

GUIDE TO OPTIONS STRATEGIES FOR TURBULENT MARKETS

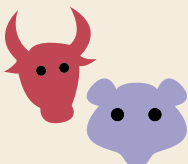


• *Puts and Calls*

• *Equity Options*



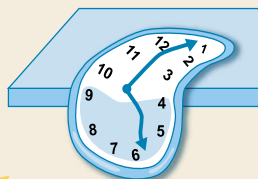
• *Index
Options*



• *Strategies*

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VIRGINIA B. MORRIS AND BESS NEWMAN

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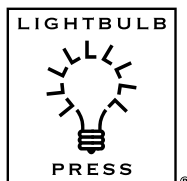
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Call Writing

You can write covered calls to earn income on your stocks.

Writing calls is a straightforward options strategy. When you write a call, you receive cash up front and, in most cases, hope that the option is never exercised. It can be conservative or risky, depending on whether you're covered or uncovered.

INVESTOR OBJECTIVES

You might write calls in order to receive short-term income from the premium you'll be paid. If that's your strategy, you anticipate that the option you write will expire out-of-the-money, and won't be exercised. In that case, you'll retain all of the premium as profit. If you've written this call on stocks you already own, known as a **covered call**, the premium can act as a virtual dividend that you receive on your assets. Many investors use this strategy as a way to earn additional income on nondividend-paying stocks.

Alternately, you could view the premium as a way to reduce your cost basis, or the amount that you paid for each share of stock.

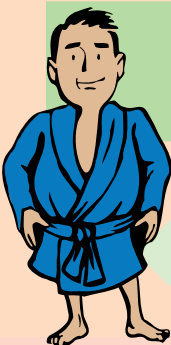
CALCULATING RETURN

In order to calculate the return on a written call, you'll have to take into account the transaction costs and brokerage fees you pay for opening the position, which will be deducted from the premium you receive. And if your option is exercised, you'll have to pay another round of fees. But since you probably plan for your option to expire unexercised, if you're successful you won't face any exit transaction fees or commission.

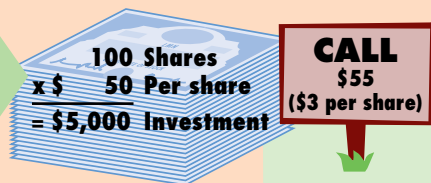
If you write a call on stock you hold in a margin account, you should consider the margin requirement imposed by your firm when calculating return. If your trade is successful you retain all of your capital, but it will be tied up in the margin account until expiration. That means you can't invest it elsewhere in the meantime.



COVERED CALLS



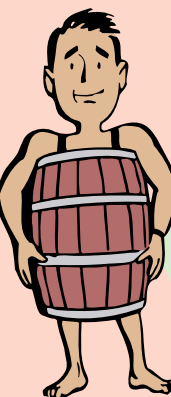
1 When you write a covered call, you own the stock. For example, say you purchased 100 shares of LMN stock at \$50.



\$300

2 You write a 55 call on the stock, and receive a \$300 premium, or \$3 for each share covered by this contract.

NAKED CALLS



A much more risky strategy is writing **naked calls**, or options on stock you don't own. Also known as **uncovered call writing**, this strategy appeals to bearish investors who want to capitalize on a decline in the underlying shares.

\$300

1 You write a 55 call on a stock, and receive a \$300 premium, or \$3 for each share covered by this contract.



2 If the price doesn't go up and the option expires unexercised, you keep the \$300 premium as profit.

If you have written an option on a stock with an upcoming dividend distribution, it's important to know that the likelihood of exercise is much higher right before a dividend payout. If the stock's dividend date on a call you've written is approaching, you should re-evaluate and determine whether to close out your position.

EXITING AND EXERCISE

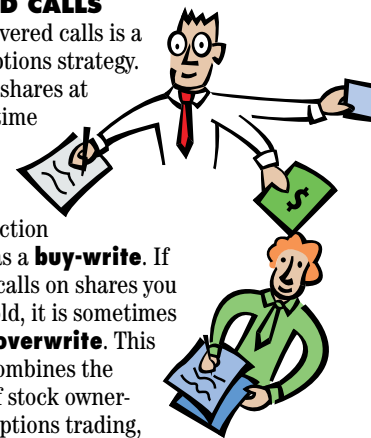
If the stock or other equity on which you wrote a call begins to move in the opposite direction from what you anticipated, you can close out your position by buying a call in the same series as the one you sold. The premium you pay may be more or less than the premium you received, depending on the call's intrinsic value and the time left until expiration, among other factors. You can also close out your position and then write new calls with a later expiration, a strategy known as **rolling out**.

If the call you wrote is exercised—as is possible at any point before expiration—you will have to deliver the underlying security to your brokerage firm. The **assignment** for an exercised call is made by OCC to any of its member brokerage firms. If your brokerage firm receives an

assignment on an options series on which you hold a short position, you may be selected to fulfill the terms of the contract if you were the first at your brokerage firm to open the position, or by random selection, depending on the policy of the firm. It is extremely rare for the writer of an in-the-money call to not have to sell the underlying stock at expiration.

COVERED CALLS

Writing covered calls is a popular options strategy. If you buy shares at the same time that you write calls on them, the transaction is known as a **buy-write**. If you write calls on shares you already hold, it is sometimes called an **overwrite**. This strategy combines the benefits of stock ownership and options trading, and each aspect provides some risk protection for the other. If you write a covered call, you retain your shareholder rights, which means you'll receive



dividends and be able to vote on the company's direction.

Writing covered calls is a way to receive additional income from stocks you already own. It can also offer limited downside protection against unrealized gains on stocks you've held for some time, since you lock in a price at which to sell the stock, should the option be exercised.

You should realize, however, that if a stock on which you've written a covered call rises in value, there's a very real chance that your option will be exercised, and you'll have to turn over your shares, missing out on potential gains above the strike price of your option.

3 That means that the \$50 you paid for each share is offset by the \$3 you received, so your **net price paid** is actually \$47 per share.

$$\begin{array}{r} \$5,000 \\ - \$300 \\ = \$4,700 \\ \text{or } \$47 \text{ Per share} \end{array}$$

4 Even if the option is exercised, you'll receive \$55 per share, which is a profit of \$8 per share, or \$800.

$$\begin{array}{r} \$5,500 \\ - \$4,700 \\ = \$800 \text{ Profit} \end{array}$$

However, if the stock price rises significantly above \$55, you won't share in that gain.

3 If the stock price goes up to \$59 and the 55 call is exercised, you receive \$55 a share or \$5,500. But you'll have to buy the stock at market price, or \$5,900. The premium reduces your \$400 loss to \$100.

$$\begin{array}{r} \$5,900 \text{ Purchase} \\ - \$5,500 \text{ Exercise} \\ = \$400 \\ - \$300 \text{ Premium} \\ = \$100 \text{ Net loss} \end{array}$$

While this loss is moderate, every additional dollar that the stock price increases means your loss increases by \$100—and there's no limit to how high your loss could climb.

If you choose this strategy, you'll have to keep the minimum cash margin requirement in your margin account, to cover the possibly steep losses you face if the option is exercised. If you are assigned, you must purchase the underlying stock in order to deliver it and fulfill your obligation under the contract.

Put Buying

You can hedge your stock positions by going long with puts.

Buying puts is a simple strategy that can help protect your assets or let you profit even in a bear market. If you think the market is going to decline, buying puts might be more advantageous than either selling the stocks you own or selling stock short through your margin account.

INVESTOR OBJECTIVES

Put buying is a strategy some investors use to hedge existing stock positions. For the cost of the premium, you can lock in a selling price, protecting yourself against any drop in asset value below the strike price until the option expires. If you exercise your option, the put writer must purchase your shares at the strike price, regardless of the stock's current market price.

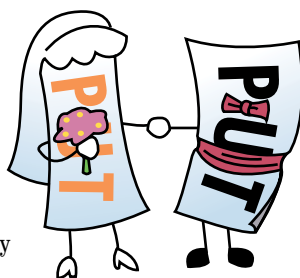
But if the stock price rises, you're still able to benefit from the increase since you can let the option expire and hold onto your shares. Your maximum loss, in that case, is limited to the amount you paid for the premium.

Speculators who forecast a bearish equity market often buy puts in order to profit from a market downturn. As the price of the underlying equity decreases, the value of the put option theoretically rises, and it can be sold at a profit. The potential loss is predetermined—and usually smaller—which makes buying puts more appealing than another bearish trading strategy, selling stock short.

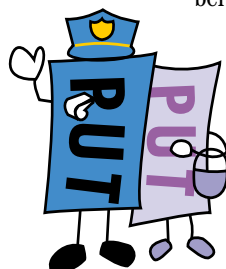
GETTING MARRIED

If you buy shares of the underlying stock at the same time that you purchase a put, the strategy is known as a

married put. If you purchase a put on an equity that you've held for some time, the strategy is known as a **protective put**. Both of these strategies combine the



benefits of stock ownership—dividends and a shareholder's vote—with the downside protection that a put provides.



Holding the underlying stock generally indicates a bullish market opinion, in contrast to

other long put positions. If you would like to continue owning a stock, and think it will rise in value, a married put can act as an insurance policy in case the stock price drops, minimizing the risks associated with stock ownership. In the same way, a protective put locks in unrealized gains on stocks you've held, in case they begin to lose value.

SHORT A STOCK OR LONG A PUT

If you **sell stock short**, you borrow shares on margin from your brokerage firm and sell them on the stock market. If—as you hope—the stock price drops, you buy the equivalent number of shares back at a lower price, and repay your brokerage firm. The difference in the two prices is your profit from the trade. For many investors, buying puts is an attractive alternative to shorting stock.

Shorting stock requires a margin account with your brokerage firm. A short seller also faces the possibility of a margin call if the stock price rises, and could be forced to sell off other assets.

Shorting stock involves potentially unlimited loss if the price of the stock begins to rise and the shares have to be repurchased at a higher price than they were sold.

Investors can only short stock on an uptick, or upward price movement. The uptick rule is meant to prevent a rush of selling as the price of a security drops.

Puts are purchased outright, usually for a much lower amount than the margin requirement, so you don't have to commit as much cash to the trade.

A long put poses much less risk to an investor than shorting stock. The holder of a put always faces a predetermined, limited amount of risk.

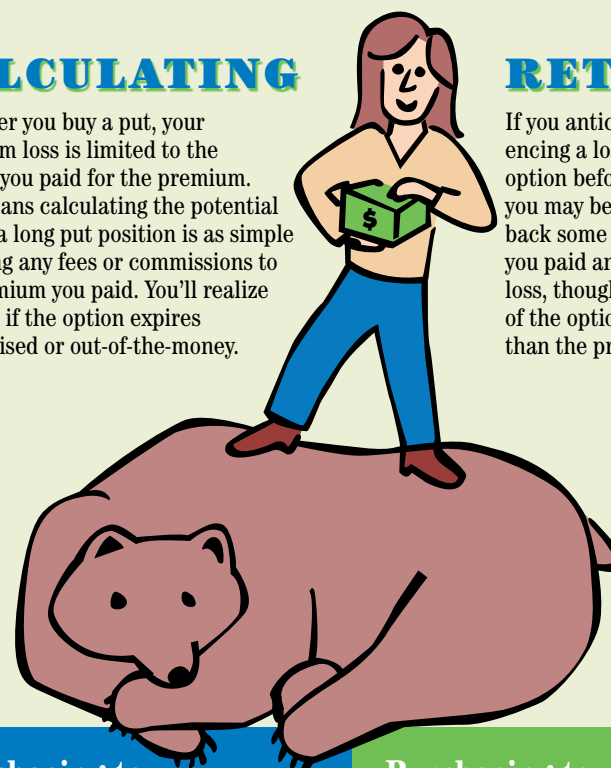
Puts can be purchased regardless of a stock's current market price.

CALCULATING

Whenever you buy a put, your maximum loss is limited to the amount you paid for the premium. That means calculating the potential loss for a long put position is as simple as adding any fees or commissions to the premium you paid. You'll realize this loss if the option expires unexercised or out-of-the-money.

RETURN

If you anticipate experiencing a loss and sell your option before expiration, you may be able to make back some of the premium you paid and reduce your loss, though the market price of the option will be less than the premium you paid.



Purchasing to Hold or Sell the Option

If you purchase a put and later sell it, you can calculate return by figuring the difference between what you paid and what you received.

For example, say you purchase one LMN put for \$300, or \$3 per share.

A month later, the price of the underlying equity falls, placing the put in-the-money. You sell your option for \$600, or \$6 per share.

Your return is \$300, or 100% of your investment.

\$600 Sale price
– \$300 LMN put price
= \$300 or 100% return

If the price of the stock has risen after a month, the put is out-of-the-money, and the premium drops to \$200.

You decide to cut your losses and sell the put. You've lost \$100, or 33% of your investment.

\$300 LMN put price
– \$200 Sale price
= \$100 or 33% loss

Purchasing to Hedge a Stock Position

If you purchased the put to hedge a stock position, calculating your return means finding the difference between your total investment—the price of the premium added to the amount you paid for the shares—and what you would receive if you exercised your option.

For example, if you purchased 100 LMN shares at \$40 each, you invested \$4,000.

If you purchased one LMN put with a strike price of \$35 for \$200, or \$2 per share, you've invested \$4,200 total in the transaction.

If you exercise the option, you'll receive \$3,500, for a \$700 loss on your \$4,200 investment.

\$4,200 Total investment
– \$3,500 Receive at exercise
= \$ 700 Loss

A \$700 loss might seem big, but keep in mind that if the price of the stock falls below \$35, you would face a potentially significant loss if you didn't hold the put. By adding \$200 to your investment, you've guaranteed a selling price of \$35, no matter how low the market price drops.

Spread Strategies

You can limit your exposure using two or more options on the same stock.

A spread is an options strategy that requires two transactions, usually executed at the same time. You purchase one option and write another option on the same stock or index. Both options are identical except for one element, such as strike price or expiration date. The most common are **vertical spreads**, in which one option has a higher strike price than the other. The difference between the higher strike price and the lower strike price is also known as the **spread**. Different spread strategies are appropriate for different market forecasts.



You use a **bear spread** if you anticipate a decline in the stock price. You use a **bull spread** if you anticipate an increase in the stock price.



Each options transaction is known as a **leg** of the overall strategy, and most options spreads stand on two legs — though there are some strategies with three or more legs.

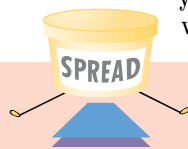
WHAT ARE THE BENEFITS?

Many options investors use spreads because they offer a double hedge, which means that both profit and loss are limited. Investors who are interested in more aggressive options strategies that might expose them to significant potential losses can hedge those risks by making them one leg of a spread. The trade-off is that the potential profit is limited as well.

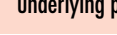
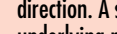
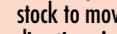
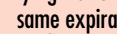
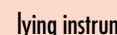
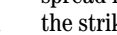
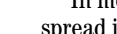
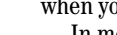
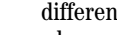
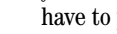
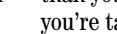
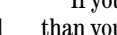
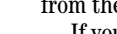
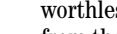
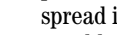
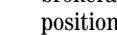
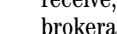
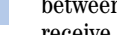
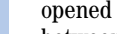
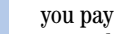
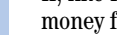
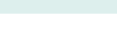
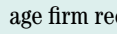
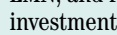
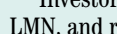
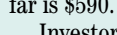
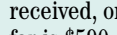
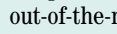
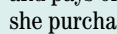
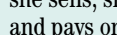
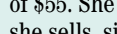
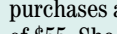
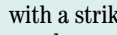
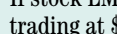
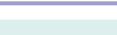
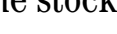
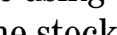
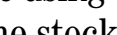
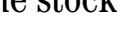
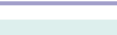
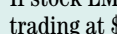
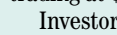
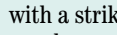
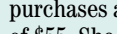
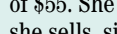
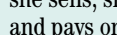
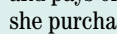
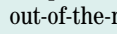
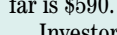
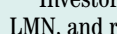
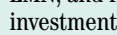
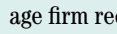
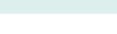
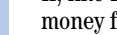
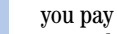
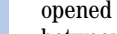
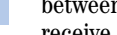
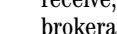
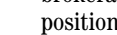
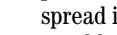
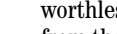
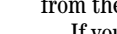
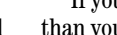
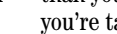
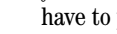
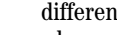
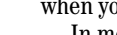
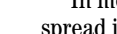
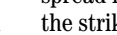
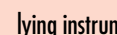
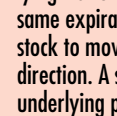
It might help to think of spreads in terms of insurance. Just as you can open an options position to protect against losses in a stock position, you can open an options position to protect against losses in another options position.

MORE TYPES OF SPREADS

A **calendar spread** is the purchase of one option and writing of another with a different expiration date, rather than with a different strike price. This is usually a neutral strategy.



A **straddle** is the purchase or writing of both a call and a put on an underlying instrument with the same strike price and the same expiration date. A buyer expects the underlying stock to move significantly, but isn't sure about the direction. A seller, on the other hand, hopes that the underlying price remains stable at the strike price.



INVESTOR A

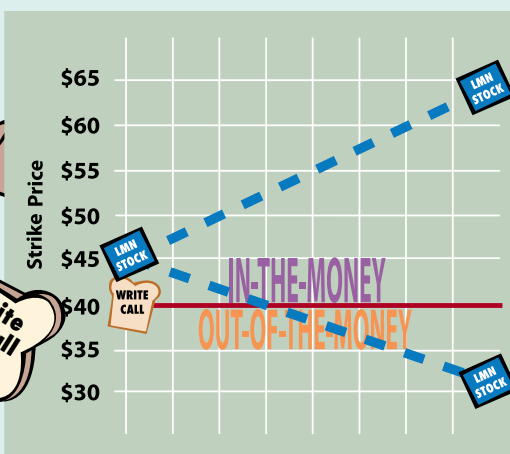
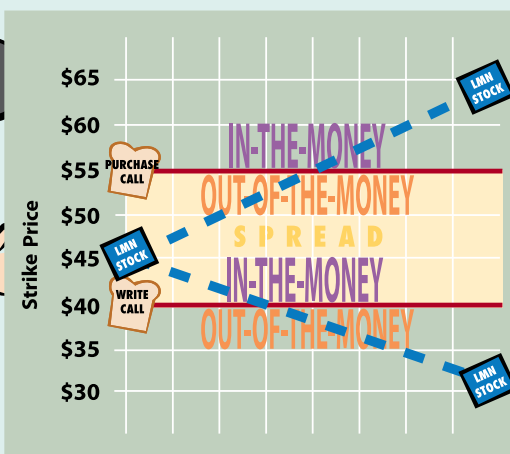
HOW YOU HEDGE WITH SPREADS

If stock LMN is trading at \$45:

Investor A sells a call with a strike price of \$40, and purchases a call with a strike price of \$55. She receives \$720 for the call she sells, since it is in-the-money, and pays only \$130 for the call she purchases, since it is out-of-the-money. Her cash received, or net credit, so far is \$590.

Investor B writes a 40 call on LMN, and receives \$720. His net investment is the margin his brokerage firm requires for a naked call.

INVESTOR B



If the stock price rises to \$60 at expiration: Investor A's short call is in-the-money, and she must sell 100 LMN shares at \$40 each. However, her long call is in-the-money as well, which means she can buy those same shares for \$55 each. Her net loss for each share is \$15, or \$1,500 total. This is offset by the premium she received, reducing her maximum potential loss to \$910.

If the stock price falls below \$40 at expiration: Both of Investor A's options expire out-of-the-money, and she keeps the \$590 for the maximum profit.

If the stock price rises to \$60 at expiration: Investor B's short call is in-the-money, and he must sell 100 LMN shares at \$40 each, for a total loss of \$2,000 over their market price. His credit offsets this by \$720, reducing his maximum potential loss to \$1,280.

If the stock price falls below \$40 at expiration: Investor B's option expires out-of-the-money, and he keeps his entire \$720.

Credit spread:
premium you receive > premium you pay

Debit spread:
premium you receive < premium you pay

ARE YOU QUALIFIED?

Although spreads aren't always speculative or aggressive, they are complex strategies that aren't appropriate for all investors. Your brokerage firm may have its own approval levels for debit spreads and credit spreads, to ensure that you're financially qualified and have adequate investing experience. Additionally, managing spreads as expiration nears requires time and attention, so you should be sure you want to take on the challenge.

EXECUTING A STRATEGY

- 1 The first step in executing a spread is choosing an underlying security on which to purchase and write the options.
- 2 Next, you'll have to choose the strike prices and expiration dates that you think will be profitable. That means calculating how far you think a stock will move in a particular direction, as well as how long it will take to do so.
- 3 You should be sure to calculate the maximum profit and maximum loss for your strategy, as well as the circumstances under which you might experience them. Having realistic expectations is essential to smart options investing.
- 4 Finally, you'll have to make the transactions through a margin account with your brokerage firm. The minimum margin requirement for a spread is usually the difference between the two strike prices times the number of shares covered.



A **strangle** is the purchase or writing of a call and a put with the same expiration date and different — but both out-of-the-money — strike prices. A strangle holder hopes for a large move in either direction, and a strangle writer hopes for no significant move in either direction.

Collar Transactions

You can use a collar to rein in profits you haven't yet realized, but you might have to give up future gains in return.

A **collar** is a spread strategy designed to protect unrealized profits on stock you already own. You purchase a protective put on your long stock position, and offset the cost of that put by writing a call that is covered by your long stock position. The collar spread is also known as a **fence** for the protection it provides.

In most cases, both the long put and the short call are out-of-the-money. If the call you write is less expensive than the put you buy, you'll pay more premium than you receive, and will establish a **debit collar**. If the put you buy is less expensive than the call you write, you'll receive more premium than you pay, and will establish a **credit collar**.

RULE OF THUMB

Call and put options move in opposition. Call options usually rise in value as the underlying market prices go up. Put options usually rise in value as the market prices go down—but time decay and a change in volatility also have an effect.

INVESTOR OBJECTIVES

A collar is most often used as a protective strategy. If you hold a stock that has made significant gains, you might want to lock in those gains, protecting your position against a future drop in price. Writing a covered call can fully or partially offset the cost of purchasing a protective put. Just as with other spread strategies, the risk you face with a collar is limited—and, in return, so is the potential profit.

For example, say you purchased 100 shares of LMN at \$15 two years ago, and its current market price is \$30.

100 Shares
x \$ 15 Per share
= \$ 1,500 Original cost

If you purchase a 25 put, you'll have the right to sell those shares at \$25 before expiration, locking in a \$10 profit on each share, or a total of \$1,000. Suppose that put costs you \$275, or \$2.75 per share.

Let's say you also write a 35 call with the same expiration month, and receive \$250 in premium, or \$2.50 per share.

\$275 Put price paid
- \$250 Call price received
= \$ 25 Net cost

If the price of LMN rises above \$35 at expiration, your call most likely will be exercised. You'll receive \$3,500 for your shares, or a \$2,000 profit, but you'll miss out on any further gains the stock may have.

Since the put you purchased cost more than the call you wrote, your net cost is \$25—less than one tenth of the price of the protective put alone. It would cost you only \$25 to ensure that you could sell at a



YOUR OPTIONS AT EXPIRATION

Depending on the direction the stock moves, your choices at expiration of the legs of your collar vary:

If the price of the stock rises above the strike price of the short call:

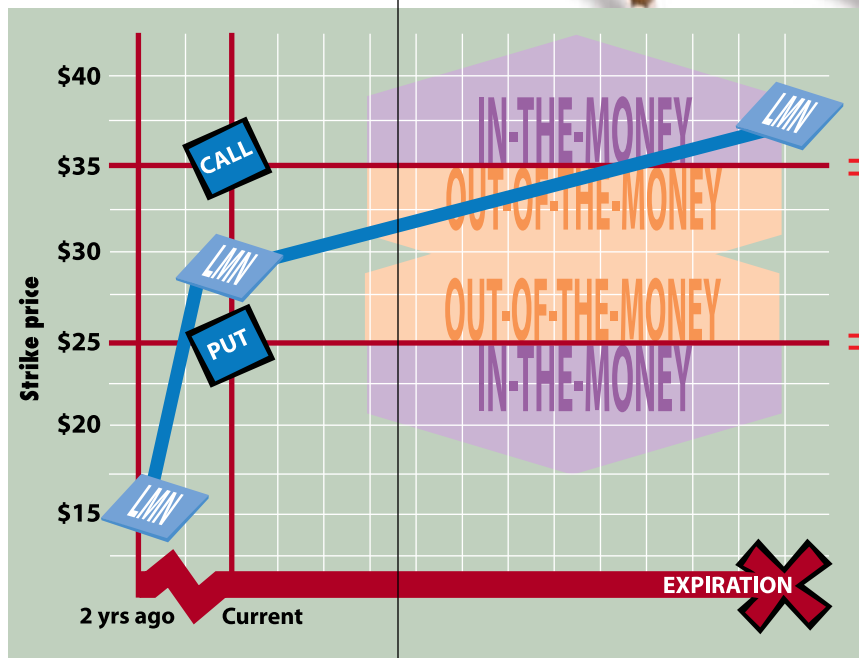
If assigned, you can fulfill your short call obligation and sell your shares at the strike price. You'll lock in profits over what you initially paid for the stock, but you'll miss out on any gains above the strike price. Alternately, you could close out your position by purchasing the same call you sold, quite possibly at a higher price than what you paid for it. This may be worth it if the difference in premiums is less than the additional profit you anticipate you'll realize from gains in the stock's value, or if one of your goals is to retain the stock.

If the price of the stock remains between both strikes:

You can let your put expire unexercised, or sell it back, most likely for less than what you paid, since its premium will have decreased from time decay. Your short call will probably expire unexercised, which means you keep the entire premium. Depending on whether your collar was a credit or debit spread, you'll retain your initial credit as a profit, or debit as a loss.

If the price of the stock falls below the strike price of the long put:

By exercising your put, you can sell your shares at the strike price. Your short call will probably expire unexercised, and you keep all of the proceeds from the sale of the call.



When executing a collar, it's important to define your range of return, or the strike prices for both the put you purchase and the call you write. The strike price of the protective put should be high enough to lock in most of your unrealized profit. The strike price of the covered call should be high enough to allow you to participate in some upward price movement, but not so far out-of-the-money that the premium you receive does little to offset the cost of your protective put.

minimum profit of \$10 per share, or \$1,000 per contract.

In most cases, a collar works best if you have a neutral to bearish market forecast for a stock that has behaved bullishly in the past, leaving you with unrealized gains you'd like to protect. Some investors use collars as income-producing strategies by selling them for a credit. While that approach can be profitable, it also requires time and attention to manage the strategy.

COMMISSIONS AND FEES

As with stock transactions, options trades incur commissions and fees charged by your brokerage firm to cover the cost of executing a trade. You'll pay fees when opening a position as well as when exiting. The amount of these charges varies from brokerage firm to brokerage firm, so you should check with yours before executing any transaction. Be sure to account for fees when calculating the potential profit and loss you face.

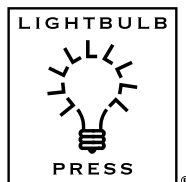
You should also keep in mind that spread transactions that require two legs mean you may face double commissions at entry. And it also helps to consider that any strategy that ends with an unexercised option, such as a covered call, means—if you're not assigned—you won't pay any commissions or fees at exit.

These pages are excerpted from An Investor's Guide to Trading Options.

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