



# THE VALUE LINE

## Daily Options Survey

*On Line at the Opening Bell, Every Trading Day*

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### The Weekly Option Strategist

January 12, 2004

## Writing Puts: An Alternative to Covered Call Writing In This Issue:

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When you write a put on a certain stock with a certain strike and expiration, you have a position that has a very similar gain and loss potential to that of a covered call on the same stock with the same strike and expiration. Put writes can either be *cash covered* (where the writer has cash in the account equal to the strike minus the premium) or they can be *margined* (whereby the investor posts a margin equal to 10% to 20% of the underlying stock and leaves the premium in the account). This week, we show an example where the put write can be preferable to the covered call. We will also show you an example of hedging naked put writes with index options.

### Two Equivalent Positions

When you write a put, you receive a premium in return for granting someone else the right to sell you the stock at the strike price. Usually if the stock ends up above the strike price, the put never gets exercised and you get to keep the entire premium. If the stock ends up below the strike price of the put, you may be exposed to losses, but not necessarily. As long as you can close out the po-

sition by buying the put back for less than the premium you originally received, you will have made a profit. At expiration, the profit or loss of a short put is equal to the original premium minus the tangible value (if any) of the put. Before expiration, your gain and loss will usually equal your original premium minus the cost of buying the put.

When you write a covered call, you own (or buy) the stock and write a call on it. You receive the call premium in return for granting someone else the right to buy the stock from you at the strike price. The profit/loss of a covered call at expiration equals the gain or loss in the stock plus the call premium received, minus the tangible value (if any) of the call.

Usually, for calls and puts of the same strike and expiration, the time premium, net of interest and dividends, is extremely close. There are theoretical as well as practical reasons for this being so. Theoretically, call and put premiums cover essentially the same risk whether

**Table 1 - Covered Call and Naked Put Comparison**

Standard Pacific Corp. 1/7/04

Stock Price	\$ 46.55				Interest Rate	1.00%	
Strike Strike	\$ 45.00				Dividend Yield	0.70%	
March \$45 Call	\$ 4.00				Number of Days	73	
March \$45 Put	\$ 2.55						
%Change Cmn	-25%	-10%	-3%	0%	3%	10%	25%
Common Price	\$34.91	\$41.89	\$45.00	\$46.55	\$48.10	\$51.20	\$58.19
March \$45 Covered Call							
Gain/Loss Cmn	(\$1,164)	(\$465)	(\$155)	\$0	\$155	\$465	\$1,164
Gain/Loss Short Call	\$400	\$400	\$400	\$245	\$90	(\$220)	(\$919)
Dividend on 100 Shares	\$7	\$7	\$7	\$7	\$7	\$7	\$7
Net on Covered Call	(\$757)	(\$59)	\$252	\$252	\$252	\$252	\$252
March \$45 Put Write							
Gain/Loss Short Put	(\$754)	(\$56)	\$255	\$255	\$255	\$255	\$255
Interest	\$9	\$9	\$9	\$9	\$9	\$9	\$9
Net on Short Put	(\$745)	(\$47)	\$264	\$264	\$264	\$264	\$264

you are bullish or bearish. Practically, these premiums tend to be close because option floor traders can arbitrage between calls and puts. (For instance, if a call at a particular strike price and expiration offers more time premium than the put at the same strike and expiration, the market maker can buy the put, sell the call and cover the risk of both options by buying the stock.) Thus, if *The Value Line Daily Options Survey* is recommending a particular call for covered writing, then there is also a strong possibility that we are recommending the corresponding put for "naked" put writing as well. On January 6<sup>th</sup>, for instance, 79 of our 200 *Selected Calls for Covered Call Writing* had corresponding puts with the same underlying, strike, and expiration in our *Selected Options for Naked Put Writing*.

In Figure 1 on page 1, we have selected the Standard Pacific Corp. March \$45 covered call and naked put with the stock at \$46.55. Both options are close to the money with the March \$45 naked put, recommended on January 7,

selling at \$2.55, and the March \$45 call recommended for covered call writing at \$4.00. As illustrated, both positions have almost identical dollar payoffs given certain percentage moves for the common. Note: in calculating the naked put's return, we factor in the interest on the cash balance that would otherwise have been invested in the covered call.

On these options' April expiration date, should the stock have fallen by 25%, the covered call would lose \$757, while the naked put would lose \$745. If the stock ends up at or above the \$45 strike price, the covered call will earn \$252, while the naked put will earn \$264. In our example, the short put has an advantage over the covered call. Also, in making an investment decision, you should factor in the commissions that you would need to pay to close out your short call at expiration (if the stock is above the strike). In addition, you need to consider your own expectations. If you expect the stock to end up above the strike price, then the short put may be the preferable alternative.

## Leverage and Diversification

Writing short puts on margin can allow the user greater leverage and diversification. In the example below, we have selected 16 recommended

put writes for a total margin cost of \$31,217 (shown in column U) versus the approximate \$220,000 it would take to establish comparable covered calls. We evaluated this portfolio using our template Portnew4.Xls (used in Figure 2.) In addition, we have been able to cover some of the risk of these positions by buying index options that will produce an offset if the stock market declines. In columns S and T of the spreadsheet, we show the effects of an immediate 10% rise and a 10% decline in the underlying stocks.

Note: the calculations in columns S & T are recent additions to Portnew4.Xls. Subscribers can download new editions of this template from our *Options Templates* page.

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	A	C	D	E	F	G	H	I	K	L	M	N	O	P	Q	R	S	T	U
8	Figure 2 - Sample Margined Put Portfolio Hedged with Options on the QQQ																		
9	OPTKR	Trn	Num. Opts	Beg Date	Beg Cm	Beg Prem	Common Ticker	Company Name	Expiration	Strike	Common Price	Premium Bid	Premium Ask	Position	P / L	\$Delta	+10%	-10%	CapReq
10	Grand Total													(3,000)	-1,605	26,322	1,278	(4,739)	37967
11	pb Total													6,500	-250	(40,627)	(3,180)	5,035	6750
12	QQQ	UK pb	25	01/06/04	37.2	2.7	QQQ	NASDAQ 10	Sep-04	37.00	37.17	2.60	2.70	6,500	-250	(40,627)	(3,180)	5,035	6750
13	ps Total													(9,500)	-1,355	66,949	4,458	(9,774)	31217
14	AWA	RV ps	3	01/06/04	12.5	1.85	AWA	America We	Jun-04	12.50	12.50	1.85	2.05	(615)	-60	1,560	135	(170)	750
15	AZR	NX ps	4	01/06/04	23.4	1.25	AZR	Aztar Corp.	Feb-04	22.50	23.42	1.25	1.50	(600)	-100	3,550	270	(446)	1506
16	LQH	NH ps	5	01/06/04	44	1.1	CELG	Celgene Cor	Feb-04	40.00	44.00	1.10	1.25	(625)	-75	5,518	370	(793)	2400
17	QDG	OG ps	2	01/06/04	38.7	2.05	DIGE	Digene Corp	Mar-04	35.00	38.67	2.05	2.30	(460)	-50	2,318	183	(287)	813
18	FL	NX ps	7	01/06/04	23.3	0.7	FL	Foot Locker	Feb-04	22.50	23.25	0.70	0.85	(595)	-105	6,001	385	(868)	2730
19	GQD	OB ps	4	01/06/04	10.1	1.3	GERN	Geron Corp	Mar-04	10.00	10.11	1.30	1.35	(540)	-20	1,683	143	(191)	765
20	GTI	RV ps	4	01/06/04	13.9	1.25	GTI	GrafTech Int	Jun-04	12.50	13.94	1.25	1.50	(600)	-100	1,746	149	(198)	558
21	ESI	PI ps	2	01/06/04	48.7	2.45	ESI	ITT Educatio	Apr-04	45.00	48.65	2.45	2.85	(570)	-80	3,117	244	(392)	1216
22	LM	NO ps	6	01/06/04	79.9	0.9	LM	Legg Mason	Feb-04	75.00	79.91	0.90	1.15	(690)	-150	10,994	535	(2,073)	6643
23	NTE	RF ps	1	01/06/04	30.2	5.8	NTE	Nam Tai Ele	Jun-04	30.00	30.17	5.80	6.30	(630)	-50	1,179	103	(127)	586
24	NYB	PG ps	7	01/06/04	37.4	0.75	NYB	New York Ct	Apr-04	35.00	37.38	0.75	0.90	(630)	-105	7,334	439	(1,155)	3567
25	UPE	PE ps	3	01/06/04	27.1	1.75	ODSY	Odyssey He	Apr-04	25.00	27.14	1.75	2.25	(675)	-150	2,688	222	(318)	986
26	QPT	NX ps	8	01/06/04	23.6	0.6	PETM	PETsMART	Feb-04	22.50	23.62	0.60	0.75	(600)	-120	6,122	389	(907)	2883
27	PHM	NV ps	5	01/06/04	45.8	1.1	PHM	Pulte Homes	Feb-04	42.50	45.75	1.10	1.20	(600)	-50	6,238	397	(937)	2950
28	TGQ	SG ps	2	01/06/04	38	2.6	TECH	Techne Corp	Jul-04	35.00	38.00	2.60	3.00	(600)	-80	2,488	202	(297)	920
29	TK	NK ps	2	01/06/04	56.6	2.05	TK	Teekay Ship	Feb-04	55.00	56.60	2.05	2.35	(470)	-60	4,414	295	(616)	1944

**Market Review - Week Ending 01/06/04**

<b>Market Indexes</b>	<b>Close</b>	<b>% Change</b>	<b>Volatility Indexes*</b>	<b>% Change</b>
Dow Jones Industrial	10,538.66	0.40%		
Nasdaq 100	1,504.69	2.52%	22.21	-4.92%
S&P 100	556.86	1.43%	16.10	-8.94%
S&P 500	1,121.90	1.10%		

**Performance Tables**

<b>Common Ranks</b>	<b>% Change</b>	<b>Count</b>	<b>Percent</b>
Rank 1	1.53%	9377	9.21%
Rank 2	3.24%	20884	20.52%
Rank 3	2.34%	53069	52.15%
Rank 4	1.53%	14863	14.60%
Rank 5	0.07%	3575	3.51%

**Call Buyer's Ranks**

Rank 1	14.85%	4444	8.76%
Rank 2	17.51%	9255	18.24%
Rank 3	11.76%	37054	73.01%

**Call Writer's Ranks**

Rank 5	-4.10%	1887	5.80%
Rank 4	-7.12%	4772	14.66%
Rank 3	-11.42%	25885	79.54%

**Covered Call Ranks**

Rank 1	-1.36%	2180	6.70%
Rank 2	0.68%	5159	15.85%
Rank 3	0.39%	15564	47.82%
Rank 4	0.89%	6418	19.72%
Rank 5	0.80%	3223	9.90%

**Put Buying Ranks**

Rank 1	-6.69%	5473	10.72%
Rank 2	-9.80%	9418	18.45%
Rank 3	-5.04%	36147	70.82%

**Put Writer's Ranks**

Rank 5	3.97%	1904	5.52%
Rank 4	8.22%	5099	14.79%
Rank 3	9.02%	27478	79.69%

**Married Put Ranks**

Rank 1	0.45%	4598	9.01%
Rank 2	0.65%	9622	18.85%
Rank 3	0.80%	22847	44.76%
Rank 4	0.87%	7123	13.96%
Rank 5	1.05%	6848	13.42%

\* - VIX for the S&P 100 and VXN for the Nasdaq 100