THE VALUE LINE

Daily Options Survey

***The Weekly Option Strategist,* June 17, 2021**

When to Close Out an Option Position

You have bought (or written) an option. Then what? In this report, we discuss at what point you should close out your option position.

Follow the Ranks

One of our goals is to enable the subscriber to replicate (as much as possible) the performance of our option ranks. (For a summary of our performance, go to the Weekly Option Performance directory at our web site.) With this goal in mind, we advise subscribers to initiate new call and put purchases when the rank of the “ask” price is a 1, new covered call positions when the covered call rank (for the “bid” price) is a 1 and new “naked” call and put writes when the writer’s rank (of the “bid” price) is a 5.

In general, we advise subscribers to hold their option position until the rank goes to a neutral 3. Thus, you can hold a call or a put purchase (or a covered call), even if its rank has gone to a 2. And you can hold a “naked” call or put write even if its rank has shifted from 5 to 4.

Our performance numbers tend to bear out this “follow the ranks” principle. Since the third quarter of 2001, our option buying and writing ranks, and our covered call ranks, have more often than not shown the correct rank order discrimination. This is: for call buying, put buying, and for covered call writing, the 1s have outperformed the 2s, which in turn have outperformed the 3s. On the writing side, the rank 5s have outperformed the 4s (as expected), which in turn have outperformed the 3s.

Other Considerations

Beyond the option ranks, investors need to consider other factors when deciding whether or not to close out an option position. Here are some pointers that may help you make your decision.

Diversification: In order to emulate the performance of our option ranks, you need to be reasonably diversified. Ideally, you should have at least 8 to 10 different option positions of approximately equal size for any given strategy.

Relative Size: If one position gets unduly large (or unduly small) in relation to the others, you need to rebalance your option portfolio. For option purchases and for “naked” writes, a simple rule of thumb is to close out if the position rises by 100% from its original size. This, of course, means that you take your profits on option purchases and that you cut your losses on “naked” writes that have moved against you.

Alternatively, you should consider what to do if the size of a naked option position drops by 50%. The answer here is somewhat different depending on whether you are a buyer or a writer of options.

If you have bought an option and its value has fallen 50% (but its rank is still a 1 or a 2), then you need to consider whether that option is worth holding. Does the option now conform to your original investment objectives? Remember that a drop in premium usually means that the stock has moved in the wrong direction (down for a call, up for a put) - or that time has passed so that the likelihood of the option making its original profit has diminished. If your option no longer conforms to your original profit objective (and risk tolerance), then depending on the ranks of other options, you should either roll your option into another one on the same stock or close it out entirely and buy another option on a different stock.

Taking Profits on Option Writes: If you have written an option and the price has dropped by 50%, it means that you have made a profit (you can now buy back the option for less money than you collected). If the call or the put has moved far enough out-of-the-money (a good outcome for you), then you need to decide whether the remaining reward is worth the risk. Bear in mind that even an out-of-the-money option can tie up a fairly large amount of margin capital. It helps to calculate the yield of the remaining premium as a percentage of the margin funds. If this return is low compared to the forecast probability that the option will end up in the money, then you should consider closing out the short position.

Covered Calls: A covered call is a hedged position with less volatility than the underlying stock. Therefore, beyond waiting for the rank to go to a 3, there are other guidelines for closing out or rolling over your covered call. Basically, you need to consider whether the covered call still offers you an attractive combination of income, profit potential and downside protection.

Prepared by the Option Strategist Team