TMX Montréal Exchange

EQUITY OPTIONS STRATEGY

Repair strategy

SITUATION

An investor who has purchased a certain number of shares would sometimes face a situation where the price of his shares dropped due to a bear market or to disappointing news issued by the company. The investor in this case can either sell his shares at a loss and try to forget about his bad market experience, or he can try to reduce his average cost by doubling up his position. This strategy is interesting if the investor thinks that the price of the shares may rise again in the future to reach at least his new break-even point. The investor's objective has actually changed. He is aware that he will not make a profit with the purchased shares, but hopes at least to recuperate the amount invested in this purchase. However, doubling up a stock position requires investing more money, which may not be available. Also, by doubling up his position, the investor is doubling his downside risk with twice the number of shares.

OBJECTIVE

Reduce the break-even point without investing more funds and without doubling the downside risk.

STRATEGY

An investor holds 1,000 shares of ABC for which he paid $27.50. ABC is now trading at $22.20. He thinks that the price of the stock may go up to $25.00, and that a good strategy would be to average down his break-even point from $27.50 to around $25.00. In order to do so, the investor has to buy 1,000 ABC shares at the actual market price of $22.20. This purchase needs the investment of $22,200.00, and by doubling his stock position he would be doubling his downside risk. He decides to do the following options strategy:

- Buy 10 ABC SEPT 22.50 calls at $2.50
- Sell 20 ABC SEPT 25 calls at $1.30
- Net credit: $0.10

Thus, the investor has purchased the right to double his position at $22.50, and he is committed to sell them $25.00, which is his new break-even point. The 20 calls sold are covered by the ABC shares held in the portfolio and by the 10 22.50-strike calls purchased in this strategy.

RESULTS

- If the price of ABC stays unchanged or below $22.50, both series will expire worthless and the investor keeps the $0.10 premium collected.
- If ABC goes up to $24.00, the investor can recuperate $1.50 by selling the 22.50 calls at their intrinsic value. The ABC 25 calls will expire worthless.
- This strategy meets its objective if ABC goes up to $25.00. In this case, the investor will exercise his right to buy 1,000 shares of ABC at $22.50 — reducing his average purchase price to $25.00. He would break even by selling 2,000 shares of ABC on the market.
- What if ABC goes up suddenly to $27.50? He can always exercise his right to buy 1,000 shares at $22.50, but the investor is committed to selling his shares at $25.00. This strategy will not enable him to profit from a price increase above the break-even point.

However, when ABC is at $27.50, the investor can still unwind this strategy with zero or close-to-zero cost by buying back the 20 ABC SEPT 25 calls at $2.50 and selling the 10 ABC SEPT 22.50 calls at $5.00 for a total cost of $0.00.