THE FUTURE IS YOURS TO SEE.

Equity Options
Strategy

MONTRÉAL EXCHANGE

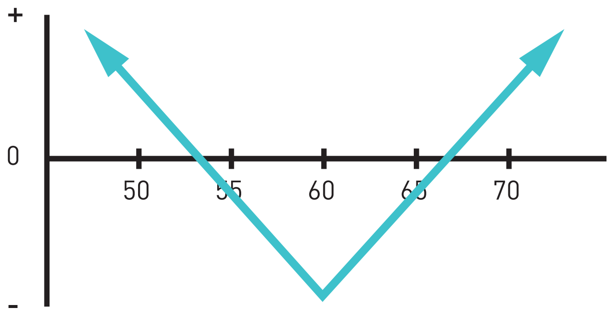
Long Straddle

Description

A long straddle is a combination of buying a call and buying a put, both with the same strike price and expiration. Together, they produce a position that should profit if the stock makes a big move either up or down.

Typically, investors buy the straddle because they predict a big price move and/or a great deal of volatility in the near future. For example, the investor might be expecting an important court ruling in the next quarter, the outcome of which will be either very good news or very bad news for the stock.

Long Straddle
Net Position



Example

Long 1 XYZ 60 call
Long 1 XYZ 60 put

MAXIMUM GAIN
Unlimited with the call

MAXIMUM LOSS
Premium paid for the call and put options

UPSIDE BREAKEVEN
Strike + premiums paid

DOWNSIDE BREAKEVEN
Strike - premiums paid

Outlook

Looking for a sharp move in the stock price, in either direction, during the life of the options. Because of the effect of two premium outlays on the breakeven, the investor's opinion is fairly strongly held and time-specific.

Volatility

Extremely important. This strategy's success would be fueled by an increase in implied volatility. Even if the stock held steady, if there were a quick rise in implied volatility, the value of both options would tend to rise. Conceivably that could allow the investor to close out the straddle for a profit well before expiration.

Conversely, if implied volatility declines, so would both options' resale values (and therefore, profitability).

Time Decay

Extremely important, negative effect. Because this strategy consists of being long a call and a put, both of them at-the-money at least at the beginning, every day that passes without a move in the stock's price will cause the total premium of this position to suffer a significant erosion of value. What's more, the rate of time decay can be expected to accelerate toward the last weeks and days of the strategy, all other things being equal.

Assignment Risk

None. The investor is in control.

Expiration Risk

Slight. If the options are held into expiration, one of them may be subject to automatic exercise. The investor should be aware of the rules regarding exercise, so that exercise happens if, and only if, the option's intrinsic value exceeds an acceptable minimum.

Comments

This strategy could be seen as a race between time decay and volatility. The passage of time erodes the position's value a little bit every day, often at an accelerating rate. The hoped-for volatility increase might come at any moment or might never occur at all.