



STOCK OPTIONS

Long Straddle (Straddle Buying)

Situation

Investor X believes that MNO options are undervalued. She knows that the best way to benefit from undervalued options is by buying a straddle.

Objective

Investor X wishes to profit from her view that MNO options are undervalued by buying both calls and puts on MNO, expecting the subsequent moves in the price of the stock to be greater than the money she paid out for the options.

Strategy

Initial Data:

MNO is trading at \$40.00 on April 19.
MNO June 40.00 calls are trading at \$4.50.
MNO June 40.00 puts are trading at \$4.00.

Investment Action:

Investor X buys 10 MNO June 40.00 calls and pays out \$4,500 (\$4.50 per share x 100 shares per contract x 10 contracts). She also buys 10 MNO June 40.00 puts and pays out \$4,000 (\$4.00 per share x 100 shares per contract x 10 contracts). Her net outflow of cash is therefore \$8,500 (\$4,500 + \$4,000).

Results

Investor X pays out \$8,500. She is expecting a move in the price of the stock of greater amplitude than \$8.50 per share. If the stock drops, she will be able to buy the shares at a lower price in the market and exercise her puts to sell the shares at \$40. If the stock rises, she will be able to exercise her calls, buy the shares at \$40 and sell them at a higher price in the market. Her break-even point on the downside is \$31.50 and her break-even point on the upside is \$48.50. This means that the trade will be profitable as long as the price of the stock moves beyond these prices.

Scenario #1: MNO's stock price is below \$31.50.

At expiration, Investor X will buy the shares at a price below \$31.50, she will exercise her puts and sell the shares at \$40. Given that she purchased the shares at a price below \$31.50, she will make a profit greater than \$8.50 – the amount she initially paid out for the position.

Scenario #2: MNO's stock price is between \$31.50 and \$40.00.

At expiration, Investor X will buy the shares at the market price, she will exercise her puts and sell the shares at \$40. Given that she purchased the shares at a price above \$31.50, she will receive less than \$8.50 – the amount she initially paid out for the position – thereby not making back enough to make the trade profitable.

Scenario #3: MNO's stock price is between \$40.00 and \$48.50.

At expiration, Investor X will exercise her calls, buy the shares at \$40 and sell the shares at the market price. Given that she sold the shares at a price below \$48.50, she will receive less than \$8.50 – the amount she initially paid out for the position – thereby not making back enough to make the trade profitable.

Scenario #4: MNO's stock price is above \$48.50.

At expiration, Investor X will exercise her calls, buy the shares at \$40 and sell the shares at the market price. Given that she is selling the shares at a price above \$48.50, she will make a profit greater than \$8.50 – the amount she initially paid out for the position.

* It is to be noted that if the call and the put have different strike prices, the strategy is quite similar and it is called a "strangle".

