Forget Roller Coasters: Investors Find Thrills Riding the Risky Options Market

HEARD ON THE STREET

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William and Rise Will raised the $80,000 they needed to renovate their San Jose, Calif., home, not through mutual funds, not by "day trading" Internet stocks, but through an even more hair-raising pastime: trading options.

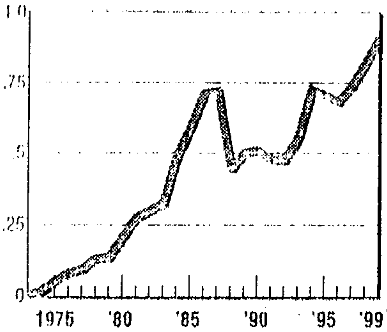
They're going against the advice of friends and professionals, who see options as far too risky. "Even the Smith Barney broker I went with said, 'No, you're crazy to trade in the options market,'" Mrs. Will says. "My own father, who's been in the market for over 45 years, said, 'Options? You're out of your gourd, kid.'"

Trading in stock options — agreements allowing an investor to buy or sell a stock at a set price for a limited time — is heating up among individual investors, despite lots of advice against it.

Part of the allure is the adrenaline thrill of the occasional home run — and the hovering risk of losing your entire wager. "On some days, it is absolutely an addiction," says Mike Schwartz, who at 38 has retired from the telecommunications industry and is trading options full-time in San Rafael, Calif. "I'm up every day at 5 o'clock" preparing for the day's trading.

Placing Bets

Average daily volume of all options on the Chicago Board Options Exchange, in millions



*Average January through June
Source: CBOE

Long-term investors shudder. "Both the leverage and the costs just stack up against you," says Ben Edwards III, chairman and chief executive of A.G. Edwards, a brokerage firm based in St. Louis. Mr. Edwards's firm accommodates options trading but doesn't recommend it to clients except to hedge existing stock holdings. "It's exciting," Mr. Edwards says, "but if someone goes to a casino, he can get the same kicks."

Nevertheless, options trading by individuals is growing. At discount broker Charles Schwab, daily trading volume in options soared nearly 80% in the second quarter of this year compared with the year-earlier period. Still, the old advice against options scares off lots of investors. Trading in exchange-listed stocks grew 94% in the same period at Schwab, while trading in Nasdaq stocks grew by 159%, about double the growth rate of options. The volume of stock trading still far exceeds the volume of options trading.

Options trading offers extreme leverage, providing the opportunity for big gains on relatively small investments. A nominal premium payment can obtain for an investor the price gain or loss of a large block of stock.

But options also present a much higher chance that an entire investment position can expire worthless in only a matter of days or weeks if, in the case of a call option, the underlying stock hasn't exceeded the "strike price" for the option.

And some strategies — such as writing, or selling, "naked calls" — present investors with huge risks. Imagine being contractually obligated to buy and deliver to someone else the stock of a company that has just soared in price due to a takeover bid. Your only compensation would be the small "premium" you received when you sold the naked call.

The entire mind-set of options traders is at odds with that of stock investors. Time, the friend of the long-term stock investor, is usually a ruthless enemy for options buyers. The Greek name given to

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Stock-Option Trading Is Gaining in Popularity Among Individual Investors, Despite Warnings

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the time decay in the price of an option is *theta*. Price decay is especially steep in options that expire in less than 30 days, but such short-lived options are popular among inexperienced investors -a major reason most investors lose money in options, traders say.

Despite, or because of, the hurdles, investors are swarming to seminars to learn the tricks of the options trade. Prices for such seminars range from free introductory classes to as much as $4,000 for multiday seminars.

Wesley and Glenda Sparling have gone to about nine classes, most of them free, offered by the **Chicago Board Options Exchange**, the largest stock-options exchange, and the Options Institute arm of the CBOE. At first, "it was all Greek. It was difficult to understand," Mr. Sparling says. But with time, he says, he has learned more and more, graduating from hedging his existing stock portfolio with options, to earning extra income by selling options on his holdings, and finally to using options--particularly long-term options called Long-term Equity AnticiPation Securities, or LEAPS--as direct investments.

The Sparlings say they have boosted their investment earnings by five figures annually. They insist on the importance of study, and that their use of options reduces their risks. "There's a huge misconception out in the public that options are one of the riskiest things in the world," Mrs. Sparling says. "You can lose your money investing in just traditional methods" as well.

It costs about $2,400 to attend a two-day options seminar outside Boston run by **Global Investment Research**, a San Mateo, Calif., firm. Attendees can return free of charge for a refresher course. The seminar's cost may appear steep, but it's merely "one bad trade," says Richard Cawood, chief executive of Global Investment.

A legal disclaimer signed by attendees acknowledges that options trading "is extremely risky and is not appropriate for all investors." Still, instructors promote options as a way of limiting risk. They focus on options strategies that limit losses. And they argue that buying a call option—the right to purchase a stock at a given price for a limited time—is less risky than buying the underlying stock. "Just buying the stock and hoping it goes up, we call the religious approach," jokes George Fontanills, president of Global Investment and an options trader and instructor.

Sometimes it works out that way, but not always. It's true that if you buy a stock for $100 and the price falls to $50, you lost more money than if you bought an in-the-money call option on that same stock for $15, with a strike price of $100. Your loss on the option, which expires worthless, was only $15. But the stock investor still owns a piece of a company whose fortunes might rebound.

Moreover, imagine that the stock price falls only to $95 from $100. The stock investor has lost only $5. But the options investor, if again he bought an option with a strike price of $100, has lost his entire $15 premium if the stock is at $95 when the option expires.

At the Boston seminar, an instructor asks, "Who's interested in straddles?" Most of the attendees put up their hands. Straddles are multiple-leg trades that can make money if the stock rises or falls, or lose money if the stock sits quietly. The instructor says that only a third of all straddle trades break even or make money. He suggests ways to improve the odds, such as trading when the stock is likely to be more volatile. Given a multiple-choice test afterward, it's clear that much of the audience hasn't fully grasped straddles.

But attendees are unfazed, and many of them are quite studious in their approach. Joe Aiello, a newcomer who works for an airline, is soaking up everything he can at the seminar, and he admits that much of it is over his head. But he plans to attend more classes, and to start off by doing only paper trades in options before executing real trades. His friends warn him that it's risky, "but I tell myself, they don't know what I'm talking about."

The road can be rough, even for investors with more experience than Mr. Aiello. Earlier this year, the Witts made more than $20,000 on Amazon.com options—then lost most of the profit when their next trade in Amazon options expired worthless. To trade options these days, Mr. Witt says, "You have to be able to take $10,000 in your fist, stand at the edge of a cliff and throw it off."