NEW OPTIONS

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Buying or Selling Options - Which is Better?

Options are different from any other financial instrument in one very important regard: the returns are non-linear.

What does that mean to you, the investor? Essentially, it is important to understand that options buyers and options sellers have very different expectations of returns. Options sellers win most of the time. Therefore, options buyers lose most of the time. To many people, this would mean that it is much better to buy options than to sell them right?

Not quite.

The first rule of thumb is that speculators buy options and investors sell options. Why? Because if you believe that a stock will be moving in a certain direction in the coming days, weeks or months, buying call or put options is a much more efficient way of profiting from your view of the stock than buying or short-selling the stock outright.

For example: you think that stock XYZ, which is currently trading at $50, will be rising within three months. You have the choice of buying 1,000 shares of XYZ or buying 10 March 50 calls for $2.50 per underlying share.

If you had purchased the shares and, as you expected, the stock rises to $60, you will make $10 per share. This is a return of 20%. If you had purchased the calls however, you would make $10 on a $2.50 investment. This is a return of 400%.

Buying options is an efficient way of profiting from a view of the market. You do not need to place as much capital on the table and your potential loss is known. In our example, if the stock had not risen, the worst that could happen is that you would have lost your $2.50 investment. Therefore, given that everyone's capital is limited, you can use the rest of your capital more effectively with other investments rather than having to set $50,000 towards the purchase of 1,000 shares and hope that they go up – with a possibility of losing the entire amount should the stock's price collapse.

But the important question remains: why do options buyers lose more often than options sellers?

If you had purchased the XYZ March 50 calls, the stock had to rise beyond $52.50 before you could start making any money with your options (the strike price of $50 plus the $2.50 you paid for the calls). The stock was at $50 when you purchased the calls, therefore one could reasonably assume that there was a 50/50 chance that the stock were to rise or fall at the outset. For the stock to rise all the way to $52.50 and beyond, there is approximately a one-in-six chance. This means that an options buyer will "win" on his trade once out of every six purchases and options sellers will "win" five out of every six trades. How can this be?

Because options buyers pay small amounts to option sellers. If, however, the option buyer wins, he could very well win big.

In our example, XYZ will probably not go up by $2.50, but it COULD rise by much more over the next two months. The market prices the option in such a way that, over the long term, the seller and the buyer of this option will break even.

Option buyers pay out small amounts of money often and will win big once in a while. Naked option sellers will take in small amounts of money often, but they are always running the risk of losing big. Of course, very few people will sell uncovered options, preferring to use options writing to reduce the risk of owning shares.

Therefore, the moral to this story is that, to understand options, you must understand that it is not the frequency of the winning trades that counts, but rather the amplitude of the returns over time. This isn't immediately intuitive, but one does catch on after a few options trades.

Year End Reflections

by *Richard N. Croft*

Will covered writing be the ideal investment strategy for 2003?

The major U.S. indexes posted losses for a third consecutive year, something not seen since the 1930s. The S&P/TSX Composite posted a loss for the second consecutive year.

There is no escaping the fact that the stock market appears to be accurately reflecting the state of affairs in the economy. Seemingly beset by intractable overcapacity, the U.S. manufacturing sector remained pretty much stalled through the year. The business environment – particularly in the US - resembles nothing so much as a slowly deflating blimp. Throughout 2002, corporations were unable to do anything but jettison dead weight in an effort to stay airborne. Which meant liquidating inventories, closing idle plants and divisions, laying off employees, and cutting costs to the bone.

And yes, heaving all that stuff overboard kept many companies in the black, quarter after grinding quarter. But investors realized that the watered down black ink wasn't a result of revenue growth or increasing market share. The earnings were Scrooge-like - a result of miserliness, penny-pinching, and a keen eye on the thermostat. This never can be a recipe for growth, and generally flaccid share valuations through the year reflected this reality.

Add to this, a particularly nasty December, which has been more challenging for investors than most Decembers over the past ten years. The problem is a Christmas retail season that looks to be weaker than expected, which seems to indicate a slowdown in consumer spending. This is a worrisome development, because consumer spending accounts for some two thirds of economic activity, and it is consumer spending that has kept the wheels of commerce rolling for the past 18 months.

On the positive side, consider that while three straight years of market declines is rare, the US stock market has never gone down four straight years. As well, 2003 is the third year in the US Presidential election cycle, which traditionally, has been the best year for stocks.

Further, the period from September to the end of March has historically, provided 80% of the markets overall gains for the last eighty years. Considering the weak performance in the last quarter of 2002, one might argue that the market would put on a substantial rally in the first quarter of 2003 if we are to keep that record intact.

Still none of these optimistic overtones is much to hold onto. Especially in light of the sell-off that took place over the last two weeks of 2002. The bears continue to hold the dominant position, and for investors, the only certainly, is that the markets will remain uncertain. That also means increased volatility, which does noting to comfort stock investors, but does open some doors for option traders.

To me the performance of the US stock market over the last couple of years, looks a lot like the two year performance witnessed in 1973 to the end of 1974. That too was a brutal bear market, which wrung out the excesses created in the 1960s. Veterans market watchers will remember the nifty fifty growth stocks which included the likes of Polaroid, IBM and Xerox, to name a few. In retrospect, the excesses brought about by the technology boom of the 1990s, looks a lot like the 1960s.

When the market started to gain some traction in 1975, it didn't soar. Anything but. While the worst of the bear was over by the end of 1974, what that lead to was a rather broad based trading range, which single digit gains, until the end of the 1970s. We may see a repeat of that performance, over the next several years.

What's different this time, is the high level of option premiums. Usually in a market that is locked in a trading range, option premiums decline. However, we are seeing premium levels that are twice the levels they were in the 1970s, and almost three times the levels we saw for most of the 1980s.

In that environment, covered call writing looks like a particularly attractive investment strategy. Especially if we have a market that is locked in a broad based trading range, or that sees single digit year over year increases.

Covered call writing is a strategy where an investor buys individual stocks, and writes at the money or slightly out of the money covered calls against the position. For example, you could buy 100 shares of XYZ Electric at $24.75 per share and write (i.e. sell) the XYZ March 25 calls at $1.60 per share.

With this strategy, you own XYZ and are entitled to any dividends the company pays. However, you have agreed to sell your shares to the call buyer at $25 per share anytime between now and the third Friday in March (the last trading day for the March options).

That doesn't mean you will in fact sell your shares at $25 in March. If XYZ is trading at a price below $25 per share, the call buyer will not exercise his option, and you will retain your shares. The March call option will simply expire worthless.

If XYZ is above $25 in March, you will end up selling your shares. To ascertain your return should the shares be called away, you have to start with the cost base of your position. The cost base is your original purchase price less the premium received.

Remember, you bought the stock at $24.70 per share, and received $1.60 per share in premium income, which means your adjusted cost base is $23.10 ($24.70 less $1.60 = $23.10).

Your rate of return should the stock be called away in March is $25 strike price divided by the adjusted cost base ($23.10) for a total return of 8.2%. That does not take into account transaction costs, and does not add any dividends that would have been received over the holding period. And remember that return is over three months.

If the stock remains the same – i.e. at $24.70 per share – your total return is still 6.9%. And you don't lose any money on this position, as long as XYZ remains above your adjusted cost base of $23.10.

On the negative side, should XYZ experience a strong rally in the first quarter, you will not participate beyond the $25 strike price. It is never very appealing having to sell your shares top the call buyer at $25 per share, if the stock is trading at $35 per share. Still, covered call writing will perform admirably, if the market remains locked in a trading range, or rises slightly over the coming year.

Question of the Month

Why aren't "stop" orders accepted at options exchanges?

"Stop" orders are orders that are meant to limit losses. You can send a stop order to a stock exchange, which states that, if the stock trades at or below a given price (the "trigger" price), you want to sell your shares. Therefore, you are setting a lower bound on the possible price your shares can go.

In the options market, options prices can move (because the underlying stock's price moves) without any trades being done. In such a case, the price of an option can go very far below your trigger price without any trades being done that would trigger your stop. Therefore, when an option trade finally occurs, you could be stopped out at an unacceptably low price. This is why there are no options exchanges that will accept stop orders.

If you have a question about options, please send it to **options@m-x.ca**.
Your question may be published in the next issue of this newsletter.