cost or benefit, but more on the reduction of potential exercise price by 5 points.

Three Types of Rescue Strategies

A sensible strategy is to develop a contingency plan to rescue the stock if and when your put is exercised. (This is comparable to an exit strategy or other contingency plan you employ in managing your portfolio even if you don't use options.) If the short put is exercised, it will mean current market value is below the strike price, so you would end up with more shares at a reduced basis off your original cost but at a basis *above* current market value. Your rescue strategy in this case may take three forms:

1. *Take no further action.* You can wait out the market in the belief that while the downward price movement is lasting longer than you thought, the stock's value will rebound. Because you continue to believe the stock is a quality investment, there is no long-term problem with waiting out the market. Having sold the put, you have reduced the overall basis in stock, and its value will eventually rise. Because you averaged down your basis, it will take less time to return your investment to breakeven or profitable status.
2. *Sell short puts again.* You can repeat the strategy in the belief that the price level is lower than the stock's long-term support. In severe marketwide price declines, this situation can occur, but it does not necessarily signal a disaster. It can be viewed as yet another opportunity to average down your basis. However, you also need to decide when to stop shorting puts. A conservative standard may dictate that you not continue to buy stock as prices fall, regardless of where you believe the stock's lowest likely level resides.

3. *Sell covered calls.* You have acquired additional shares, and this provides the potential to revert to a covered call strategy. Your true basis in stock is the average share price of all shares you own, minus put premium you received. Can you sell covered calls on those shares and—in the event of exercise—produce a net profit? That is an important first question because if it is not possible, then it makes no sense to invite a net loss upon exercise. Second, you must select calls on the same basis as your selection of puts: for example, limiting your positions to a predetermined minimum annualized yield and number of points out of the money.

Using Calls in Down Markets

Using puts to average down your basis and acquire more shares—or to increase income when those short puts are not exercised—is one way to manage your portfolio in a down market. You can also use calls based on the same arguments.

Long calls can be used to maximize your position as long as you remember these guidelines:

1. *Buy calls on stocks already qualified or owned.* The conservative use of long calls has to be based on the fundamental value of the underlying stock, so limit your call-buying activity to stocks you already own and intend to hold for the long term or to stocks you have already qualified based on your risk profile and conservative investing standards. If you intend to exercise the calls when the stock's price rises, do so to increase your holdings while averaging down your basis.
2. *Buy calls only when the stock's price is low.* Timing is everything with options. Speculators often pay little if any attention to the underlying stock; they are concerned solely with option values and potential for short-term gain. However, because all of your decisions are related to your long-stock portfolio (and perhaps to its potential expansion), you should buy calls only when the underlying stock's price has declined dramatically.

The "normal" trading range for the stock should be well above current market price, increasing the probability that the decline is a spike, a reaction to a marketwide decline or to a temporary decline in the sector. In those cases, a reversal will occur in the short term, so timing your call purchase to such moments is essential.

3. *Identify and define an exit strategy.* When will you close the long-call position? In some cases, your purpose will be strictly to exploit a short-term price decline in a stock you have qualified, so you will want to know exactly when to sell the position and take your profit. For example, you may decide to sell if and when premium values will produce a post-trading-expense doubling of your investment; or you may also identify a specific premium price level. If you intend to exercise the call (again, assuming the stock's price rises above the call's strike price), at what level will you exercise? While you might decide you want more shares today, you could change your mind in the future based on emerging fundamentals.

4. *Select strike prices with your intent in mind.* You should select a strike price you consider an attractive price for the stock based on the trading range prior to the price decline. This is premised on your belief that the stock's market value will return to that level, so strike price has to be selected with exercise in mind. If you decide later to just sell the call instead of exercising it, that is a subsequent decision. At the onset of the position, you want to pick a strike price that will average down your basis when you exercise. For example, if you bought 200 shares at $84, and today's price is $72, which strike price is most appealing? If you buy one 75 call and later exercise it, your average basis is $81. If you buy two 75 calls, your average is $79.50. Another way to average down involves dramatically increasing your holdings using long calls. For example, if you originally bought 100 shares at $84 and today sold two 75 calls, your exercised average basis would be $78. So, if the stock's market value at the time of exercise was $78 or above, then you would have recaptured all of the paper losses associated with the price decline.

The combination of long puts and short calls in this situation can be quite interesting. Consider the possible outcomes: the cost of the long call may be covered by the premium you receive for the put. If the market price rises, the call grows in value and the put becomes worthless, so you benefit for no cost or low cost. If the market price declines further, the put may be exercised (or rolled forward and down) and the call expires worthless. However, even though the call becomes worthless, the zero cost (or close to zero cost) of the position provides increased upside potential with no more downside risk than you would experience by simply selling puts.

5. *Coordinate cost and expiration so that the strategy is logical.* In picking long calls in down markets, limit the premium cost, since all of the premium is in time value, and allow enough time until expiration that the stock can rebound to its previously established trading range. This suggestion assumes that you limit your long-call positions to out-of-the-money calls and that you have a sense of how long it may take for prices to return to normal levels. If you have survived through previous market-price changes, you know that short-term movement is usually an overreaction to current economic news and that the situation tends to correct itself in a very short period. However, you also know that investors are cautious during volatile periods, and a reversal of a price decline can take more time. So, picking the right call is a matter of judgment.

Calls Used for Leverage, but Not for Speculation

The selection of calls in your conservative portfolio is a matter of leverage rather than speculation. The difference is based on ownership of the stock or on restricting the activity to the short list of stocks you have analyzed and qualified. It makes sense to have a list of stocks you would purchase if given the chance, and a price decline is the perfect opportunity to buy shares—assuming you are right about the timing and extent of the decline itself. Given this uncertainty, using long calls is more conservative than putting a large sum of capital into the purchase of shares. With calls, your potential loss is limited to call premium, and the poten-

tial profit is theoretically unlimited. When you buy stock, the same profit potential exists, but you risk further price decline if you time market volatility incorrectly.

The question of using long calls is a problem when you consider how time value affects price movement. If you have only a few months to go before expiration, you need the stock to appreciate enough to both create intrinsic value and offset time value. Consider the case of buying a call 4 points out of the money and paying a premium of 3. By expiration, the stock must increase 4 points just to reach zero and another 3 points just to break even. In addition, you pay trading costs when you buy and again when you sell. If you use the average of a half point for the complete two-part trade, you need the stock to rise 7.5 points just to break even. If you want to double your premium investment, the stock must rise 10.5 points by expiration. With listed options, this is a problem; but with LEAPS, the potential use of long calls gives you much greater flexibility.

Rather than limiting your selection of calls to the next 8 months or so, you can also consider using LEAPS calls of up to 36 months. The longer the time until expiration, the more you pay, but if the stock's price is depressed and you're not sure how long it will take for prices to return to normal levels, LEAPS calls can provide flexibility by allowing more time for strategies to season. An analysis of a range of prices, as done in Chapter 6, reveals this flexibility. In Chapter 6, Table 6–1 lists a series of long calls with contingent purchase in mind. The same list demonstrates the potential for long calls as part of a rescue strategy during down markets. It shows that for relatively small risk, you can lock in the share price in anticipation of a change in market price. LEAPS calls extend your period significantly.

You can also employ the ratio-writing technique in down markets to speed up your recovery and to close the gap between net basis and current market value. For example, if you own 400 shares and you write five calls, your ratio will produce more income than strict one-to-one coverage provides. (You eliminate the uncovered call risk by purchasing a higher long call.) While ratio writing is one method to rescue paper loss positions, with well-chosen stocks your premise for holding them is a belief that prices will recover in the near future. Other rescue techniques

are more prudent and contain less market risk; a ratio write may turn out to be a poor strategy if the stock's market value rises more rapidly than you expected and you end up exiting the position through exercise of stock you would rather keep.

Evaluating Your Stock Positions

Whenever a stock's price falls, you have to ask whether the decline is part of a short-term technical correction that will reverse in the future. If so, then the buying opportunities should not be ignored. However, there is also the chance that the stock's volatility and technical safety have changed. Why?

Changes in volatility can be caused by a number of company-specific reasons. Marketwide volatility is better understood because investors tend, as a whole, to think of the market singularly. This can be a deceptive point of view, because a long-term quality investment may demonstrate short-term volatility, so it may appear higher risk than you thought it was. A temporary problem can be ignored or exploited with the well-timed use of options.

Rescue Strategies and Opportunity

A conservative options strategy makes sense as part of a rescue strategy or as a way to take advantage of down-market buying opportunities. Such opportunities are often best dealt with using options because that is a safer and more conservative approach than buying more stock. Timing, in all investment strategies, is both the key to profits and the potential gateway to losses. However, conservative investors, referring faithfully to in-depth analysis of the fundamentals, are less likely to fall victim to short-term price changes. Your decisions, if based on conservative investing standards and well-established fundamental indicators, will likely be more successful than the average technical investor's, because you do not buy into short-term trends: you prefer to exploit those trends to find real bargains in market pricing.

Another question has to be asked, however: Have the fundamentals changed? Among the many causes of stock-specific volatility, a plateau of a growth trend is one of many signals that a growth period is slowing down or even stopping. All trends eventually flatten out; nothing continues in the same direction forever. If you look back over stock market history, you realize that companies like Polaroid—with heavy dependence on now-obsolete photo technology—lost its market leadership position because its products did not evolve with the times. Some experts believe the same problem may be happening to Kodak in the digital camera industry. Similar changes have happened to many industries due to either exhaustion of markets or technological change. Railroads, steel, public utilities, dotcom companies, and retail sectors have all changed drastically over the last 50 years. New technology and the Internet, new modes of travel, energy efficiency, and changing methods of consumer shopping are examples of how the past growth companies have been replaced or forced to evolve. Today's leaders must change with ever-emerging technology or they too will become obsolete.

Examining the Causes of Price Volatility

Fundamentals do change, often for reasons beyond anyone's control, so when stock market volatility changes, the related volatility in conservative investments cannot be automatically blamed on the marketwide trend. The fundamentals deserve another look. Among the possible causes for individual stock volatility are the following:

1. *Cyclical movement.* Many sectors have predictable cycles, and at various points in those cycles, price volatility is predictably higher than at others. As one of the many factors worth reviewing, even the most dedicated fundamental investor will benefit by studying cyclical price trends. Coordinated review of fundamental cyclical change with those price and volume trends may reveal a correlation that explains the change in volatility and perhaps even signals immediate buying (or selling) opportunities in that stock.
2. *Economic and political developments.* Some sectors are more sensitive than others to outside changes. Beyond marketwide

cycles, also consider the cause and effect of economic and political situations. For example, a slight change in interest rates affects utility stock values, and world events can drastically impact the value of airline stocks.

3. *Basic revenue and earnings changes.* A strong growth curve usually combines a consistent rate of growth in revenues, well-controlled ratios to cost and expense levels, and growing dollar amounts of earnings with a consistent net return. These fundamental indicators are perhaps the most popular for spotting long-term trends and, of equal importance, a slow-down or reversal in those trends. Assuming that you have faith in the accuracy of reported operating results, you probably rely heavily on these trends.

4. *High core earnings adjustments.* Core earnings—the revenue and expenses related specifically to a company's primary product or service—are not always the only items reported on operating statements. Noncore items may include proceeds from the sale of an operating subsidiary or fixed assets; one-time adjustments due to accounting changes and other extraordinary items; and pro forma profits from invested assets such as pension plan assets. Some expenses are properly a part of core earnings but may be excluded, such as the exercise value of employee stock options granted during the year.

You may notice a direct relationship between core-earnings adjustments (a fundamental indicator) and price volatility (a technical indicator). This important relationship has been documented.[2] As a general observation, the greater year-to-year core-earnings adjustments, the greater the tendency for market price to fluctuate, and vice versa.

Investigating the possibility that a company's fundamentals have changed is crucial, even when short-term market volatility is the obvious cause. It is often the case that market volatility reflects economic or

[2] The author's book, *Stock Profits: Getting to The Core*, Financial Times Prentice Hall, 2005, pp. 245–46, demonstrates the direct relationship between technical and fundamental volatility (the latter being attributed largely to core-earnings adjustments).

sectorwide changes, so volatility itself may be a symptom of fundamental change. It is, at the very least, a possibility worth looking into. Your conservative risk profile requires that once the conservative investing standards in your portfolio change, you must change from hold to sell. It is unrealistic to expect that stocks you own today will continue indefinitely to offer all the features you require in your portfolio. It is more realistic to select stocks that have those attributes today but to continually monitor each stock you own and, if and when changes occur, replace those stocks with other issues that better suit your requirements.

Deciding When to Sell and Replace Stock

When you decide it is time to dispose of stock, it is fairly simple to sell and replace if you are holding stock at a profitable position. As a matter of policy, you may wish to employ options in various ways to turn paper losses into paper profits on all stocks you intend to keep and on all stocks in which you would like to increase your holdings. If you can achieve this goal, then your portfolio will always be in good shape. But there is also a strong likelihood that once it is time to sell a particular stock, its price will be depressed. There is a tendency to want to keep stocks as long as their price is *higher* than original basis and to take a second look only when the price falls. In that situation, do you accept the loss or use options to recapture your basis before you sell? The dilemma is that you decide you want to sell the stock, but to do so will create an immediate loss.

If the stock's attributes have changed significantly, you are probably better off to wisely accept the loss and put your money elsewhere, preferably in shares of stock you can use for covered call writing. That is a far more profitable strategy than hoping for a price recovery, especially if you have already noted a decline in fundamental value. It is less likely than ever that you will recapture your full basis under these circumstances. As difficult as it is to accept losses, that may be the most conservative decision.

One alternative is to use options in a combination strategy to provide potential recapture of value, along with protection against further price decline. When you combine a long put with a strike price immediately

below current market value with a covered call above current value, you may be able to recapture your paper loss without additional risk—assuming some conditions are present:

1. *The net cost of the position should be as close to zero as possible.* This is a rescue strategy combined with a desired exit from the long stock position. The cost of opening the long put should be offset by the premium you earn from selling the short call. This is not the time to spend more money on options; it is a time to provide downside protection against further price decline (long put) while being able and willing to sell shares through exercise (short call).

2. *The call's strike price should be adequate to produce a net profit upon exercise or to yield a desirable exit price.* The call's strike price may be high enough to produce an overall net profit on the total position. That is the most desirable outcome, of course, but it will create a net loss. Your alternative—simply selling shares at today's market price—would not be as profitable as long as your short call's strike price is higher. So, selling the call may be the preferred position, even though it still produces a loss.

3. *The exposure time should be limited; you want to exit this position.* Given that you want to exit this position, you do not want to be committed to a long-term covered call position. The premium levels have to be high enough to justify the exposure, but with expiration occurring soon enough that you are willing to wait.

4. *The long put should expire at or after the short call, but not before.* As part of your exit strategy, you cannot risk further price decline. If the net cost of the long put and short call are close to zero, you are protected against any downside movement. If the stock moves below the put's strike price, each point is protected (since your combined option cost is at or near zero). However, be sure that the long put will expire at the same time as the short call or later. Otherwise, your stock position is vulnerable to further price decline, thus additional losses. If the put were to expire first, you would own long stock and be short a call. If the stock's value declined at that point, you would have a bigger loss than you face today.

Stock Positions and Risk Evaluation

If you want to coordinate your various portfolio management requirements by using options, you must first classify risks and keep them in perspective. Inexperienced options traders commonly forget to pay attention to stock fundamentals, picking options in isolation. Even if a speculator uses only long-option positions and never buys or sells stock, fundamental analysis invariably affects (a) the success of an option trade; (b) pricing trends based on support, resistance, and overbought or oversold conditions; and (c) timing of purchase and sell decisions for options.

Risk evaluation of stock based on both price volatility and fundamental volatility (levels of period-to-period changes in revenue and earnings trends) are at the heart of risk analysis. The two types of analysis—technical and fundamental—are directly related and have a cause and effect on one another. The tendency to look at only one set of indicators is a mistake because to truly understand the causes of market trends, you need both.

The Relationship Between Stock Safety and Options

The better the fundamentals for a company, the safer your selection of options. A stock whose price volatility makes it high-risk is invariably also a high fundamental risk. Companies are unlikely to have safe fundamentals but high-risk technical indicators, or vice versa. The two go hand in hand. The same point applies to option strategies. If your stocks are selected based on corporate strength, excellence of management, strong revenue and earnings trends, dividend history, and competitive stance within a sector, then the option choices will match the stock's fundamental strength.

Some observers counter that safe stocks do not offer great potential in option trades. In other words, time value is not as strong in safe stocks as it is in highly volatile stocks, and the real short-term option opportunities are found in highly volatile situations. That is all true. However, the program in your conservative portfolio is not to maximize option income at the risk of your long-term portfolio; the purpose is to manage

portfolio positions in a variety of strategies using options: puts to insure paper profits, basic covered call writing, contingent purchase using long puts or short calls, and rescue strategies in down markets. You do not want to expose yourself to high-risk situations because option income is likely to be better; in fact, income levels of short-term option positions are indicative of higher risk levels if and when those strategies require that you take long positions in high-volatility stocks. No matter which strategies you employ, the essential safety of your long stock positions is the highest priority.

That is why some down-market conditions indicate your best course of action is simply to sell. Cut your losses and invest capital in other companies whose value is greater and whose long-term growth prospects are more promising. Accepting losses is part of investing in the market, and few people will suggest that any line of strategies can make your portfolio foolproof. You will continue to have losses in the future, just as you have in the past. However, well-selected option strategies can protect you against losses, help you solidify paper profits, improve short-term income, and reduce your basis in stock positions—all without having to assume higher levels of risk and, in many cases, without any added market risk whatsoever.

Examining Your Risk Profile

Even when you have defined yourself as conservative, it can be instructive to review your attitude toward long positions in stocks. There are three likely points of view, and you may even hold these views in different ways for different issues in your portfolio:

1. *Long-term hold for conservative stock growth.* The traditional conservative view is that stocks should be selected based on long-term value, growth potential, dividend record, and capital strength; kept for the long term; and used to build wealth over many years. This ideal continues to provide an intelligent investing method for many individuals.
2. *A vehicle for current income via covered calls.* Many investors select stocks using sound conservative principles, but with the primary idea of earning consistent current income from writ-

ing covered calls. This is also a sound investment program. It is entirely possible to earn option-generated current income with no added market risk, as demonstrated in Chapter 5, "Options as Cash Generators." This strategy works best when stocks have been picked using sound fundamental analysis associated with conservative investing.

3. *A combination, the best of both worlds: long-term value investing with potentially high current returns.* You can have it both ways. If your portfolio consists of carefully picked stocks of value that offer long-term growth potential, you can also generate current returns with covered call writing. Exercise is avoided with rolling techniques. When exercise does occur, you can reinvest capital in other stocks offering strong growth potential, wait for appreciation, and then include those stocks in your covered call program.

Options and Downside Risk

An essential element of using calls in down markets is the reduction of losses caused by further downside movement. Premium earned for writing short calls reduces net basis in stock, which also helps close the gap between basis and current market value. Long puts or long calls provide profitable outcomes as long as stock prices move enough in the desired direction; the problem with long-option positions is twofold. First, time works against you when you buy options. Second, time value declines as expiration approaches, requiring far more price movement in the stock to justify the decision to go long in the option.

The Down-Market Benefits of Options

Consider the four primary down-market benefits of options in determining when to use them to manage your portfolio:

1. *Short positions reduce basis.* The first benefit worth analysis is that writing short options produces income, which reduces your basis in stock. This rescues a part of the paper loss during the down market; in some cases, writing short positions can

completely eliminate a marginal loss position. A short position may not be exercised due to lack of movement in the stock price; or, if the position moves in the money, exercise can be avoided with rolling techniques, further reducing the paper loss and the potential effects of eventual exercise.

The short position can be repeated if the option expires or loses enough value so that it can be closed profitably. In either event, you are then free to write new short positions with richer premium. Ultimately, you recover the paper loss through the combination of improving market price levels and ongoing short-option strategies. A short position, when properly timed and when strike prices are properly selected, is programmed to ensure net profit positions and/or reduced overall long-stock basis. If short puts are exercised, the overall, lower basis position in stock can be advanced to a secondary rescue phase, writing covered calls, and if short covered calls are exercised, the resulting sale of stock will either produce a net profit or mitigate losses, freeing you to reinvest funds in more promising stocks.

2. *Short-put premium reduces overall basis in the event of exercise.* Writing short puts produces income and, possibly, allows you to accept exercise if the stock continues to decline. The strategy is also a feature of your *long* portfolio strategy. The price depression is a buying opportunity. As long as you have confidence that prices will eventually rally, the short put either produces income to reduce the basis in your existing holdings or, if exercised, lowers your basis in the stock, often significantly. Both events speed your price recovery.

It is a mistake to view short-put writing as simply an options-only, isolated strategy. If it is performed without a logical, fundamental basis for the decision, then it is not advisable. If it is performed as a strategic form of contingent purchase, it places you at an advantage because actual basis in the stock becomes the strike price minus put premium. If the stock's support level is at or above that net basis price, then short puts are a powerful method for contingent purchase. The third reason for selling puts—to reduce overall basis in the stock when the puts are

exercised—can speed recovery time in a down market. As demonstrated in Chapter 6, the rescue strategy often transforms a paper loss into a paper profit *immediately*. When the short put is exercised and followed with the covered call leg of the strategy, it is entirely possible to recover all of the paper loss without waiting out the market. If, in the meantime, the fundamentals of the company change for the worse, this fast recovery enables you to complete an exit strategy and still create a net gain.

3. *Repetitive covered call writing increases current income while cushioning risk range.* The most conservative strategy—writing covered calls on existing stock positions—also helps to protect against paper loss, even in a down market. The strategy can be entered repeatedly, with current positions closed at a profit, allowed to expire, or rolled forward to avoid exercise. This creates a cash cow of current income without increasing market risk. This approach assumes, of course, that if exercised, those covered calls would create a gain in stock, not a net loss. If you are close to breakeven or if you will suffer a loss in the event of exercise, then covered call writing is an ill-conceived strategy under any circumstances except intentional exit due to changed fundamentals.

4. *Downside risk is also reduced with price averaging.* When a short put is exercised, you end up with reduced-basis stock. This is a positive outcome as long as you want more shares; however, if the fundamentals of the company are weakening, this is not a conservative strategy. The inadvisability of putting more money into a poor investment makes this point. Conservative principles mandate that you cut losses as soon as the fundamental attributes of a company begin to change. This does not always require an immediate sale. Earlier in this chapter, the example was given in which a covered call was written at the same time as a long put at a lower strike price. This is a rescue strategy that protects your position in the event of a downward price movement while producing potential gains in the event of a price rally. The strategy is most practical when the long-put cost and short-call premium are close enough that the positions can be opened with little or no net cost.

Option Planning with Loss Carryover

One potentially troubling aspect of using options in down markets is the possible tax effect. If you create capital gains through exercise, those gains are taxable. Do you prefer reversing paper profits or deferring taxable gains? A lot of emphasis is placed on tax deferral, but in reality, you are better off accepting additional tax this year if that tax results from creating net profits.

The alternative—holding on to shares of stock whose basis is higher than current market value—affects your current investment return and, in some cases, traps you in a losing portfolio position. If you can use options to change the course of profits, you are far better off. For example, let's assume that your effective tax rate (federal and state combined) is 40 percent. All additional income you generate will be taxed at the 40-percent rate, and your after-tax profit will be the remaining 60 percent. In this condition, are you better off waiting?

If your income is high enough this year that you would prefer to take profits in the future, then you can avoid creating additional profits from options. However, the outcome of that decision is zero additional profits. If you can create additional earnings on your investment portfolio, you are ahead with a net 60 percent—compared to no profit at all.

Current-year profits can also be sheltered entirely if you have a large carryover loss. With a limitation of $3,000 maximum net loss deduction per year, you may need many years to absorb your loss. One solution is to generate profits in conservative strategies this year. Another is to offset current-year gains against losses in stocks you want to dispose of without option activity. A third is to invite exercise by writing deep in-the-money covered calls to dispose of stock at a sure profit and to absorb a part of the carryover. In this situation, the loss of long-term status is not a concern because your purpose is to dispose of stock *and* to use up the carryover loss.

Timing: Matching Current-Year Profits and Losses

When it comes to tax ramifications, planning ahead is essential. If you face a large capital gains event this year, be careful to avoid writing in-the-money covered calls, which may put your long-term gain status in

jeopardy. Such a consequence can be suffered unintentionally. For example, if you roll a short call forward and create an in-the-money situation without realizing its consequences, and then the call is exercised, you could end up with a large short-term gain instead of a long-term gain. The resulting tax liability could more than offset any option profits you earned in the strategy.

Even without options, timing is an important aspect of tax planning. If you have stocks you would like to sell and replace with more promising growth issues, time the loss to offset part of the big gain you expect to realize this year. By planning ahead, you can match gains and losses in the same year to minimize the impact of both, and if you are carrying forward a large loss, it can be used to shelter short-term gains from option trades.

A carryover loss should be viewed as an investment portfolio problem and as an opportunity as well. It is a problem because it represents a zero return on your investment. You can use only $3,000 per year, so if you are working with a $30,000 net loss, it will take 10 years to realize the full benefit, and a $90,000 loss would take 30 years to absorb if you had no gains in ensuing years. This situation is an advantage because you are free to realize year-to-year gains without worrying about the tax consequences. Timing of sales does not matter, because your profits will be absorbed to the extent of the loss carryover. The sooner you absorb the carryover loss, the greater the benefits. In taxation, the concept of deferring liabilities while accelerating benefits is well understood. It is similar to calculations of internal rate of return. You maximize your earnings by compounding your return, avoiding idle cash or other value (and "value" can include the benefit of sheltered gains), and seeking maximum gain without additional risk. So, a large carryover loss presents flexibility in the timing of current-year profits.

Taxes complicate the calculation of net gain. This makes it necessary to think about *all* of the aspects of gain and loss on a *net* of taxes basis. A marginal gain can actually turn out to be a net loss if you do not plan ahead. With taxes and trading costs in mind, some options traders prefer to trade in blocks of options rather than in single contracts. The question of how many contracts to use is a complex one for your conservative approach to options. It depends largely on the number of

shares you own and the additional number you would like to acquire. The strategies we have shown employing single contracts can be easily applied in multiples. Risks are identical as long as the relationship between the number of shares and the number of options remains the same, at least on the short position. When you consider using long options, the question of risk changes. The more contracts you buy, the greater your exposure to market risk, so you need to balance the dollar amount of risk with the potential benefits in long options—and you also must understand the tax rules in any option strategy you use.

Multiple option strategies also open up a range of strategic expansion. You can use rolling techniques to incrementally increase the number of short calls. If you own 1,000 shares, you can replace a single option contract with as many rolled-up contracts as you wish. This provides a credit on the transaction while avoiding exercise effectively. Conservative option strategies, when you own multiple lots of shares, also expand potential profitability and may even reduce risk. For example, you can write a series of covered calls at several strike price and expiration levels. These strategies may not save trading fees, but they do add interest and profit potential to your conservative use of options, notably to covered call strategic possibilities.

The next chapter explains conservative combination strategies involving options. These can be used to dramatically reduce your basis in stock while creating current returns with options and without incurring added market risk.

8

COMBINATION CONSERVATIVE TECHNIQUES

The most impressive returns available using options involve combination *strategies: spreads and straddles. With short straddles, you can achieve higher-than-average current returns. However, in utilizing these more advanced strategies, there are two important points to remember. First, the complex tax rules for such positions could jeopardize your long-term capital gains status. Second, the risks involved are conservative only if and when the basic assumptions continue to apply. These include your willingness to acquire more shares of stock and to accept exercise if and when it occurs, and your continued belief that the fundamental value of the companies remains strong.*

Options traders employ a vast variety of strategies, combining options in short and long positions, hoping for various forms of price movement (or lack of movement), and hedging other positions in stock, both long and short. Most of these strategies are inappropriate for your portfolio. However, some combinations can provide a valuable way to maximize your income from options without added market risk.

Many of these strategies have always been available on short-term options but considered impractical because expiration invariably occurred too soon. With the advent of LEAPS options, the entire picture has changed. Because LEAPS options last up to 36 months, advanced strategies have moved from the realm of theory into the realm of practicality. For speculators, this means that it is possible to take greater risks and create combinations with potential for higher-than-average earnings or losses. For conservative investors, the availability of long-term options increases the current income potential with less concern for pending expiration.

In this chapter, we briefly explain the various types of combinations to provide a complete background and explanation of the range of possibilities; and then we provide examples of some very interesting conservative strategies that do meet your conservative profile: the creation of higher-than-average returns without a corresponding increase in market risk.

Spread Techniques

The first popular strategy is the *spread*, the opening of two or more option positions on the same stock, involving different expiration dates or different strike prices. A more complex spread involves both different expiration and strike features.

The options industry has its own range of specialized terms, each used to communicate specific strategies and positions. For example, a spread can be described as vertical, horizontal, or diagonal. A vertical spread has different strike prices but the same expiration date. A horizontal spread is the opposite: it contains the same strike price but different expiration dates. A diagonal spread has different strike prices and different expirations. These three spreads are compared side by side in Figure 8–1

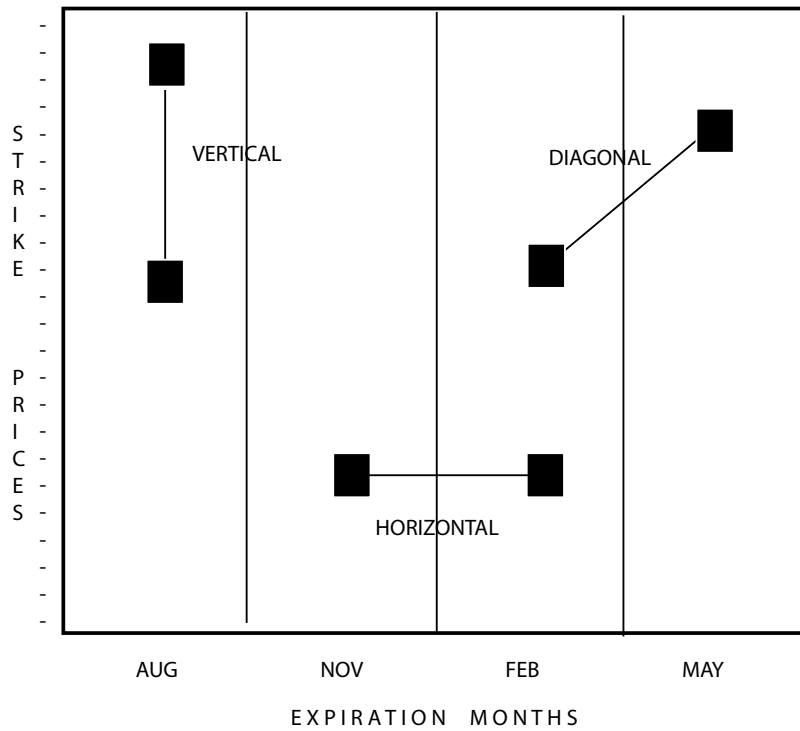


Figure 8–1 Types of spreads.

By viewing the shape in each type of spread, you get an idea of how these strategies can work. The spread is distinguished in other ways as well. For example, a *bull* spread is one designed to work out profitably if and when the value of the underlying stock rises. In comparison, a *bear* spread is maximized when the underlying stock's value declines.

A *box* spread is the simultaneous opening of a bull spread and a bear spread. The use of any of these spreads depends on the direction of price movement you expected to see in the stock between the opening date and the expiration date. However, because you must spend money (for long positions) or expose yourself to market risk (for short positions), a spread—but for a few exceptions—is usually not appropriate for your conservative portfolio. The selection of long options whose premium is greater than the premium from any short options in the spread is called a *debit* spread (in other words, you have to pay money out to open the position). In the reverse situation—the use of short positions exclusively, or of short positions whose total premium receipts are higher than the cost of long positions—is called a *credit* spread.

Advanced Spread Terminology

The terminology is even more complex than these basic definitions. For example, a *ratio calendar spread* is any spread in which the long and short positions are not identical in numbers. As part of a complex rescue strategy, for example, you may open a series of long calls in the belief the stock will rise, and you may also offset (or cover) a portion of those long calls by writing higher strike-price short calls. This reduces the overall cost but still enables you to benefit from upward price movement. A *ratio calendar combination spread* involves a ratio of a greater number of long and short options with a box spread. A conservative use of options rarely employs this advanced strategy. However, it is possible to end up with complex strategies by opening a series of simpler option at various times. The point is that while you are wise to know about the full range of option strategies, you probably will never use them.

One final advanced spread is called the *butterfly spread*. This strategy has three parts: open options within a strike-price range, offset by other options at both higher and lower strike price ranges. The purpose of the butterfly is to limit losses in exchange for limited profits. It is difficult to justify such positions, and they often result from a series of less complex decisions over a period of time and in reaction to price movement in the underlying stock.

Straddle Techniques

While the spread involves variation of strike price, expiration date, or both, the *straddle* by definition requires that strike price and expiration are the same. To open a straddle, you buy an equal number of calls and puts (a *long* straddle) or sell an equal number of calls and puts (a *short* straddle); in either case, the option positions would have the same strike price and expiration date.

With a long straddle, you experience a loss in the middle range, represented by a point spread on either side of the strike price, and profits either above or below that range. For example, if the total cost of opening a long spread is 11 ($1,100), then the stock must move either up or down by 11 points for you to break even. Anything beyond that range is profitable, and if the stock's price remains within the 11-point range until expiration, the position becomes an overall loss. You can close one side of the position without closing the other. For example, if the price of the underlying stock moved up enough points to make the calls profitable, they could be closed, and the puts left open. The same argument is true on the downside. Puts could be closed and calls left open. In writing a long straddle, the best possible outcome would be price movement in both directions, enough so that each side can be profitable in turn. The long straddle is highly speculative.

Short Straddles for Conservative Positions and High Rates of Return

The short straddle involves opening two short positions with the same strike price and expiration. An equal number of calls and puts produce a middle-range profit zone with potential loss zones above and below. For example, if you receive a net premium of 9 by opening a short straddle, your profit zone is 9 points on either side of strike price; above or below that range, you face a loss zone. The troubling aspect of the short straddle is that you are always at or in the money on one side or the other, so exercise is an ever-present possibility. You can roll forward and up with the short call to avoid exercise, and you can roll forward and down with the short put. If you own shares of the underlying stock and you write no more than one call per 100 shares, the risks in this position are minimal.

However, if you do not own 100 shares, then the short straddle is a high-risk strategy because the call is uncovered.

The short straddle is one variation of the contingency strategies covered in Chapter 6, "Alternatives to Stock Purchase." It involves a contingent sale of stock you own (the covered call) with a contingent purchase of additional shares (the uncovered put). Because premium income can be substantial in this combined strategy, the short straddle can be a viable conservative strategy. Later in this chapter, we propose a similar strategy with less risk, designed to maximize your returns without adding to market risk.

Long or Short Positions

The obvious problem with advanced strategies is the high-risk attributes of each. Positions involving long calls and puts require substantial point movement; even in a net debit position (in which the cost exceeds the receipt), you must fight against time value. Positions with any short calls or puts involve questions of market risk. Uncovered calls are the highest risk position possible using options—clearly inappropriate in a conservative portfolio. Short puts may or may not be appropriate either, depending on your opinion of the underlying stock, its fundamental strength, and whether or not you are willing to buy shares at the put's strike price.

When the mix between long and short positions is used, the possible variations of spreads and straddles present conservative possibilities. Some have already been introduced. For example, to remove the risk factor from a ratio write, you can add a long call at the top of the strategy. If you own 300 shares, you might write four calls with a strike of 50. You also buy a call at 55, 5 points above the strike price of the ratio. thus covering the uncovered short option. The net receipts from the short calls come to $2,200, and the long call costs $100, so your net cost before trading expenses is $2,100. The top-side long position is a form of market risk insurance; if the stock's price were to rise so that all four calls were exercised, you could cover three of them with your 300 shares; the remaining call is covered with your long 55 call. You would lose $500 on the difference between those strike prices. However, there

are two mitigating factors. First, you received $2,100 for the overall ratio write. Second, the $500 loss is preferable to the possibility of being exercised and losing much more. This is a conservative use of options to manage a ratio write, transferring it from a potentially risky strategy to a very safe one.

Mixing the Long and the Short

Another example using combinations of options is the opening of a long call and a short put in a down market. This provides multiple benefits. First, the cost of the long call should be offset by the income from writing the short put. Second, if the stock declines further in value and the short put is exercised, your basis in the stock is averaged down. The average basis consists of the average price between original purchase of shares and the strike price of newly acquired shares, minus put premium. Third, if the stock does rise, you can either close the call at a profit or exercise it and buy additional shares below market price, further reducing your average basis in the stock. This strategy—assuming you would be satisfied if and when the short put was exercised—is very conservative. It involves low cost or zero cost (in some cases, even a small credit), and it is advantageous under any scenario of price movement. Even no movement would be satisfactory, considering that the combined strategy is a zero-cost one.

Using long puts to insure paper profits against the possibility of price decline is a sensible strategy by itself. But consider yet another variation combining long and short options: the long put and short call combination. In this instance, you achieve downside protection in two ways. First, the long put would match in-the-money price movement dollar for dollar. That put can be exercised and shares sold above market value, or it could be closed at a profit to *take* paper profits without selling shares, a highly desirable attribute of the insurance strategy. Second, the covered call offsets all or part of the long put cost, so that you end up with free downside protection, and it may reduce your basis in the stock to the extent that the short premium of the call exceeds the long premium of the put. Remembering, too, that time works to the advantage of the short position, the covered call can be closed at a profit, allowed to

expire worthless, or exercised. You can also roll forward and up to avoid exercise if the stock's price continues to rise.

These are only some examples of how you can continue to manage your portfolio on a conservative basis using options in combination, enabling you to take appropriate action in three market conditions:

1. In up markets, protecting or realizing paper profits without having to sell stock.
2. In low-volatility markets, increasing current income with covered calls.
3. In down markets, averaging down your basis and turning paper losses into paper profits or realized profits.

Theory Versus Practice

The *concept* of using options in your long-term portfolio works as long as you structure that use within the guidelines of your conservative risk profile and consider all possible outcomes. For example, whenever you go short on either calls or puts, you should fully understand the consequences of exercise.

The primary requirement for a conservative application of options is that any and all strategies should involve stock that you have qualified under your individual standards, that you either own or want to own, and that you consider an attractive long-term investment. Nonconservative option strategies tend to be overly complex and, while they may work out quite well on paper, they do not always produce the high rates of return that seem so easy. Stocks rarely move in the desired direction, or quickly enough, for high-risk strategies to become profitable. Speculators—especially inexperienced ones—often pay too much attention to the profit potential of complex option combinations and far too little to the associated high risks. In especially complex option strategies, the minimal loss is often offset by a related minimal profit as well. In calculating the cost of opening these positions, speculators often suffer a net loss due to trading expenses for opening *and* closing the positions.

Simplicity as a Worthy Goal

One conservative principle worth adopting is, *Keep it simple*. The fallback position for any option strategy is to return to the basic conservative theme: select high-quality growth stocks, and hold for the long term, selling only if and when the fundamentals change. If any options strategy is overly complex or difficult to understand, it should be avoided without exception. There are plenty of worthwhile conservative strategies that you can use to contend with short-term paper profits, offset depressed markets, and employ for contingent purchase; you do not need to extend your risk range because a particular option strategy would require it.

Risk analysis is an important and essential part of the informed option strategy. This is the process by which you determine whether or not a particular strategy is appropriate, given the range of risks involved. The analysis also includes evaluating the outcomes that may occur, and then comparing potential return to the potential market risk and other risks (lost opportunity risk, for example).

In performing a risk analysis, the worst-case outcome has to be considered in deciding whether to proceed. Actual outcome comparisons are difficult because one involves selling stock and another does not; so the purpose of analyzing outcomes has to be to ensure that in any possible event, you are satisfied with that outcome. For example, if you are thinking about writing puts in a down market, the obvious worst-case outcome is a continued decline in the stock. Writing puts qualifies as a conservative strategy if you have already determined that

- the stock is a good value at current levels.
- the strike price would be attractive if the put were exercised.
- premium income is high enough to justify the short position.
- you will accomplish an attractive averaging down of your basis if the put is exercised.
- you would like to acquire additional shares of the stock.

If any of these features is not part of your conclusion, then writing puts makes no sense.

Worst-Case Outcome as a Desirable Result

The worst case has to be viewed as desirable based on the standards you set for yourself. For example, what if your choices meet all of your criteria, but expiration is so far off that you are hesitant to tie up capital for that long? When you write short puts, you must have funds available in the event of exercise, and there may be a lost opportunity risk associated with leaving funds on deposit. If another buying opportunity appears that you would like to take, you cannot make a move because capital is committed to the possibility of short-put exercise. If capital is unavailable (or if expiration is so far off that you simply don't know what you will want to do in a few months), you may want to reconsider writing the puts.

The same worst-case analysis applies to writing short calls. You have to own 100 shares for each call you write (with the exception of the ratio write), or your market risks are unacceptably high. Is there a chance you will want to sell shares in the period between writing the call and expiration? That possibility will be strongest if and when the stock's market value rises, which means the call premium value would be higher as well. Using the short call makes sense only when you are willing to keep the position open until it is exercised, expires, or loses value so that it can be closed at a profit.

In your risk analysis, consider not only what might or might not take place in terms of profits in the open position, but also how the exposure and commitment to a particular strategy will affect your ability to make decisions. If you conclude that being short in options is not well timed or, more likely, that the exposure period is too long, then reevaluate your strategies. You may prefer to use shorter term options. In fact, a study of annualized returns often reveals that more attractive annualized returns are achieved on options that expire sooner. In Chapter 7, "Option Strategies in Down Markets," for example, we compared 2-month and 5-month puts on Federal Express. The puts closest to current market value (80 and 75 puts) were better yielding in the 2-month configuration than in the 5-month alternative. The two puts farther out of the money were better yielding in the 5-month mode. This disparity demonstrates the correlation between time to expiration and time value premium and the importance of also checking annualized returns

along with proximity between current market value and strike price. The question of annualized premium has to be weighed against the exposure period.

Tax Problems with Combination Strategies

The complexity of combination strategies is only one of the problems you have to sort through. As a conservative investor, you may prefer for simplicity, if only because basic conservative strategies involve fewer likely risks. The possible tax consequences may also discourage you from involvement with complex strategies.

Some forms of combinations create an unintentional wash sale, so profits or losses you intend to recognize in one particular tax year could be disallowed. Any "offsetting position" that creates a straddle could result in the loss of long-term capital gains status for long stock. The IRS definition of offsetting positions in which this could occur requires a "substantial diminution of risk of loss" in order for the capital gains penalty to apply. By definition, a conservative straddle makes sense only if it reduces your risk exposure, and under the tax rules, you do not have to actually cover stock to fall within the definition of having an offsetting position.

The Anti-Straddle Rule and Its Effect

The tax rules set up the potential consequence that the transaction will be negated under the 30-day wash-sale rule. You could also lose long-term capital gains status on stock sold, and the deferral of deduction for losses. If by definition a current-year loss is offset by a *successor* position (a related second side of a straddle, for example), the losses could be deferred and deducted from the basis in that successor position. This limitation applies to the loss on an option position, the expense of executing transactions, and applicable margin interest.

The so-called "anti-straddle rules" in the tax code are complex and designed to discourage the use of options to create current-year losses and to offset future-year gains. However, the complexity of these rules

may also discourage you from considering complex straddles as a viable part in your conservative portfolio. The very complexity itself is a form of risk—we call it "tax complexity risk"—that makes advanced options troubling. A part of the risk to which you may be exposed is the unexpected loss of long-term gains status that, in some cases, could end up causing substantially higher tax liabilities. Anyone who becomes involved with advanced options, including in-the-money covered calls or straddle positions, should first consult with a tax professional who understands the current tax rules and also question whether any use of options that may complicate the tax status of long-term stock is worth the tax complexity risk. Even if you use expert help in preparing your tax return and in planning investment income each year, the special rules concerning these option transactions changes everything. You may not simply be able to pick a strategy and proceed, without also knowing how it will affect your tax status.

The Ultimate High-Return Strategy

It is wise to shun any strategies that are overly complex, unclear as to risk levels, or complex for tax purposes—which immediately disqualifies an array of possible option strategies: the distinction is clear between conservatism and outright speculation. By the same argument, there is also a difference between those who appreciate simplicity and those who are attracted to the exotic, the complex, and the difficult to understand. Some option trading takes place for the enjoyment of the complexity rather than for a specific desire to create profits.

One particular strategy is especially appealing because it creates an immediate return, it is not complicated, and market risks are not increased. A straddle involves the simultaneous opening of a call and a put with identical strike prices and expiration dates. By modifying the straddle, we can create a short position without also facing the near certainty of exercise. Instead of employing identical strike prices, we employ out-of-the-money strikes to create a short combination made up of covered calls and uncovered puts.

A Review of Your Conservative Assumptions

In order for the modified straddle to work, the following 10 rules must be observed:

1. *You are willing to accept exercise of the covered call.* As with all conservative strategies involving short options, you must be prepared for exercise. If you are unwilling to face even the remote chance that the call could be exercised, then this strategy is not be a good fit for your portfolio.
2. *Exercise of the call will result in a profit in the stock.* There is never any reason to open a covered call position if exercise would create a loss. Ensure that your basis in stock is lower than strike price of the call. The farther the gap between basis and strike, the better.
3. *You are willing to accept exercise of the uncovered put.* You also need to acknowledge that the short put could be exercised. The strike price of the put should represent a desirable buy price for the stock, in your opinion. For example, if your portfolio strategy calls for purchasing more shares of the stock if the price falls adequately to become a bargain, you achieve the same outcome by selling a put.
4. *You have funds available to buy shares if and when the put is exercised.* Your broker requires that you have funds available to complete this transaction if the put is exercised. Even if you use margin and can complete this option position for only a portion of the possible price of the stock, you still have to leave funds on deposit.
5. *You consider the put's strike price a good price for stock.* The put's strike price should, in your opinion, be a desirable price. This reduces the chance of exercise; even if exercise does occur, you would expect the stock to return to its established range *above* that support level.
6. *The strike prices are selected with the stock's trading range in mind.* Your review of this strategy should be coordinated with a study of the stock's recent trading range history. The ideal situation is

one in which the stock has demonstrated a consistent, steady growth in market price within a relatively narrow trading range. While exercise of either side of this transaction would be welcomed, the best outcome allows you to manage the positions to avoid exercise, and then repeat the position later.

7. *Premium income from both positions is attractive.* In order to justify any option position, the premium levels have to be right. In this strategy, you write two short positions. Longer exposure increases the chance of exercise on either side of the transactions, but rolling techniques can help you to avoid exercise long enough that the positions can both be closed at a profit.

8. *The proximity of strike prices to current market value is ideal.* The current market value of stock should ideally reside exactly halfway between the strike prices of the call and the put, or within one dollar of the halfway mark. For example, if your strike prices are 45 and 55, the ideal market price of the underlying stock us $50 per share. (For the purposes of illustration, we limit the examples that follow to strike prices at least 5 points out of the money.)

9. *A fundamental analysis of the underlying stock has passed your review.* It is always essential to evaluate the stock before deciding to buy shares or to continue holding shares you already own. This strategy makes sense *only* if it also makes sense to own the stock, based on your conservative profile.

10. *You have evaluated all possible outcomes, and you are satisfied that this strategy is worth entering.* Consider all possible outcomes, including the net portfolio value when the stock declines below the put's strike price and you end up with a paper loss. Your analysis should be comparative based on your outcome if you simply continue holding shares of the stock without writing options.

Examples of the Strategy in Practice

This combination strategy requires several steps.

Pick Your Portfolio

We use our model portfolio of 10 stocks. Using the same stocks in previous chapter examples, we show how the combination strategy works in various situations.

Pick Expiration Dates

We make the comparisons among our model portfolio stocks assuming that expirations will occur in 15-month or 27-month periods. In practice, you can alter the expiration dates between call and put. There is no specific reason why identical expirations are necessary for this strategy unless you are working from an assumed target date for final closure of the strategy.

Review Trading Range Trends

The next step is to review the trading ranges for these stocks. We discover the following moderate-level volatility over the past 12 months:[1]

Stock	**Trading Range**
Clorox	$45–55
Coca-Cola	35–55
Exxon Mobil	35–50
Fannie Mae	60–80
Federal Express	65–95
General Dynamics	85–100
J.C. Penney	25–40
Pepsi Cola	45–55
Washington Mutual	35–45
Xerox	12–17

[1] Price ranges over 52 weeks, rounded to closest 5-point increment.
Source: *http://www.schwab.com.*

Look for Available Options and Strike Prices

Next, we check available options on all of the issues. We look at the 15-month and 27-month LEAPS calls and puts for each option and select those that are out of the money in each instance. For most of the stocks, we limit our analysis to options at least 5 points out of the money. (Exceptions are the two stocks with the highest and lowest price ranges: for General Dynamics, we looked for options out of the money 10 points in either direction, and for Xerox, we reviewed options a minimum of 2.5 points out of the money.)

In examining the available options, we discover a range of calls and puts meeting our criteria, summarized in Table 8–1

The information in Table 8–1 is difficult to judge comparatively for several reasons. First, it is not annualized, but we are dealing with significantly different expiration terms, price ranges, and distances between current market value and strike price. For example, Fannie Mae and J.C. Penney strike price spreads are 20 points apart, and Xerox has a spread of only 7.5 points. To a degree, variation in the point spread is a factor of stock price level; we also have extended some of these examples to achieve the desired minimum 5-point difference between market value and strike price (the exception to this is Xerox). In choosing between the 15-month and 27-month alternatives, we cannot make a valid judgment until we annualize the returns and then review them side by side. Table 8–2 shows combined short call and put for each strike selection and also annualizes each return.

This summary allows you to look at potential returns side by side between stocks and between expiration dates. Even so, this analysis is only accurate on the assumption that all options expire worthless. The return will be quite different if one or both options are exercised. For example, if the Coca-Cola 45 call is exercised, the spread between strike price and current market value will be six points; but if the General Dynamics call is exercised, the spread will be 10 points.

Table 8–1 Stocks for Combined Call and Put Short Strategy

Name of Company*	Symbol	Current Price	15-Month Options		27-Month Options	
			Call	Put	Call	Put
Clorox 60 call/50 put	CLX	$55.91	$2.85	$2.15	$5.10	$3.80
Coca-Cola 45 call/30 put	KO	$38.90	$1.05	$0.50	$2.15	$1.20
Exxon Mobil 55 call/40 put	XOM	$48.70	$1.45	$1.10	$2.70	$1.80
Fannie Mae 80 call/60 put	FNM	$67.65	$2.85	$4.90	$4.80	$6.60
Federal Express 95 call/80 put	FDX	$87.78	$5.90	$4.50	$10.10	$6.70
General Dynamics 110 call/90 put	GD	$100.01	$5.60	$4.60	$9.60	$7.20
J. C. Penney 50 call/ 30 put	JCP	$38.20	—	$1.45	$2.50	$2.35
Pepsi Cola 55 call/40 put	PEP	$48.48	$1.20	$0.95	$2.30	$1.70
Washington Mutual 45 call/30 put	WM	$38.43	$1.10	$1.30	$1.65	$2.05
Xerox 17.50 call/10 put	XRX	$14.32	$0.80	$0.50	$1.60	$0.75

* Stock prices and option premium values based on closing prices as of October, 2004.
Source: Chicago Board of Exchange (CBOE).

Table 8–2 Annualized Return, Combined Call and Put Short Strategy

Stock and Expiration*	(A) Combined Premium	(B) Current Stock Price	(C) Simple Return	(D) Months to Expiration	Annualized Return**
Clorox		$55.91			
15-month	$5.00		9.8%	15	7.8%
27-month	8.90		15.9	27	7.1
Coca-Cola		$38.90			
15-month	$1.55		4.0%	15	3.2%
27-month	3.35		8.6	27	3.8
Exxon Mobil		$48.70			
15-month	$2.55		5.2%	15	4.2%
27-month	4.50		9.2	27	4.1
Fannie Mae		$67.65			
15-month	$7.75		11.5%	15	9.2%
27-month	11.40		16.9	27	7.5
Federal Express		$87.78			
15-month	$10.40		11.8%	15	9.4%
27-month	16.80		19.1	27	8.5
General Dynamics		$100.01			
15-month	$10.20		10.2%	15	8.2%
27-month	16.80		16.8	27	7.5
J.C. Penney		$38.20			
15-month	$—		— %	15	— %
27-month	4.85		12.7	27	5.6
Pepsi Cola		$48.48			
15-month	$2.15		4.4%	15	3.5%
27-month	4.00		8.3	27	3.7
Washington Mutual		$38.43			
15-month	$2.40		6.2%	15	5.0%
27-month	3.70		9.6	27	4.3
Xerox		$14.32			
15-month	$1.30		9.1%	15	7.3%
27-month	2.35		16.4	27	7.3

* Stock prices and option premium values based on closing prices as of October 22, 2004. Source: Chicago Board of Exchange (CBOE).

** The calculation to annualize involves the following two steps:
Divide total premium (Col. A) by stock value (Col. B) to arrive at simple return (Col. C).
Annualize with the following formula to reflect return on a 12-month basis:
[col. C ÷ col. D] × 12

Compare Yields

The final step before making a decision is to develop a valid comparison. If calls are exercised, you gain points between current market value and strike price. The exercised rate of annualized return is calculated based on current market value; also consider your original basis in each stock as part of the process to determine whether, in your opinion, this combined strategy is worth the exposure.

The return will also be different if either option or both options decline in value and are closed or if you replace them by rolling forward and up (calls) or forward and down (puts). These variables point out the difficulty in making accurate comparisons between stocks and between outcomes. However, if we make a few generalizations, we can compare the outcomes as reflect in Table 8–2.

The last column shows that, in fact, the two best outcomes are found in the 15-month positions for Fannie Mae and Federal Express. This comparison demonstrates the complexity of return analysis. We use the basic assumptions involving the same time to expiration in order to make these analyses as comparative as possible. This comparison also does not take dividend yield into account, although some methods do include dividends. For example, the Chicago Board of Exchange includes dividend yield. It can make a considerable difference. Fannie Mae paid an annual dividend of 3.1 percent, and Federal Express was at 0.3 percent on the date of this analysis. So, if we add in the annualized dividend yield to these returns, the comparison takes on a different result:

Stock	Annualized Premium Yield	Dividend Yield	Dividend Total
Fannie Mae (15-month)	9.2%	3.1%	12.3%
Federal Express (15-month)	9.4	0.3	9.7

Both of these stocks will yield high returns on an annualized basis, using the combined short-option strategy. However, Fannie Mae is

more desirable when dividend yield is added into the total. Another reason this stock is more desirable than most of the others is the point spread between current market value and strike prices of the short call and put. The range is a full 20 points (higher than all of the other stocks except General Dynamics and J.C. Penney) and by far the highest yield with dividend yield included.

Select Stocks for the Short Combination Strategy

The final step is to pick the stock you will use for this strategy. Assuming that you have been following all of the model portfolio stocks but do not yet own any, you could easily narrow down your choice to Fannie Mae or Federal Express—assuming that all else is equal in the fundamentals of all of these stocks.

Suppose you buy 100 shares of Fannie Mae at $67.65 and, at the same time, write a 15-month 80 call and a 15-month 60 put:

Buy 100 shares of FNM @ $67.65	$6,765
Sell one 15-month 80 call	–285
Sell one 15-month 60 put	–490
Net basis before trading costs	$5,990

The strategy, based on current value of stock at the price of $67.65 per share, is illustrated in Figure 8–2.

The profit zone is the difference between the strike prices plus the number of points received for selling the short puts. This zone is quite wide. It does not include dividend income (assuming that dividend yield comparisons were useful in comparing potential outcomes but are not a part of the option-specific returns). There would no loss zone on the upside. In the event the call was exercised, shares would be called away at the strike price of $80 per share, producing a capital gain of $12.35 per share, or 18.3 percent (if this occurred on the last day before expiration, annualized capital gain would be 14.6 percent). In the event the put was exercised, your basis would be the put's strike price averaged

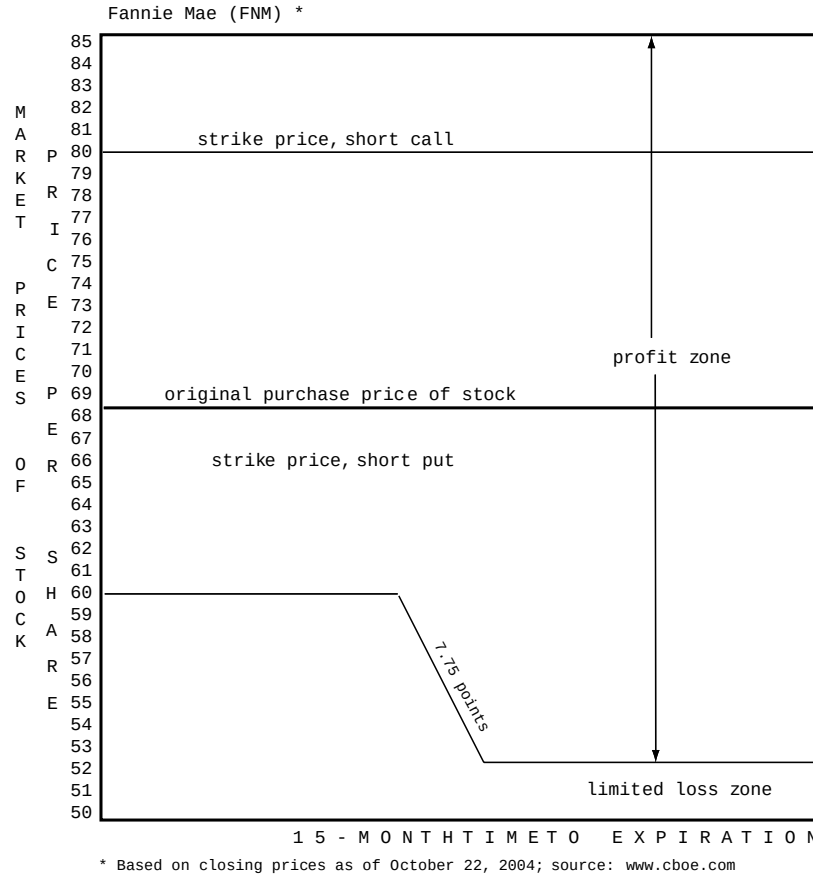


Figure 8–2 Profit and loss zones, short-option combination.

with your original basis. If you bought shares at $67.65 and then had the put exercised for an additional 100 shares, average basis would be $63.83 per share. If both options were exercised, you would end up with 100 shares of stock. The original 100 shares would have been called away when the call was exercised at $80 per share, and another 100 shares were put to you when the put was exercised at $60 per share.

In this transaction, the combined call and put premium reduces your basis in the stock to $59.90 per share. The profit zone in the illustration extends downward to the price of $52.25, reflecting the strike price of 60 minus 7.75 points for total short option premium.

As long as you would be happy to accept exercise of either option, the possible outcomes of this transaction are all positive. In the case of the put, the assumption would be that the strike represents a fair purchase price in your opinion. Based on the Fannie Mae 12-month trading range from about $60 to $80, this does seem to be a fair conclusion. Your net cost of $52.25 upon exercise of the put is below the 12-month trading range.

Outcome Scenarios

Even after identifying a desirable yield, it still makes sense to go through the various possibilities to make sure that you understand what could occur and what actions, if any, you would want to take in response.

Planning Ahead for Each Outcome Scenario

You must consider what actions, if any, you would take in the following scenarios:

1. *The trading range of the stock remains in between the strike prices.* If the stock's trading range remains below the call strike price and above the put strike price, neither will be exercised. This condition occurs in one of two instances. First, the price of stock simply does not move in either direction more than the example's 20-point range. In this case, you can wait for expiration or, when the value of either option or both options has declined to near zero, you can enter a closing purchase transaction and cancel the short positions. Once this is done, you are free to sell more options under the same strategy. Second, when the stock's price approaches one strike level or the other, you may roll forward to avoid exercise. This extends your period of exposure, but also extends the future strike price (upward for calls and downward for puts). So, if the call were eventually exercised, it would be at a higher price (in the case of the call) or a lower price (in the case of the put).

You are free to close or roll either of the short positions without changing the risk profile in the remaining segments of the position. This is only true, however, as long as you own 100 shares for each short call written. The risk profile provides great flexibility. As the trading range of the stock begins moving in one direction or the other, you can roll forward, close the position, or alter expiration dates and strike prices. The decisions about how you deal with the short call or the short put are independent of one another. They work well together due to the high returns you can earn consistently without increases in market risk; that does not mean you are limited in terms of strike prices or expiration dates.

2. *Both options are exercised.* If price in the underlying stock moves enough points in the money on *both* sides, you could experience exercise of both options. This would require not only movement into the money, but early exercise on both sides as well, and You would end up where you were before entering the transaction. Upon exercise of the call, your 100 shares are sold; and upon exercise of the put, you receive 100 shares at the strike price. Because the space between strike prices is 20 points, this outcome produces a 20-point gain in option exercise, plus the premium income. In the example, the total $775 premium is yours to keep no matter what; but if you were to sell 100 shares at $80 and acquire 100 shares at $60, you would have an additional $2,000 capital gain. However, because you end up with a net 100 shares and no open short positions, this outcome is highly desirable. Once it has occurred, you can once again write a short call and a short put.

   When both options are exercised, the most desirable sequence would be for the put to be exercised first, and then the call. The outcome then creates a situation in which you own appreciated stock. For example, if your original basis were $6,765 (the market value at the time the short positions were entered), it would be desirable to have stock purchased at $60 per share.
   This outcome is the same as if you simply bought 100 shares of stock and set a goal to buy an additional 100 shares if the

stock's price falls to $60 and to sell shares if the stock's price rises to $80. The difference with the option short combination is that you express the same goals but earn a higher profit and extend the profit zone at the same time. You do not depend on price movement to reach the profit goal: the strategy produces a profit through call and strike premium, no matter which direction the price moves.

3. *The call is exercised but the put is not.* In this situation, your stock is called away at $80 per share (based on the preceding example), but you are not required to repurchase those shares. The short put either expires worthless or is closed through purchase. The outcome is desirable because your gain consists of $1,235 on the stock plus $775 on option premium. The downside of this outcome is lost opportunity. When your stock is called away, it is because that stock has appreciated in value, so you end up earning a profit, but you no longer own the stock. If you can consistently produce high returns—and with this strategy, you can—then the lost opportunity may be viewed as a worthwhile trade-off.

4. *The put is exercised but the call is not.* If the put is exercised, you acquire an additional 100 shares. Because the original basis is $67.65 per share, the new combined basis of 200 shares is $63.83 before considering option premium. When you deduct the $775 option premium, the basis is further adjusted down to $59.95:

   ($6,765 + $6,000 – $775) = $5,995 (200 shares)

   Although current market value of the stock in this situation may be below your net basis, we have to assume that you entered this strategy with a few important qualifications in mind: You considered $60 per share a fair price for the stock, and you are happy to acquire additional shares because this stock meets your long-term fundamental criteria. Having 200 shares may also be seen as a way to double the potential returns in writing future short positions. It is advisable, however, to

wait until the price rebounds to ensure that all outcomes of short-option positions would be profitable.

5. *The stock's market value falls below the put strike and remains there.* This is the worst outcome of all—whether you write short options or not. If you simply keep your 100 shares, a price decline has no mitigation. In having generated 7.75 points of reduced basis from selling puts, you naturally hope the price returns to previous levels. Even so, this situation may require a rescue strategy. discussed in detail later in this chapter.

The Augmented Strategy—A Short Straddle

Using the previous analysis, let's see what happens if you write a straddle instead of creating a strike price gap. You do this when you would find it most desirable to have either or both options exercised. Assuming that you write a straddle as close as possible to current market value of the stock, you could create potentially high premium value in the options.

Looking once again at the ten stocks in our model portfolio, we find the status of calls and puts closest to current market value, as shown in Table 8–3.

It is essential in this analysis that you emphasize annualized return rather than dollar value of option premium. Clearly, the potential $2,360 you could receive for writing a Federal Express 27-month straddle is far higher than the $410 you would receive doing the same strategy on a Xerox January 15-month position. But the dollar values alone do not tell the whole story. In fact, the annualized return on the Xerox straddle is far better than the annualized return on Federal Express. Dollar values alone are deceptive. In this comparison, owning 600 shares of Xerox represents approximately the same capital level as owning 100 shares of Federal Express, and the option premium is higher on Xerox as well. To make the comparisons valid, we need to annualize all of these returns, as shown in Table 8–4.

Table 8–3 Stocks for Conservative Short Straddle

Name of Company*	Symbol	Current Price	15-Month Options		27-Month Options	
			Call	Put	Call	Put
Clorox	CLX	$55.91				
50 strike			$8.00	$2.15	$10.00	$3.80
Coca-Cola	KO	$38.90				
40 strike			$2.55	$3.70	$4.00	$4.90
Exxon Mobil	XOM	$48.70				
45 strike			$5.80	$2.30	$7.00	$3.30
Fannie Mae	FNM	$67.65				
70 strike			$6.20	$9.20	$8.30	$11.10
Federal Express	FDX	$87.78				
85 strike			$10.90	$6.30	$15.00	$8.60
General Dynamics	GD	$100.01				
100 strike			$9.90	$8.60	$13.90	$11.10
J.C. Penney	JCP	$38.20				
40 strike			$3.90	$5.20	$5.70	$6.40
Pepsi Cola	PEP	$48.48				
50 strike			$2.90	$4.10	$4.30	$5.00
Washington Mutual	WM	$38.43				
35 strike			$5.00	$2.80	$5.40	$3.80
Xerox	XRX	$14.32				
12.50 strike			$3.10	$1.00	$3.90	$1.45

* Stock prices and option premium values based on closing prices as of October 22, 2004.
Source: Chicago Board of Exchange (CBOE).

Table 8–4 Annualized Return, Conservative Short Straddle

Stock and Strike Prices*	(A) Total Premium	(B) Current Stock Price	(C) Simple Return	(D) Months to Expiration	Annualized Return**
Clorox 50		$55.91			
15-month	$1,015		18.2%	15	14.6%
27-month	1,380		24.7	27	11.0
Coca-Cola 40		$38.90			
15-month	$625		16.1%	15	12.9%
27-month	890		22.9	27	10.2
Exxon Mobil 45		$48.70			
15-month	$810		16.6%	15	13.3%
27-month	1,030		21.1	27	9.4
Fannie Mae 70		$67.65			
15-month	$1,540		22.8%	15	18.2%
27-month	1,940		28.7	27	12.8
Federal Express 85		$87.78			
15-month	$1,720		19.6%	15	15.7%
27-month	2,360		26.9	27	12.0
General Dynamics 100		$100.01			
15-month	$1,850		18.5%	15	14.8%
27-month	2,500		25.0	27	11.1
J.C. Penney 40		$ 38.20			
15-month	$910		23.8%	15	19.0%
27-month	1,210		31.7	27	14.1
Pepsi Cola 45		$48.48			
15-month	$780		16.1%	15	12.9%
27-month	1,000		20.6	27	9.2
Washington Mutual 35		$38.43			
15-month	$780		20.3%	15	16.2%
27-month	920		23.9	27	10.6
Xerox 12.50		$14.32			
15-month	$4.10		28.6%	15	22.9%
27-month	5.35		37.4	27	16.6

* Stock prices and option premium values based on closing prices as of October 22, 2004. Source: Chicago Board of Exchange (CBOE).

** The calculation to annualize involves the following two steps:
Divide total premium (Col. A) by stock value (Col. B) to arrive at simple return (Col. C).
Annualize with the following formula to reflect return on a 12-month basis:
[col. C ÷ col. D] × 12

How the Dollar Values Alone Can Mislead

A comparison between 100 shares of Federal Express versus 600 shares of Xerox helps to clear up how this works. We need not only to annualize returns, but also to make capital investment comparable:

Stock	Stock cost	Option premium	Net cost
Federal Express 100 shares	$8,778	$2,360	$6,418
Xerox 600 shares	$8,592	$2,460	$6,132

This brief comparison demonstrates that annualized return is the key indicator. In this sample, the higher dollar-value (Federal Express) spread produced only 12.0 percent annualized return while reducing stock net basis to $6,418. Xerox produced a 22.9 percent return and reduced the basis of 600 shares down to $6,132—a lower net basis for a far higher rate of return.

Returning to our 100-share example in Table 8–4, it is clear that, without exception, the annualized yield on the 15-month options is superior to returns on the 27-month options. This is true not only because annualized yield is higher, but also because the turnover period is a full 12 months less.

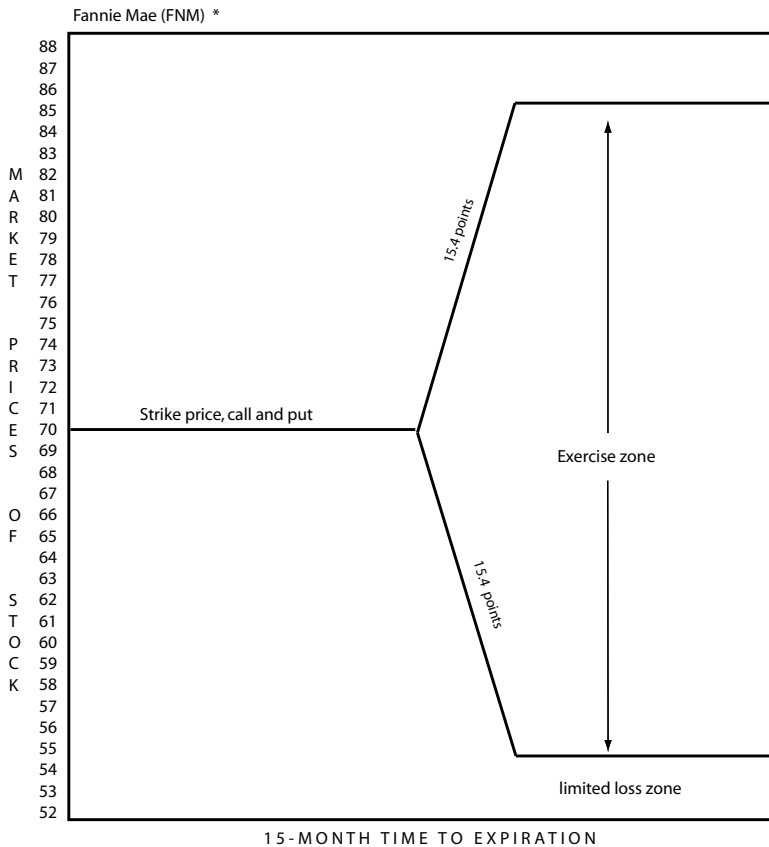
In this straddle, we create consistently high current returns on an annualized basis; however, it is also quite likely that the short options will be exercised. If you accept the premise that exercise of either the call or the put (or both) would be desirable, then this straddle example is quite impressive. The strategy works best when the short call and put strikes are as close as possible to current market value of the underlying stock. General Dynamics is the only stock in the 10-stock model portfolio that meets that test. For Clorox, we picked the 50 strike because 55s were not available for the 15-month group of expirations. We prefer to write options as close as possible to at the money. This maximizes the potential return.

The highest yielding position is the 15-month Xerox straddle, returning 22.9 percent on an annualized basis. This reduces the basis in the stock from the current price of $14.32 per share to $10.22 because you receive $4.10 for opening the straddle—a very impressive initial discount in

the price of the stock. Many of these stocks would produce impressive returns; to keep our analysis consistent, we summarize the 15-month straddle for Fannie Mae 70 call and put, which yield 18.2 percent:

Price of stock	$6,765
Short call premium	–620
Short put premium	–920
Net	$5,225

This produces a wide profit zone, as summarized in Figure 8–3.



* Based on closing prices as of October 22, 2004; source: www.cboe.com

Figure 8–3 Profit and loss zone, short option straddle.

Maximum Advantage: Large-Point Discounts

The 18.2-percent return and discount of the net price down to $52.25 per share is a good start for this position. Referring back to possible outcome scenarios, a short straddle such as this is appropriate only when you want to create exercise. It remains possible to roll out of these positions, depending on the direction of price movement. For example, if the stock's price rises, you could close the 15-month 70 call and replace it with a 75 call expiring 3 months later. If the stock's price remains below the 70 put strike price, the 15-month 70 put could be replaced with a 65 put expiring 3 months later.

Rolling to avoid exercise extends exposure time but also increases profit potential. The short straddle is conservative as long as the usual qualifications apply: you want to keep shares of stock and add to your holdings, you have qualified the stock in fundamental terms, and you consider the put strike price (discounted by short option premium) a fair price level for the stock. In the example, the 15.40-point price discount takes the potential average basis in stock far below the recent historical trading range for Fannie Mae as of the analysis date, which ranged between $60 and $80 per share over the past 12 months. If you purchased 100 shares and wrote this straddle at the price shown, an exercised put would produce an average basis in the stock of the following:

Purchase price, 100 shares	$6,765
Option premium received	–1,540
Purchase price, exercised put	7,000
Total cost, 200 shares	$12,225
Basis per share	$61.13

Risk is limited on the downside. Exercise of the 70 put occurring at any point between $61.13 and $70.00 per share would leave you with acquired stock at or above then-current market value (not considering trading costs). But what occurs if the value of the stock falls below $61.13 per share? If we consider the net of about $60 per share to be a low trading range for this stock, what does it mean when prices fall below that level?

Rescue Strategies

If you write a short combination or a short straddle, it is conservative as long as you own 100 shares for each call written. This assumes that the fundamental value of the stock has been established and that you would welcome exercise. In the preceding example, we established that a straddle on Fannie Mae produced an annualized yield of 18.2 percent and discounted the cost of stock to $52.25 per share. However, if the put were exercised, the true net cost of 200 shares (original 100 plus additional 100 shares put to you) would end up at $61.13 per share.

If the stock's market value were to fall below $61.13 per share, you would have a net loss. Remember, if your assumed fair price level for the stock is accurate, the decline may be viewed as short-term—as long as the fundamental strength of the company does not change. The price will most likely rebound above $61.13 per share at some point in the future.

Three Valuable Rescue Strategies

If necessary, you can employ one of three rescue strategies involving options:

1. *Sell covered calls.* The most basic rescue strategy is writing covered calls. With an increased number of shares, you can recover a paper loss and create a net profitable position, even if the calls are exercised. Referring to the previous example, we saw that 27-month calls for Fannie Mae were available for about $6.60 and were 12 points out of the money (refer to Table 8–1). Assuming you could find a similar situation with stock at $55 per share and your basis at $60, writing 65 calls and getting a premium of 6 points each would be profitable. Selling the covered calls reduces your basis from $61.13 to $54.13. If exercised, you would earn a total of $1,200 per call before trading costs; writing calls is a viable rescues strategy.
2. *Repeat the combination or straddle.* Once your previous short positions have been closed, exercised, or expired, you are free to write additional combination or straddle positions. If you continue to believe in the fundamental value of the stock, you end

up with 200 shares at reduced basis (in the preceding example). You could write new covered calls and uncovered puts, further reducing your basis while increasing your holdings in the stock. This proposal assumes that, at reduced price per share, you remain willing to acquire more shares in the stock.

3. *Sell uncovered puts to reduce basis further.* Yet another alternative is to gain additional premium income by selling puts. For example, you have 200 shares, and you are willing to increase your holdings to 300. Your 200 shares have an average basis of $61.13 per share. If you write a 55 put and earn a premium per put of 6, or $600, it would reduce your net basis to $55.13 per share on your 200 shares. If that put were exercised, your overall basis would be $69.09 per share:

$$\$61.13\ (2) + \$55.00 = \$59.09\ (300\ \text{shares})$$

As long as you have confidence that this adjusted basis remains a fair price for the stock, selling puts is a good form of contingent purchase *and* an effective rescue strategy. In the case of Fannie Mae, recall that the historical trading range was between $60 and $80 per share. If you use that to measure average cost, as proposed above, your a basis remains *below* the typical trading range of this stock.

In the next chapter, we conclude with a review of sound stock selection fundamentals with option strategies in mind.

9

STOCK SELECTION AND THE OPTION CONTRACT

Selecting stocks based on your risk profile is never an easy matter. In this chapter, we provide conservative guidelines for smart stock selection. The worst criterion for picking a stock is basing the selection on option premium levels. By definition, high option premiums represent greater market risk, so option premium levels are good indicators of stock market risk. We propose conservative standards, offer guidelines for managing the tax complexity of options trading, and suggest methods for using options as a part of your conservative theme.

When all possible option strategies are considered in the context of your conservative profile, what are the criteria for determining which (if any) strategies are appropriate? A recurring theme in this book is to focus on risk profiles and remain faithful to your original investing themes, limitations, and capabilities.

No option strategy is appropriate if its use requires you to alter your risk profile. However, if you discover while investigating options that you *are* willing and able to take on higher risks than you had assumed previously, then you need to reevaluate all of your underlying assumptions. The process of defining risk tolerance is and should be an ever-evolving process. Risk level is determined by a broad range of other matters: knowledge and experience as an investor, personal income and capital, change of job, marriage, birth of a child, divorce, death of a family member, changes in a family member's health.

As your personal career and life events emerge, your risk profile changes as well. This is natural and expected. The problem some investors experience is that when they suffer losses in their portfolio, they may take reckless actions, accept greater risks, and go through a transition from moderate or conservative to a more speculative profile. The intention, in many of these instances, is to gain back the losses as quickly as possible, but that is a mistake. There is wisdom in the advice to chess players: When you lose a chess piece, don't make the mistake of attacking to try and even up the score. When you are behind in points, the smart thing to do is to go on the defensive, become more cautious, and look for ways to protect your remaining position. The same advice applies to investing, especially if you define yourself as conservative. It is a mistake to try to recapture losses by taking on more risks. Everyone loses; the wise attitude is to look for ways to reduce future losses by protecting capital, insure paper profits and exploit market price swings, and seek conservative strategies that improve overall performance. These goals are all met by the thoughtful and sensible application of the option strategies explained throughout this book.

Remembering Your Conservative Profile as a Priority

Even with a thorough grounding in options and their context, you must continually remind yourself of your personal goals, limits, and standards. The market is a playground full of temptations, and many well-intended investors become distracted from their sensible goals and drawn to the many dangerous but exciting high-risk, exotic, and potentially profitable schemes that are so visible and so popular. Conservative, fundamentally based strategies are not terribly exciting, especially in the media-focused market environment. The media tends to emphasize index movement, substantial point change in high-profile stocks, and market rumors and news. Even fundamental news like earnings reports is focused on variation between analysts' predictions and actual outcome rather than on the value of the company as a long-term investment. This scorekeeping is the popular game on Wall Street—at the expense of less exciting but more important fundamental analysis.

The market, as a media-driven "store" containing a vast array of products (stocks, bonds, commodities, and derivatives in many forms) is indeed a distracting place. It is very much an open market with barkers tempting buyers with promises of easy riches. Little, if any, attention is paid to the analytical, detail-oriented fundamental study of a company's financial statements and other financial information. Why should the media highlight a subtle change in a capitalization or working capital ratio? It is easy to report a two-cent variation between earnings and predictions or a four-point movement in the stock's price. So, your difficulty in maintaining your focus is a constant in the market. Your success, which may be defined in terms of losing less often than average, depends largely on making good decisions at the right time.

Dangers and Pitfalls in Using Options

Options, like so many aspects of the market, offer a wide array of temptations. The speculator is drawn to the positive aspects: leverage of capital with the potential for fast profits, often in triple digits, and the fast pace of the market. They rarely pay attention to the other attributes of risk associated

with options: equally fast losses, long-position disadvantages, and the virtual impossibility of profiting from speculation consistently.

It is always tempting to go for fast and easy profits at the expense of conservative standards. However, you know that, by definition, your standards include resisting that temptation. You are aware that opportunity and risk cannot be separated and that those potentially high returns are *usually* accompanied by a similar high scale of risk. While there are exceptions within the options market, conservative strategies all have a common attribute: they are geared toward augmenting returns and protecting positions in your portfolio.

A most important theme is to remember how easy it is to lose sight of your original goals. It is easy to slip out of your conservative mode, allowing risks to expand unintentionally, and to become fascinated with the potential of a particular options strategy. Throughout this book, we emphasized how important it is to test every strategic choice against the sound, conservative risk profile you have already established in your portfolio.

Allocation by Risk Profile

Some people believe that a sensible way to use options is to create a base in their portfolio at some percentage of capital. For example, they may devote 80 percent of their capital to conservative investments. The remaining 20 percent is "mad money," put aside to give in to temptation and to seek high returns along with high risk. However, this is poor advice. The majority of outcomes involve losing that 20 percent. As an alternative, why not invest 100 percent of your portfolio in high-value stocks and then use options conservatively to augment returns, protect long stock positions, and take advantage of market price overreactions? It makes far more sense. You will experience consistent current yields using strategies like contingent purchase, covered calls, and short combinations (involving covered calls and uncovered puts, which is in effect a contingent purchase and a contingent sale opened at the same time). These specific uses of options do not add to market risk. Their overall theme is easily summarized: they are designed to provide conservative

returns consistently over time. Of course, you will occasionally have shares of stock called away and lose the opportunity to make a higher profit. So, in exchange for the occasional lost opportunity, you can modify your portfolio to create option returns, a trade-off you will probably view as an obvious good choice.

Without exception, though, these strategies (along with the use of long puts or short calls for portfolio insurance) must always conform to your long-term conservative risk profile. Your purpose is to build wealth, not to speculate recklessly; so the use of options has to be restricted to those strategies that enhance your existing long stock positions or that expose you to the purchase of stock that you desire to own—either more shares of existing issues or shares of other stocks that have been prequalified as appropriate within your portfolio.

Some people, notably those who have not examined the conservative potential in the option strategies explained in this book, may argue against the concept that options can and do augment the conservative attributes of your portfolio. One conclusion is impossible to avoid: not only are some option strategies conservative, but not employing them puts your portfolio at risk. For example, when a stock's market value rises far above its normal trading range, you naturally expect a short-term correction. This is the perfect time to write covered calls. You expect the stock's value to retreat, but if strike price is properly selected with current higher-than-expected prices in mind, exercise itself would create a substantial profit. If, instead, you buy puts for insurance, you also protect the paper profits by timing your decision based on a keen awareness of trading range versus current price spikes. The same observation is true when prices decline rapidly. A downward spike is a buying opportunity. The traditional method, buying additional shares, is a difficult decision to make when prices have fallen because everyone is uncertain about the short-term volatility and potential for further decline. An alternative is to buy calls or, even more conservatively, to sell out-of-the-money puts. In either event, you create the potential to buy more shares and average down your basis in the stock without placing more capital at risk.

These are conservative strategies. The ultimate conservative approach—the short combination or short straddle explained in Chapter 8, "Combination Conservative Techniques"—creates a position in which even a drastic decline can be rescued with additional option positions. When you create a large protective range through the selection of option strategies, you *reduce* market risk rather than increase it. There are many instances in which just holding shares and taking no action becomes high-risk, even in a conservative portfolio. The long-term approach traditionally has shunned strategies based on reaction to short-term price movement in favor of holding onto conservative growth investments. That plan certainly works; however, *average* returns on a conservative portfolio are less than 10 percent. By definition, a conservative portfolio is unlikely to exceed the market averages. Options can help you to adhere to your conservative risk profile while also beating the market consistently and substantially.

We have all heard wild promises about double-digit and even triple-digit returns by applying an investing "system" of one kind or another. Experience (meaning "loss") has taught us that schemes do not work and that there are no easy or sure-fire ways to beat the market. Even the conservative use of options requires diligence, learning the techniques, mastering terminology, and becoming more knowledgeable than the average investor. Some conservative investors are content to buy shares in blue chips and to place the balance of their capital in a moderate-growth mutual fund. While this traditional approach may enable you to experience average growth or even to outperform long-term averages, it is not spectacular.

Temptation to Select Most Volatile Stocks

When your conservative portfolio does not perform as you expect, what can you do? Some investors are tempted to sell lackluster stocks and go with more exciting, more volatile issues. The idea is that you can experience profits more rapidly, make up for past losses, and outperform the market. In fact, though, this approach is an abandonment

of conservative principles. You need to continue to carefully select value stocks and then protect their equity value. That is the true conservative strategy.

Investors who like the idea of using options also face danger if and when they pick stocks inappropriate for the conservative risk profile. If you shop option premiums with the idea of buying stock and then discounting your purchase price with covered call writes, you are taking the wrong approach. A conservative application of options requires that you first select stocks based on fundamental analysis and comparison; that you pick stocks with lower-than-average volatility and the potential for price appreciation; and that the capital structure, revenue and earnings, PE ratio, dividend history, and other indicators of your stocks are a good fit for your conservative standards. Then, you use the various conservative option strategies to protect equity and enhance current income. Remember, using conservative option strategies on risky, volatile stocks contradicts your standards. The first rule is, pick your stocks carefully and then identify methods for protecting their value.

Creating a List of Potential Investments

There is no shortage of high-quality stocks. By applying conservative principles, you can easily identify at least 10 to 20 stocks you would like to own. You might not be able to afford to buy shares of all of them, but that is not the point. Once you develop your list of potential quality-growth investments, you can buy shares in several of those companies; if a covered call strategy ends up with stock called away, that is not a complete loss. The transaction frees up capital that can be reinvested in the stock of another company on your list. As long as you continually maintain that list of strong candidates based on sound fundamentals, you should never have a shortage of good value investments that you can buy and hold, buy and cover, or apply in contingent-purchase strategies. It is a mistake to believe that there are only a limited number of "good" stocks available at any given time; more likely, there will be far more issues than you can afford to own, which gives you great flexibility in moving capital from one stock to another if you need to. A long-term buy-and-hold strategy makes sense as long as

fundamentals remain strong, but does not mandate that you avoid selling stock under any circumstances. The proper selection of conservative option strategies may result in shares being called away, but as long as you experience a higher-than-average current annualized return, it is a successful transaction.

You gain further flexibility in options trading when you own more than 100 shares of stock. This gives you the chance to vary the use of options, to cover partial holdings, and to change the mix of short options against long stock when you roll forward and up. You can also write covered calls with a mix of expiration and strike prices, or make combinations and short straddles more flexible and interesting with a similar mix.

Creating Sensible Conservative Standards

Assuming that you accept certain options strategies as fitting within your conservative framework, it is worth asking again, What is the definition of a conservative portfolio? In other words, what are the basic standards for stock selection? We already know that picking stocks based on potential option premium levels is a mistake that should not enter into the equation at all.

The Five Conservative Standards for Stock Selection

There are a few well-understood conservative standards for picking stocks. These analytical topic areas should include, at the very least, the following five criteria:

1. *Revenue and earnings trends.* The quarterly and annual rate of growth in revenues and consistency in earnings is always a starting point in fundamental analysis. In spite of the popularity of some dotcom stocks whose companies never earned a profit, the fact remains that conservative investing is based on consistent growth in the operating statement: increasing revenues, well-controlled ratios of cost and levels of expense, and strong earnings.

In analyzing these trends, pay close attention to the gross profit and expenses. Gross profit should remain consistent even when revenues change significantly. Expenses should remain as constant as possible in relation to sales. You may expect some expansion in expenses as corporations diversify, acquire new lines of business, and expand geographically. But the ratio between expenses and revenues should *not* be negative. Revenues should outpace expenses, and when they do not, it is a sign of trouble. When you see sales flattening out or falling, but expenses continuing to rise, that is a very serious problem. Well-managed corporations should put the brakes on expenses when revenue trends slow down.

The revenue–costs–expenses–profit interaction is the essential fundamental indicator that should be the starting point in any financial review. This means that when a corporation has a net loss, there is a fundamental problem. One-time charges may explain the loss, and if that is the case, those charges should be adjusted for the purpose of performing year-to-year trend analysis of the operation. However, if net losses continue from one year to the next, it is only a matter of time until capital deteriorates. Expanding net losses are a warning sign that a once valuable investment has peaked and is on the decline.

2. *Capitalization and working capital.* The most overlooked aspect of a company's ability to remain competitive is its relative capital strength. If a company is depending increasingly on long-term debt to fund growth, that means that an increasing portion of future earnings will have to go to debt service, leaving less capital for expanded operations and dividend payments. So, a negative trend in capitalization should be an alarming signal in your conservative portfolio. Tracking working capital is another method for judging a corporation's financial health. Changes may be subtle, but trends can be observed over time, and what you seek is a company that is able to anticipate cyclical change through proper planning and working capital management. A change in these indicators is an early warning sign of a shift in long-term capital trends.

Initial review might indicate that a company is healthy in terms of working capital when it is simply not the case. For example, you may notice that a corporation maintains a strong 2-to-1 current ratio (comparison between current assets and current liabilities) from year to year, while reporting declining sales and large annual net losses. How can that be? A more detailed review may show that the corporation has been increasing its long-term debt (which is not part of the current ratio) as a means of maintaining its working capital ratio. It is a popular practice to check working capital without also reviewing the long-term debt trend. However, that trend is essential and can prove that during periods of declining sales and profits, debt is being used to bolster the balance sheet. Ultimately, the ever-growing long-term debt affects financial health, so capitalization trends have to be reviewed along with the current ratio.

3. *PE ratio trends.* The PE ratio is a perplexing indicator. It combines technical (price) and fundamental (earnings) in a single "value." But it is troubling because the price is current but earnings may be several months out of date. With this in mind, the PE is best reviewed as part of a trend over time. As PE inches upward, you may conclude that investors are placing too much value in future growth potential. A more revealing form of PE than current price and latest earnings is to compare quarter-end closing prices to quarter-end earnings, and then review that version of PE over a series of fiscal quarters.

   History has demonstrated that lower PE stocks outperform higher PE stocks with remarkable consistency. But, by definition, the higher PE also indicates greater market interest. Thus, this hybrid technical/fundamental indicator is a valuable meter of market sentiment. When the PE begins rising above its historical range, it may also indicate that the price of stock is outpacing anticipated future growth. Because the PE is a reflection of earnings multiples, the higher the PE, the more concern you should have regarding the long-term value of stock.
   Another factor that can distort PE is the degree of one-time adjustments needed in the reported profits of the company. If earnings per share (EPS) includes noncore items (see number 4,

below) or one-time extraordinary adjustments, then the PE is likely to be inaccurate and unreliable as an indicator. You may need to adjust reported earnings in order to arrive at a reliable PE for the purpose of trend analysis.

4. *Core-earnings-based analysis.* The need to make adjustments to reported financial results makes all the difference in fundamental analysis. For example, if current net earnings include proceeds from the sale of a business and other capital assets, profit from an accounting change, or pro forma earnings on invested pension assets, those items should be removed from the analysis. If employee stock options were granted in the current year but are not included as an expense, their value should be deducted from reported net earnings. In many cases, core earnings adjustments can significantly change the fundamental conclusions you will reach about a particular company or about company-to-company comparisons. The intention in making core earnings adjustments is to identify the true core earnings so that comparisons from period to period or between corporations are valid.

   If you do not calculate core earnings adjustments, all other fundamental indicators are unreliable as well. For example, the PE ratio compares the stock price to earnings per share; however, if earnings per share is distorted, then the PE will be distorted as well. One solution is to compute *core* earnings per share and use that in calculations of the PE. As a result, the core PE ratio becomes an indicator of the company's long-term growth trend.

5. *Dividend history and reinvestment plan.* The history of dividend payments and the current yield are very important indicators. In a comparison of various options strategies, for example, we demonstrated that the dividend yield makes a big difference in which company you select. If you limit your selection to dividend achievers, those companies that have increased dividend payments every quarter over the past 10 years, you naturally pick from among the strongest value investments available. If you also limit your list of potential investment candidates to companies that have DRIP plans, you can achieve a compound rate of return on dividend income, which over time adds great

value. You will find plenty of conservative investments that meet these criteria, and it is an excellent method for narrowing down the list of candidates.

This list is only a starting point—the bare minimum of fundamental indicators that you need. In your own conservative analysis program, you may also use any number of other indicators you find useful, including a broad range of balance-sheet or income-statement ratios. management indicators. or combinations of fundamental and technical trends. For example, in judging the safety of a company, the fundamentals are of paramount importance, but you should also examine technical volatility and implied volatility (both in stock and option price and volume trends).

Maintaining Fundamental Clarity

There is a tendency among investors to believe that good values are difficult to find. However, confusion arises in an attempt to define "value" in the market. Some investors believe they should buy stocks that double in value immediately after they purchase shares. So, even conservative investors may end up chasing short-term profits and conclude that it is difficult to find value—by a double-in-value definition—with any consistency.

Under a truly conservative standard, a quality investment should be defined as a strongly capitalized, well-managed, profitable, and competitive company whose stock has performed strongly and consistently, and whose fundamental and technical risks are a good match for the conservative profile. Under this definition, there are many good values to be found in the market. The argument against covered call writing—that you risk losing stock—is often premised on the idea that a particular stock, once lost, cannot be replaced. In fact, though, good values abound and can be located using fundamental criteria. You may want to develop a list of prequalified companies. The list may be far larger than the number of stocks you can afford to own, but it broadens your strategic range, and you come to realize that having "good" shares called away is not truly a loss. As long as you can consistently earn current returns in your portfolio *and* maintain a conservative standard, there is no real lost-opportunity problem. You simply replace one opportunity with another.

Distinctions: Risk Standards Versus Brand Loyalty

The clarity with which you view your long-term goals has everything to do with how you manage your portfolio. A second tendency among investors is to develop a "brand loyalty" to the stocks they own. Closely related to this is an aversion to some companies based on noninvesting criteria. For example, some people hate Wal-Mart, Microsoft, or Halliburton to the extent that they will never buy shares in those companies. Some investors are faithful to IBM, Sears, or Kodak. These love-or-hate opinions often are not based on fundamental analysis but on some personal, social, or political opinion. To maintain clarity, it is advisable to avoid investing in companies that you either love or hate, if only because strong feelings about a particular company cloud judgment. You can make more objective decisions about when to buy, hold, or sell a company's stock if you are neutral about its management, policies, politics, or social impact. For example, if you once owned a small retail store and you were forced out of business because Wal-Mart opened a Supercenter across the street, you may not be able to objectively evaluate the investment value of Wal-Mart stock. If you swear by Kodak products for your personal use, you may not be able to analyze the company's ability to compete in the digital camera market.

Given the large number of excellent quality investments, it makes sense to limit your analysis to those companies that you can evaluate objectively. In stock selection as well as in a decision to employ option strategies, there is plenty of fundamental analysis to be done without also struggling with personal feelings about the company itself.

Once you pick companies that qualify for your fundamental, conservative standards, you also want to maintain clarity on two other levels: stock ownership and the use of options. The decision to hold or sell should be based on consistency in fundamental indicators or on emerging changes in trends. A particular stock might be a good candidate for option strategies; this does not mean that the stock continues to qualify as part of your portfolio. It makes sense to sell shares of stock as soon as the risk factors change and those factors are clear and precise, based on financial information and capital strength, not on technical aspects of option values.

The second form of clarity is the use of options. There are a limited number of appropriate strategies in your conservative portfolio, and once you have set standards limiting their use, it is important to avoid the temptation to wander from those limited, conservative applications. To review, your criteria may include the following:

1. Use options only for stocks you own or want to own.
2. Use short calls only if and when you are willing to accept exercise.
3. Use short puts only if you are willing to buy additional shares, either through a contingent-purchase plan or when market movement presents buying opportunities.
4. Premium value from writing short options should be at or greater than a minimum annualized return (we used 10 percent as a minimum in our examples).
5. Long options may be purchased to (a) protect existing paper profits, (b) exploit unusual and temporary market movements, and (c) average down your basis in the stock.
6. Long calls may also be used as a form of contingent purchase, but only for stocks you want to buy; it is one way to leverage capital by locking in strike prices on numerous stocks.
7. Writing short combinations or straddles is appropriate only when the call side is covered and when all possible outcomes have been evaluated and qualified to meet your conservative standards.

The Importance of Taxes in the Option Equation

Even when you have defined clear guidelines for using options in your portfolio, you may yet face complications due to the tax rules, one of the most troubling aspects of including options as a strategy. While everyone hopes for tax simplification, history shows that reforms in the federal tax system have only made matters more complex.

A seemingly innocent strategy, such as a short straddle, can cause complex tax problems. The least of these may be deferral of losses to a future period when a second leg of a straddle closes.

Five Tax Guidelines

A more significant threat than deferral of losses is the loss of long-term status in exercised stock. Some tax guidelines worth remembering include the following:

1. *Limit covered calls to out-of-the-money positions.* Using out-of-the-money calls avoids the complexities that arise when writing in-the-money calls. Additionally, the most conservative method in the market involves out-of-the-money positions, so this makes sense based on your risk profile as well.
2. *Accept exposure to loss of long-term capital gains only when you have carryover losses.* Most people are not happy to exchange a large, long-term capital gain for the higher short-term rates. One exception is that if you have large carryover losses to absorb, you can maximize options strategies by accepting short-term gains and sheltering them by using up a part of the carryover loss.
3. *Be aware of how the tax rules affect any combination strategies, especially short straddles.* This book emphasizes the strategic possibilities of taking various options positions as well as maintaining a conservative risk profile while maximizing potential profits. However, you should also be aware of how a specific strategy affects your tax liabilities.
4. *Remember that rolling out of one position and into another could change the status of taxation.* If you begin with an out-of-the-money covered call and then roll forward to a later expiring in-the-money position, you could trigger the loss of long-term status for the underlying stock. Before picking a new position, be aware of the potential higher tax as a result.
5. *Check with a qualified tax expert before you enter into trades.* The tax rules for options are complex and, in some cases, uncertain. For example, the anti-straddle rule is so vague that it

may even be unclear when it applies. Make sure that you and your tax expert understand the rules and the tax consequences of your decisions before executing actual trades.

Option Volatility to Judge Stocks

Tax rules are certainly a complication in your portfolio. Taxes alone may prevent your entering specific types of transactions. However, knowing the tax outcome in advance provides you with better information and guidelines for proceeding. For most investors, managing market risk—usually measured by degrees of volatility—is a more immediate problem.

Most investors agree that, as a technical indicator, changes in volatility signal changes in risk. High volatility in option premium is a warning sign. Although higher-than-average option premium (caused by implied volatility) is attractive, it also tells you that buying shares of stock is a high-risk idea. It contradicts your conservative risk profile.

The temptation to buy highly volatile stocks specifically to sell covered calls is difficult to resist. But the greatest trap is to start out as a conservative investor and end up with a portfolio of inappropriate stocks. It can happen easily if your selection is based on option-specific valuation rather than on tried-and-true fundamental indicators. It is not necessary to stray from the conservative standard because it is not difficult to earn option-based returns using conservative strategies. This is possible using LEAPS options in short positions on conservative stocks with strong fundamentals. A 16-percent annualized return using options with a conservative stock is far better than a 32-percent return from covered calls on a highly volatile stock. Compare the potential return to what you earn on average rather than on what you could earn using more volatile stocks and higher risk strategies. That is the key.

Volatility as an Early Indicator

Option volatility itself may indicate emerging fundamental problems in a company. The problems may be temporary or permanent. For

example, the current quarter's earnings may be lower than expected, which creates momentary volatility. But in the long-term, bigger picture, the company's fundamentals have not changed. In other instances, perhaps a corporation has peaked and is now beginning a gradual downward earnings slide, loss of competitive position, or subtle changes in financial strength. If debt capitalization is inching upward as a percentage of total capitalization, for example, it could signal a change in fundamental strength. This ultimately affects dividends and erodes working capital; recognizing such changes early helps you to time decisions. Option volatility is not always an early indicator, but it could be. So, if option volatility changes suddenly, it is worth the effort to check fundamental changes, evaluate recent news or earnings reports, and look for any confirming signs that the financial strength and position of the company have changed.

Using the company's fundamental indicators as a means for deciding whether or not to buy stock is always the preferred place to start. Options should be viewed as alternative strategies that may augment the conservative portfolio strategy, provide alternatives to outright purchase, or enable you to protect or take paper profits without having to sell shares.

Option volatility can help you to coordinate your fundamental analysis with technical tests. Degrees of volatility provide potential confirming information or even signal coming changes. In addition to reviewing the fundamentals, technical tests of various types can also be used—in conjunction with fundamental analysis—to augment your study of trends. Technical and fundamental volatility are closely related. For example, when a company reports consistent growth in revenues and earnings over time, you are likely to also observe a gradual increase in stock market value within a relatively narrow trading range. When the trading range is broader or erratic compared to marketwide trends, it usually signals similar volatility in the fundamentals.

With this in mind, it makes sense to test a limited number of technical indicators along with your fundamentals. These may include option premium volatility as well as trading-range trends and the stock's support and resistance levels. A comparison between fundamental and technical indicators improves your overall program and often provides

greater insight than you can achieve with a program limited only to a few fundamental indicators.

The time differences between financial reports and current trends limit the isolated use of fundamentals. Because quarterly and annual reports are outdated by the time they are released, it is difficult to equate these reports to current price trends. However, you often see emerging trends in price volatility as an indicator of pending financial changes, just as current earnings reports have an immediate effect on the technical side.

It makes perfect sense to consider option volatility within a coordinated fundamental plan; this is especially true if you incorporate technical indicators in your study of a particular company. Options have no fundamentals of their own, which is why it is so important to limit your use of options to well-selected stocks. A conservative portfolio's overall return can be both protected and enhanced with options, and done so in a way that remains faithful to the risk profile that is so crucial. You want to avoid the mistake of using options in ways that expose your portfolio to high risk. Thus, you want to isolate your options program to only those strategies that protect your portfolio or that provide premium returns without increasing market risk. As with any range of strategies, the *appropriate* range of possible uses of options is a short list, and it should be. Inexperienced investors are invariably surprised when they experience losses. Wiser investors know that while some losses are unavoidable, reducing the chances of loss is the key to success. Options can help achieve that while also improving overall rates of return in your conservative portfolio.

Appendix

OPTION TRADING STRATEGIES

Following is a summary of the strategies presented in this book.

1. Basic long call
   - **a.** as a purely speculative position
   - **b.** used to take advantage of price declines in stock
   - **c.** as a form of contingent purchase
2. Basic long put
   - **a.** as a purely speculative position
   - **b.** used to take advantage of price rise in stock (insurance for paper profits)
   - **c.** as a form of contingent sale of stock
3. Basic uncovered call
   - **a.** a highly speculative position with unlimited risk
   - **b.** as part of a ratio write
4. Basic uncovered put
   - **a.** as a form of contingent purchase
   - **b.** as part of a rescue strategy
5. Put insurance (buying long puts to insure current long-stock profits)
6. Contingent-purchase strategies
   - **a.** long calls purchased as alternative to buying stock
   - **b.** puts sold to create a credit as well as contingent purchase
   - **c.** the covered long call with higher strike price, shorter expiring short calls
7. Rolling strategies
   - **a.** rolling forward to defer expiration while creating a credit
   - **b.** rolling short calls forward and up to defer or avoid expiration and to increase potential exercise price

c. rolling short puts forward and down to defer or avoid expiration and to reduce potential exercise price

d. rolling back—exchanging a current option position for one expiring sooner

8. Ratio write

a. creating partially covered positions with some degree of risk

b. modified to eliminate all risk by buying high calls to offset short exposure

9. Rescue strategies

a. short puts to create a credit and, if exercised, to reduce average basis

b. covered calls to reduce paper loss

c. two-part combination of short puts and, when exercised, converting to covered calls

10. Forced exercise (intentional exercise using covered calls)

11. Spread strategies

a. long spread, high risk requiring adequate price movement

b. short spread with uncovered positions—high risk

c. short spread involving covered call and uncovered put—conservative when fundamental criteria and assumptions are present

12. Straddle strategies

a. long straddle, high risk requiring substantial price movement

b. short straddle with uncovered positions—extremely high risk

c. short straddle combining covered call and uncovered put—ultimate conservative strategy with higher-than-average returns, assuming that basic fundamental criteria and assumptions are present

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GLOSSARY

annualized basis a calculation of return on an option strategy, adjusted to reflect that return as if the position had been open for one year.

at the money the status of an option when its strike price is equal to the stock's current market value.

average down a technique for reducing net basis in stock as part of a rescue strategy; by purchasing shares at current market price, the overall basis in the stock is reduced so that option strategies can be employed to create a net profitable outcome.

call an option providing the buyer with the right, but not the obligation, to purchase 100 shares of a specified stock, at a specified strike price and by an expiration date, and obligating a seller to deliver 100 shares at a fixed strike price if and when the contract is exercised by the buyer.

closing purchase transaction an order to close a short position through purchase at the current price or premium.

closing sale transaction an order to close a long position through sale at current price or premium.

combination any strategy involving option contracts on the same underlying stock, when terms (strike price, expiration, or call versus put) are not identical.

core earnings the earnings of a corporation based on inclusion of revenue, costs, and expenses only related to its core business, and excluding all noncore, extraordinary, or other nonrecurring items.

covered call a strategy in which one call is sold for every 100 shares owned, considered a conservative strategy because it reduces market risk while offering exceptional return.

current market value the value of stock or option based on what a buyer would pay or on what a seller would receive if a transaction were executed now.

deep in or out a condition in which an option is more than 5 points in or out of the money. A call is in the money when current market value is higher than the strike price; a put is in the money when current market value is lower than the strike price.

discount a reduction in cost or price, creating a lower basis in stock through selling options.

dividend yield the yield from dividends paid on stock, calculated by dividing annual dividends by current value (current yield) of stock or by original cost of the stock.

downside protection advantage gained using options to protect long positions through the purchase of an insurance put or through the sale of covered calls.

exercise the purchase of stock under terms of a call, or the sale of stock under terms of a put; exercise takes place at the fixed strike price of the option, regardless of the stock's current market value.

expiration the date on which an option becomes worthless.

fundamental volatility the relative tendency of a company's operating results to be consistent from one period to another or to be erratic. The higher the inconsistency of revenue and earnings results, the higher the fundamental volatility.

implied volatility the anticipated future value of an option based on current market value of the stock and its proximity to strike price, time remaining until expiration, stock price volatility, and transaction volume in the option.

in the money the condition in which the stock's current market value is higher than a call's strike price or lower than a put's strike price.

intrinsic value the portion of option premium equal to the number of points, if any, that are in the money. When the option is at the money or out of the money, there is no intrinsic value.

leverage a strategic utilization of capital to control more capital; for example, a contingent purchase plan involving options is a form of leverage because it locks the purchase price, but the buyer has the right to exercise or not exercise the option in the future.

listed option an option available to the general public and through public exchanges, which normally expires in 8 months or less.

lock-in price the strike price of an option, which is the purchase or sell price in the event of exercise.

long position a position in stock or option in which the first transaction is an opening purchase, followed later by a closing sale.

Long-term Equity Anticipation Securities (LEAPS) an option whose life lasts up to 36 months as opposed to a traditional listed option, whose life is limited to 8 months or less.

naked position any short call not covered by an offsetting stock position. A naked call is a short position in which the seller does not also own 100 shares of stock for each option written.

opening purchase transaction an order to open a long position through purchase at the current price or premium.

opening sale transaction an order to open a short position through sale at current price or premium.

option an intangible call or put contract providing certain rights to buyers and obligations to sellers. A buyer pays a premium to acquire rights. The buyer of a call option has the right to purchase 100 shares of stock at a specified strike price and by a specified date in the future. The buyer of a put option has the right to sell 100 shares of stock at a specified strike price and by a specified date in the future. An option seller receives a premium for accepting obligations. A call seller is required to sell 100 shares of stock at a specified strike price and by a specified date in the future if and when the buyer exercises the call (calls the stock from the seller). A put seller is required to buy 100 shares of stock at a specified strike price and by a specified date in the future if and when the buyer exercises the put (puts the stock to the seller). In all cases, options exist on a specific stock and cannot be transferred.

out of the money a condition in which the current market value of stock is lower than a call's strike price or higher than a put's strike price.

premium the current value of an option, which is paid by the buyer or to the seller for opening a position.

put an option providing the buyer with the right, but not the obligation, to sell 100 shares of a specified stock, at a specified strike price and by an expiration date, and obligating a seller to purchase 100 shares at a fixed strike price if and when the contract is exercised by the buyer.

rescue strategy an option strategy designed to offset a net decline in value of stock, using options to average down basis or to offset paper losses with option profits.

ratio write a variation on the covered call strategy involving the writing of a number of calls other than one call per 100 shares of stock.

return if exercised a calculation of overall return from a short-option strategy, based on exercise of the option and expressed on an annualized basis.

return if unchanged a calculation of return from a short-option strategy, based on expiration of the option and expressed on an annualized basis.

roll down replacement of one short put with another when the strike price of the replacement put is lower than the strike price of the original put.

roll forward a replacement of one short call or put when the strike price remains the same but the current expiration date is replaced with a later expiration date.

roll forward and up/down a strategy in which an existing option is replaced to avoid exercise, often also creating a net credit. An existing short call is closed and replaced with another whose strike price is higher and whose expiration occurs later (roll up); an existing short put is closed and replaced with another whose strike price is lower and whose expiration occurs later (roll down).

roll up a replacement of one short call with another when the strike price of the replacement call is higher than the strike price of the original call.

short position a position in stock or option in which the first transaction is an opening sale, followed later by a closing purchase.

speculation an investment profile accepting high risk in exchange for the opportunity to earn exceptionally high short-term profits (or to suffer high short-term losses). Speculators usually are not interested in long-term growth or in holding equity positions.

spread a strategy in which options are either purchased or sold on the same stock, with varying strike prices, expiration dates, or both.

straddle a strategy in which an identical number of calls and puts, with identical expiration dates and strike prices, are either purchased (long straddle) or sold (short straddle).

strike price the price at which options are exercised, regardless of current market value of the underlying stock.

support level the price or price range of a stock representing the lowest likely price that buyers and sellers agree upon.

terms collectively, the contractual conditions and definitions of every option, including identification of the option as either a call or a put, the expiration date, the strike price, and the underlying security.

time value the intangible option premium, equal to all out-of-the-money value and exceeding any intrinsic value.

total return the combined return from option strategies, including option premium, capital gain, and dividend income, all net of transaction costs.

uncovered option a short call when the seller does not own 100 shares of stock for each call written, or any short put.

underlying stock the stock on which an option is bought or sold.

volatility a measurement of safety, the degree of movement in current market value of a stock's price or of an option's premium.

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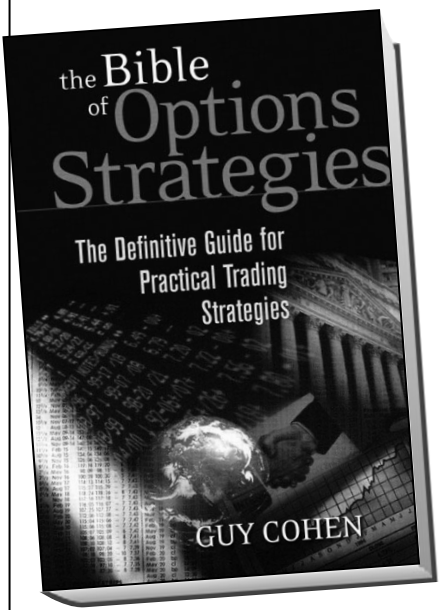

The Bible of Options Strategies

The Definitive Guide for Practical Trading Strategies

BY GUY COHEN

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BY HARRY DOMASH

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