Understanding Stock Options

LEAPS® for the Experienced Trader

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THE OPTIONS INDUSTRY COUNCIL

Disclosures

Options involve risks and are not suitable for everyone. Prior to buying or selling options, an investor must receive a copy of *Characteristics and Risks of standardized Options*. Copies may be obtained by contacting your broker or the Options Industry Council at 440 S. LaSalle St., Chicago, IL 60605

In order to simplify the computations, commissions, fees, margin interest and taxes have not been included in the examples used in these materials. These costs will impact the outcome of all stock and options transactions and must be considered prior to entering into any transactions. Investors should consult their tax advisor about any potential tax consequences.

Any strategies discussed, including examples using actual securities and price data, are strictly for illustrative and educational purposes only and are not to be construed as an endorsement, recommendation, or solicitation to buy or sell securities. Past performance is not a guarantee of future results.

Presentation Outline

- **Brief review of basics**
- **Why LEAPS®? Why bother?**
- **Strategies**
  - **Planning a stock purchase (or gift)**
  - **What stock traders should know**
  - **“Covered writing” with LEAPS®**
  - **LEAPS® protective puts and collars**
  - **A year-end (LEAPS®) tax strategy**

LEAPS® - The Basics

- **L**ong-term **E**quity **A**nticiP**P**ation **S**ecurities
- Expiration dates up to 2 1/2 years away (i.e., January 2004, January 2005)
- Different symbols / strikes
- Meaningful strikes, premiums
- All types of strategies

LEAPS® - Rights & Obligations

	CALLS	PUTS
BUYERS *(holders)*	RIGHT to buy	RIGHT to sell
SELLERS *(writers)*	OBLIGATION to sell	OBLIGATION to buy

LEAPS® Terms

- **Strike price**
- **Premium**
- **Expiration**
- **Exercise/Assignment (European / American)**

LEAPS® - Ticker Symbols

Different root ticker symbols

- **Wal Mart** — **Stock symbol: WMT**
  Regular Option symbol: WMT
  LEAPS Symbols: LWT ZWT

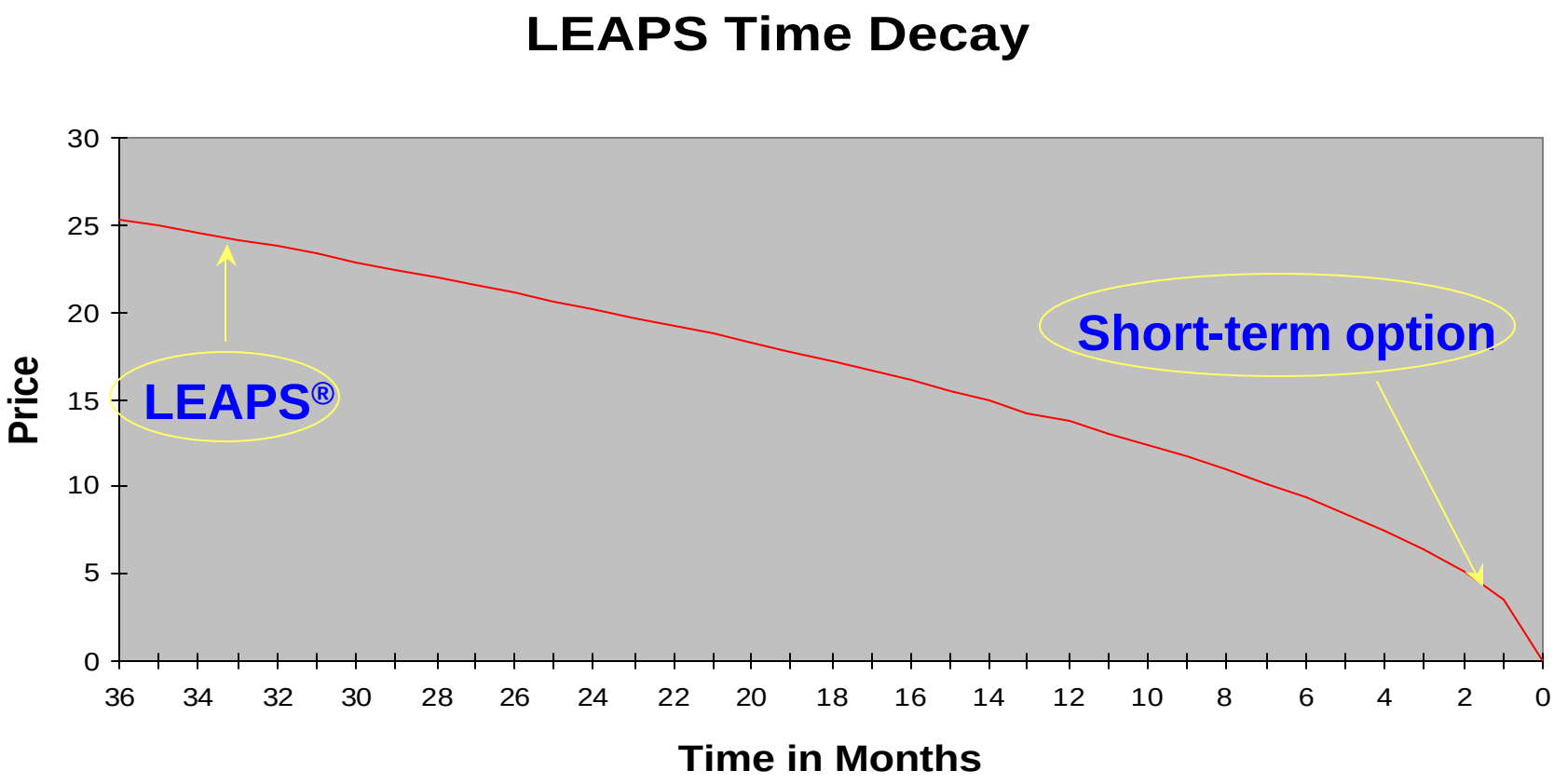
- **Microsoft** — **Stock symbol: MSFT**
  Regular Option symbol: MSQ
  LEAPS Symbols: LMF ZMF

Options/LEAPS® Pricing

- Stock price
- Strike price
- Time to expiration
- Interest rate / dividends
- Volatility

Using options requires more decisions!

Why LEAPS®? Why Bother?



*$100 stock, 100-strike call, 30% vol, 5% interest rate, no divs.

LEAPS® Time Erosion

	3-mo option	2-yr LEAP
Now:	3.40	11.00
1 month later:	2.75	10.70
2 months later:	1.90	10.40
3 months later:	0	10.10

**stock unchanged @ $50 / 50 strike calls*

WHY LEAPS®?

- **Advantages**
  - **Lower cost "per unit of time"**
  - **Less time erosion**
  - **Longer life, more time for a strategy to work**
- **Disadvantages**
  - **Higher absolute cost**
  - **Lower sensitivity to change in stock price**

LEAPS® Strategies

Using LEAPS® in a Gifting Program

Using LEAPS® in a Gifting Program

- You plan to give $10,000 per year over the next 3 years to a relative.
- You want to buy approximately $30,000 of XYZ stock today.
- Is it possible to use LEAPS® options to target these objectives?

Using LEAPS® in a Gifting Program

- **XYZ is currently trading at $39 per share**
- **The XYZ January 2005 LEAPS 30 Call is trading at $14.**
- **Step 1?**
- **Step 2?**
- **Step 3?**

Using LEAPS® in a Gifting Program

- **Step 1 - Today**

- Deposit $10,000 in recipient's account

- Buy 7 XYZ January 2005 30 LEAPS® Calls at $14 each (Total Cost $9,800 + comm.)

Using LEAPS® in a Gifting Program

- **Step 2 – Next 3 Years**

  2003 (any month) – Deposit $10,000 in recipient's account

  2004 (any month) – Deposit $10,000 in recipient's account

Using LEAPS® in a Gifting Program

- **Step 3 – XYZ above $30 in January 2005**

- If still bullish on XYZ: exercise calls and purchase 700 XYZ at $30

- Total cost 700 x $30 = $21,000 + comm. ($20,200 in recipient's account)

- You can sell the calls if you wish. (Taxes?)

Using LEAPS® in a Gifting Program

- **Step 3 – XYZ below $30 in Jan 2005**

  - Calls expire for a total loss of cost of calls.

  - There is still $20,200 in recipient's account.

Investing with LEAPS® - Variations

- **Buy LEAPS® calls for yourself and save the purchase price of the stock over 2 years.**
- **Buy LEAPS® calls now and pay for the stock with a year-end bonus.**
- **Limit the risk of a stock purchase by buying LEAPS® calls and depositing the sufficient funds in a money market account. Risk is limited to the cost of the LEAPS® calls.**

LEAPS® Strategies

What Stock Traders Should Know

What Stock Traders Should Know

Option Price Behavior

Stock Price:	**$50**	→	**$51**
Days to Exp:	**90**	→	**90**
50 Call:	**3.00**	→	**?**

What Stock Traders Should Know

DELTA: Change in option price for a one-point change in the underlying stock price. If the stock price changes by $1, then the option price will change by less than $1.

What Stock Traders Should Know

- **XYZ trading at $39**
- **January 2004 LEAPS® 30 Call trading at $13**
- **What is the delta of this call?**

If the stock rises from $39 to $45 in 60 days, what will the call price be?

* All examples do not include commissions and are not intended to be recommendations.

What Stock Traders Should Know

- **XYZ trading at $39**
- **January 2004 LEAPS® 45 Call trading at $7**
- **What is the delta of this call?**

If the stock rises from $39 to $45 in 60 days, what will the call price be?

* All examples do not include commissions and are not intended to be recommendations.

What Stock Traders Should Know

- When trading LEAPS® know the delta.
- Have three exit points in mind:
  - Profit target
  - Time limit
  - Stop-loss point
- Have the discipline to exit the trade when any of the points is reached.

Trading LEAPS® vs. Trading Stock

- **LEAPS® Advantages**
  - **Lower Investment**
  - **Lower risk**
  - **Potentially higher percentage profit**
- **LEAPS® Disadvantages**
  - **Lower absolute profit**
  - **Potentially larger percentage loss**
  - **No dividends, voting rights**

LEAPS® Strategies

“Covered Writing” with LEAPS®

"Covered Writing" with LEAPS®

- **Using LEAPS® as a stock substitute to create a position similar to a covered write (known as a Time-Diagonal spread).**
- **Example: XYZ @ 49.00 on 8/1/02**

Buy 1 XYZ Jan 2004 40 Call @ 14.00

Sell 1 XYZ Sep 2002 55 Call @ 1.65

* Must be done in a margin account.
* All examples do not include commissions and are not intended to be recommendations.

“Covered Writing” with LEAPS® 1

At September ’02 Option Expiration

Stock Price: $49.00 (unchanged)

Sep ’02 55 Call: 1.65 → 0 +1.65

Jan ‘04 40 Call: 14.00 → ?

If S-T call expires, do it again(?)

"Covered Writing" with LEAPS® 2

At September '02 Option Expiration

Stock Price: $59.00 (stock up big)

Sep '02 55 Call: 1.65 → 4.00 -2.35

Jan '04 40 Call: 14.00 → ?

S-T call is I-T-M! Assigned?

"Covered Writing" with LEAPS® 3

At September '02 Option Expiration

Stock Price: $39.00 (stock down big)

Sep '02 55 Call: 1.65 → 0 +1.65

Jan '04 40 Call: 14.00 → ?

Stock price decline - stop-loss point?

"Covered Writing" with LEAPS®

- Potential profit*= $6.00 in 50 days (8/1–9/20)
- Initial Investment = 12.35 (14.00 – 1.65)
- Percentage profit* = 48% in 50 days
- Risk limited to initial investment + comm.
- Risk of early assignment on short call

*Profit Potential and Percentage Profit are estimates only, assuming XYZ at $55 or higher
Must be done in a margin account.
All examples do not include commissions and are not intended to be recommendations.

"Covered Writing" with LEAPS®

Alternatives if short call is assigned:

- **Purchase stock and sell another S-T call**
- **Purchase stock and stay long the LEAPS® call**
- **Close entire position by purchasing stock and selling LEAPS® call**
- **Close position by exercising LEAPS® call (not advised if there is time premium in the LEAPS® call)**

"Covered Writing" with LEAPS®

- **What if the stock price declines significantly?**
  - **Will you sell the LEAPS® call at a loss?**
  - **Will you write another short-term call with a lower strike price?**
  - **Will you keep the LEAPS® Call without selling another short-term call against it?**

LEAPS® Strategies

LEAPS® Married Puts

LEAPS® Married Puts

Purchase LEAPS® puts when initially acquiring shares

LEAPS® Married Puts

Purchase put options when initially acquiring shares

Example:

Stock @ _____

Buy _____

* All examples do not include commissions and are not intended to be recommendations.

LEAPS® Married Puts

Buy 100 shares _____ @ _____

Purchase one _____ @ _____

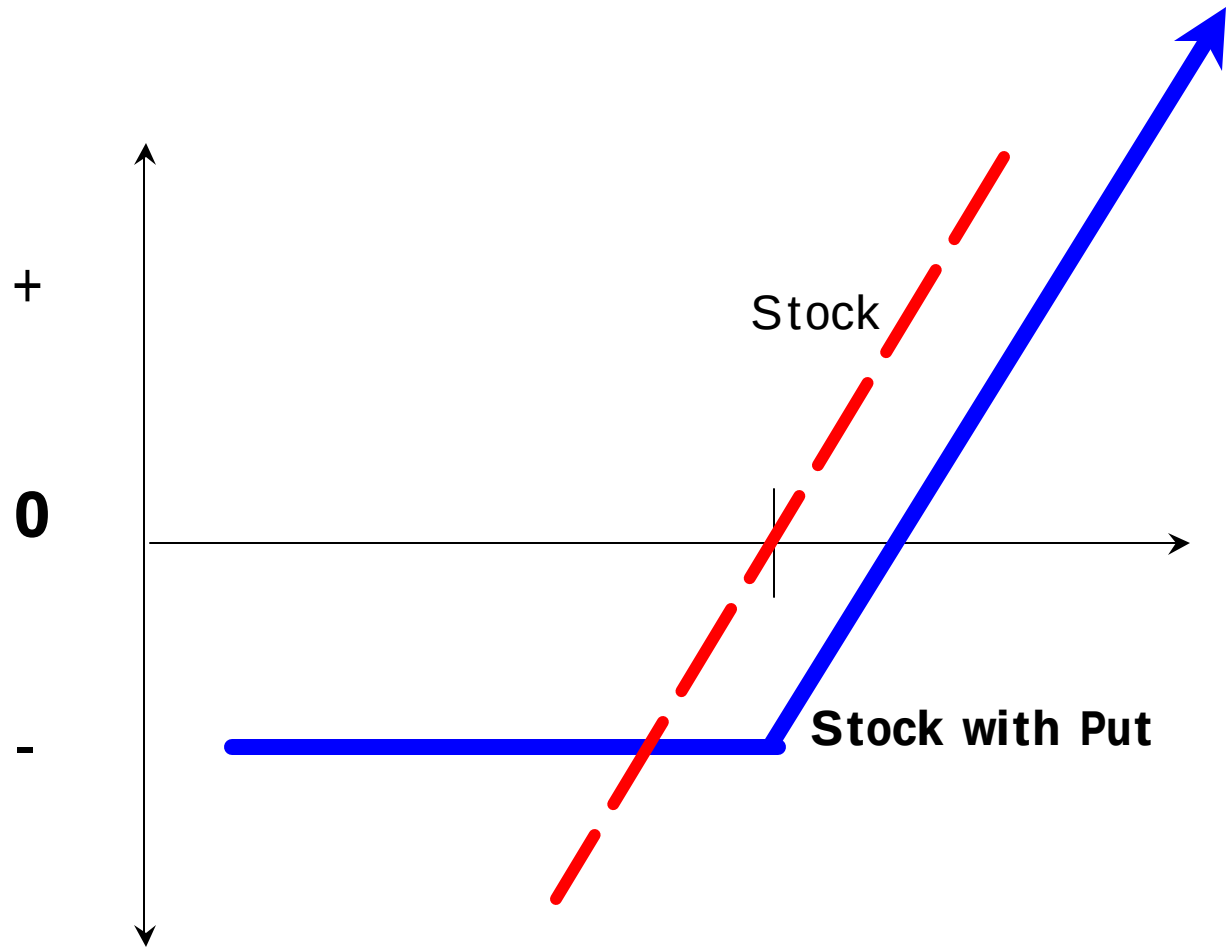
Total investment per share _____

Put exercise price (strike price) _____

Total risk _____

* All examples do not include commissions and are not intended to be recommendations.

LEAPS® Married Puts



LEAPS® Protective Put

- **Already own shares**
- **Concerned about ? ? ? ?**
- **Don't wish to sell shares now**
- ***Tax considerations?***
- **Buy LEAPS® Puts as "term insurance"**

LEAPS® Puts - Pros & Cons

- Protection at a fixed cost
- Flexibility: keep shares and dividends
- Limited cost / limited risk

- Protection can be expensive
- Increases overall cost/breakeven
- Puts expire, stock does not
- Periodic check is essential

LEAPS® Strategies

The LEAPS® Collar

The LEAPS® Collar

Collar defined:

Long an O-O-M Put and short an O-O-M Call in conjunction with a long stock position

LEAPS® Collar for Protection

Long XYZ stock @75

Action:

Buy 70 Put and

Sell 90 Call

* All examples do not include commissions and are not intended to be recommendations.

Why Use a LEAPS® Collar ?

Collar all of (or part of)
a large stock holding
with LEAPS® when
"low-cost" protection
is desired

LEAPS® Collar Case Study

You plan to retire in 2005.

You own $750,000 of XYZ.

You cannot afford to let the value fall below $600,000.

You want some upside.

You can't afford to buy puts.

LEAPS® Collar Case Study

Own 10,000 shares XYZ at 75.00

Buy _____ *puts @* _____

*Sell*_____ *calls @* _____

Net cost per collar _____

Cost of Hedge _____

* All examples do not include commissions and are not intended to be recommendations.

LEAPS® Collar Case Study

- **Minimum value at Jan ’05?**

- **Maximum value at Jan ’05?**

Using a LEAPS® Collar 2

You want to buy stock.

You want to limit risk.

You want some upside.

You do not want to pay for insurance!

Collar a stock position with LEAPS®

when <u>initially acquiring shares</u>

Using a LEAPS® Collar 2

Buy 100 shares of XYZ @ $ 75.00

Buy 1 XYZ Jan '05 70 LEAPS put 13.00

Sell 1 XYZ Jan '05 90 LEAPS call 11.60

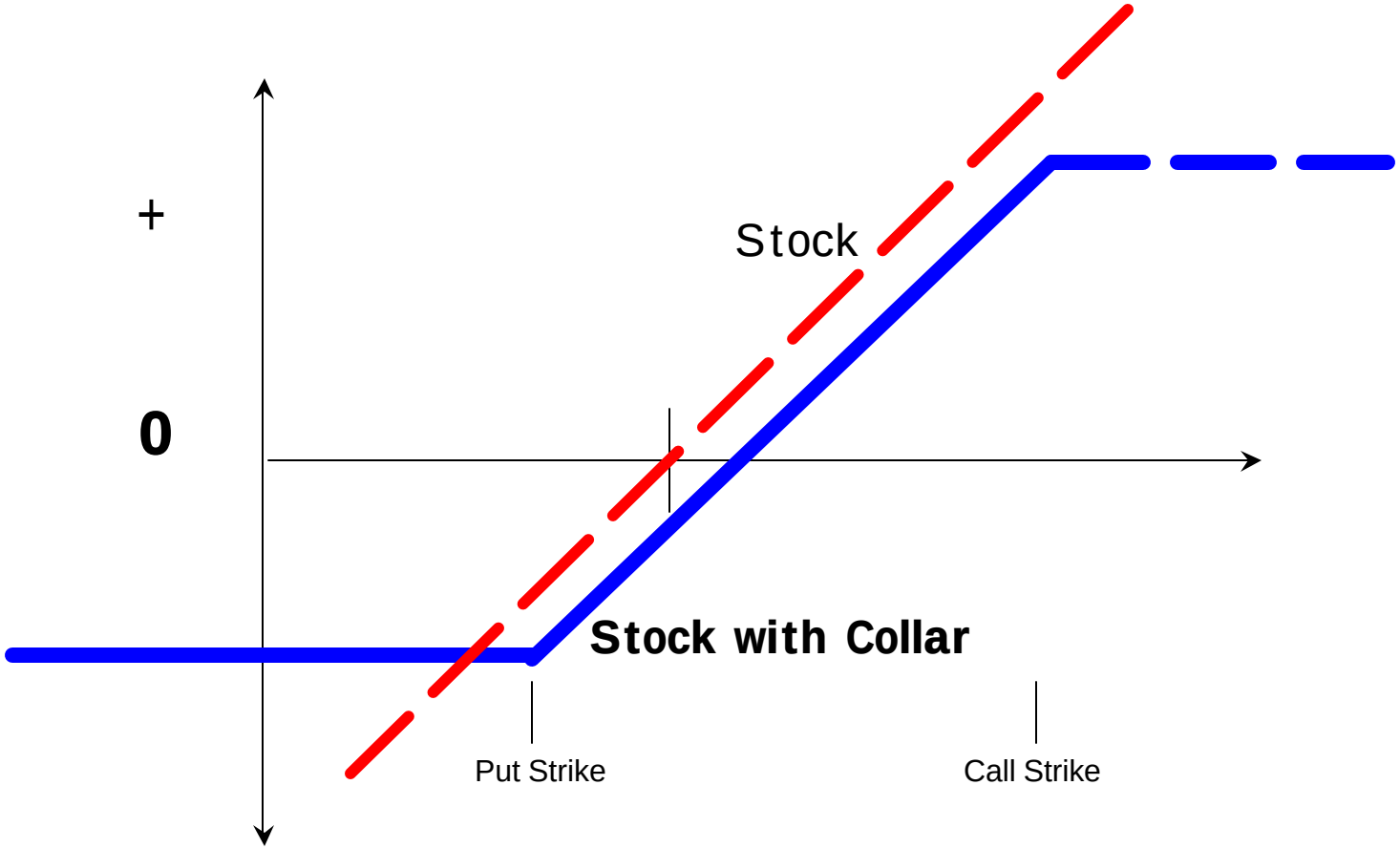
Net Cost: $76.40

Risk : $ 6.40 (8.5%)

Potential Gain: $13.60 (17.8%)

above example excludes transaction costs

Using a LEAPS® Collar 2



LEAPS® Collars - Pros & Cons

- Protection at a reduced cost
- Favorable risk/reward ratio

- Limited upside
- Limited time period
- Risk of early assignment

A Year-end (LEAPS®) Tax Strategy

You bought a stock and it went down in price

You are thinking of selling it for a tax loss

You are aware of the 30 day before/after rule (you cannot sell a security for a loss and buy it within 30 days before or after the date of sale)

You do not want to “Double up” with an additional 100 shares 31 days before

You do not want to be “out of the market” for 31 days

What can you do???

Year-end (LEAPS®) Tax Strategy

Consider the

“ ”

LEAPS® Tax Strategy

Example: Bought 100 shares XYZ at $ 65

Current Price: $ 35

Year-end (LEAPS®) Tax Strategy

- **November 25th** - buy 1 XYZ Jan '04 30 strike LEAPS® Call at $8.50
- **December 27th** – sell 100 shares of XYZ at $35

- **Jan 31st** - a choice –
  - Do nothing, control 100 shares with the long LEAPS call for 12 months with limited risk
  - Buy 100 shares and sell the LEAPS® call, re-establishing the original position

Year-end (LEAPS®) Tax Strategy

- Advantages:
  - Realize loss on stock (tax implications?)
  - Still in the market with minimal outlay and limited risk
- Disadvantages:
  - Commission intensive
  - Amount invested in LEAPS® as well as amount invested in stock at risk for first 31 days

SUMMARY

LEAPS®

- Wide range of possible uses
- Can be a strategic tool for risk management
- Can help combat one of the greatest enemies of options buyers: ***TIME EROSION***

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Additional Web Sites:

www.888options.com

www.amex.com

www.cboe.com

www.iseoptions.com

www.pacificex.com

www.phlx.com

PLEASE FILL OUT EVALUATION!

Understanding Stock Options

ANSWERS

LEAPS® for the Experienced Trader

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LEAPS® - Ticker Symbols

Different root ticker symbols

- **Wal Mart** — **Stock symbol: WMT**
  Regular Option symbol: WMT
  LEAPS Symbols: LWT ZWT
  '04 '05

- **Microsoft** — **Stock symbol: MSFT**
  Regular Option symbol: MSQ
  LEAPS Symbols: LMF ZMF
  '04 '05

LEAPS® Time Erosion

8 x 3.40 @ 27

	3-mo option	2-yr LEAP
Now:	3.40	11.00
	(0.65) or 19 %	**(0.30) or 3%**
1 month later:	2.75	10.70
	(0.85) or 30%	**(0.30) or 3%**
2 months later:	1.90	10.40
	(1.90) or 100%	**(0.30) or 3%**
3 months later:	0	10.10

**stock unchanged @ $50 / 50 strike calls*

What Stock Traders Should Know

Option Price Behavior

Stock Price:	**$50**	→	**$51**
Days to Exp:	**90**	→	**90**
50 Call:	**3.00**	→	**3.50**

What Stock Traders Should Know

- XYZ trading at $39
- January 2004 LEAPS® 30 Call trading at $13
- What is the delta of this call?

I-T-M Call

Delta = .76

If the stock rises from $39 to $45 in 60 days, what will the call price be?

$13 → $17.30

Profit +4.30 vs. +6.00

Cost 13.00 vs. 39.00

* All examples do not include commissions and are not intended to be recommendations.

What Stock Traders Should Know

- XYZ trading at $39
- January 2004 LEAPS® 45 Call trading at $7
- What is the delta of this call?

O-O-M Call

Delta = .52

If the stock rises from $39 to $45 in 60 days, what will the call price be?

$7 ➔ $9.80 Profit +2.80 vs. +6.00

Cost 7.00 vs. 39.00

* All examples do not include commissions and are not intended to be recommendations.

"Covered Writing" with LEAPS® 1

At September '02 Option Expiration

Stock Price: $49.00 (unchanged)

Sep '02 55 Call: 1.65 → 0 +1.65

Jan '04 40 Call: 14.00 → ? 13.50 - 0.50

Net Profit: +1.15

If S-T call expires, do it again(?)

"Covered Writing" with LEAPS® 2

At September '02 Option Expiration

Stock Price: $59.00 (stock up big)

Sep '02 55 Call: 1.65 → 4.00 -2.35

Jan '04 40 Call: 14.00 → ?21.75 +7.75

Net Profit: +5.40

S-T call is I-T-M! Assigned?

"Covered Writing" with LEAPS® 3

At September '02 Option Expiration

Stock Price: $39.00 (stock down big)

Sep '02 55 Call: 1.65 → 0 +1.65

Jan '04 40 Call: 14.00 → ? -9.75 - 7.25

Net Loss: - 5.60

Stock price decline - stop-loss point?

LEAPS® Married Puts

Purchase LEAPS® puts when initially acquiring shares

Limits risk during life of the put

Unlimited profit potential (less cost of puts)

LEAPS® Married Puts

Purchase put options when initially acquiring shares

Example:

Stock @ **HD @ 30.00 on 7/31/02**

Buy **HD Jan '04 30 Put @ 5.25**

* All examples do not include commissions and are not intended to be recommendations.

LEAPS® Married Puts

Buy 100 shares HD @ 30.00

Purchase one Jan '04 30 Put @ 5.25

Total investment per share 35.25

Put exercise price (strike price) 30.00

Total risk 5.25

15% risk in 18 months

Profit potential unlimited

* All examples do not include commissions and are not intended to be recommendations.

LEAPS® Collar Case Study

Own 10,000 shares XYZ at 75.00

Protecting only 8,700 shares.

Buy 87 Jan '05 70 *puts @* 13.00

Sell 90 Jan '05 90 *calls @* 11.60

Net cost per collar 1.40

Cost of Hedge 87 x $140 - $3480 = $8700

* All examples do not include commissions and are not intended to be recommendations.

LEAPS® Collar Case Study

- **Minimum value at Jan ’05?**

Exercise puts – sell 8,700 XYZ @ $70

8,700 x $70 = $609,000 less comm.

- **Maximum value at Jan ’05?**

Calls assigned – sell 9,000 XYZ @ $90

9,000 x $90 = $810,000 less comm.

Plus value of other 1,300 shares

Using a LEAPS® Collar 2

Buy 100 shares of XYZ @ $ 75.00

Buy 1 XYZ Jan '05 70 LEAPS put 13.00

Sell 1 XYZ Jan '05 90 LEAPS call 11.60

Net Cost: $76.40

Risk : $ 6.40 (8.5%)

Potential Gain: $13.60 (17.8%)

above example excludes transaction costs

Year-end (LEAPS®) Tax Strategy

Consider the

"**Thanksgiving - Christmas - Super Bowl**"

LEAPS® Tax Strategy

Example: Bought 100 shares XYZ at $ 65

Current Price: $ 35

Year-end (LEAPS®) Tax Strategy

- November 25th - buy 1 XYZ Jan '04 30 strike LEAPS® Call at $8.50 (**Thanksgiving**)
- December 27th – sell 100 shares of XYZ at $35 (**Christmas**)
- Jan 31st - a choice –
  - Do nothing, control 100 shares with the long LEAPS call for 12 months with limited risk
  - Buy 100 shares and sell the LEAPS® call, re-establishing the original position (**Super Bowl**)