Access No: 8911060090 ProQuest - The Wall Street Journal (R) Ondisc
Title: YOUR MONEY MATTERS: UNDAUNTED BY THE WILD MARKET? TRY A COVERED STRANGLE
Authors: Stanley W. Angrist Staff Reporter of The Wall Street Journal
Source: The Wall Street Journal
Date: Monday Nov 6, 1989 p: No page citation
Length: Long (1571 words)

Article Text:

Who says stock-market volatility is bad?

The wild gyrations in stock prices in recent weeks have sparked a rising chorus of complaint from individual investors, many market professionals and some members of Congress. Only last week, the New York Stock Exchange announced new curbs on computerized program trading to control 'excess market volatility.'

But for shrewd investors, there's a way to make money on just about anything -- and volatile stock prices are no exception. While all that jumping around may unnerve stock-market investors, it means fatter premiums and bigger potential profits for investors who dabble in the options market.

An option gives its owner the right, but not the obligation, to buy (a call option) or sell (a put option) 100 shares of the underlying stock at a certain price, called the strike or exercise price, until the option expires.

In return for those privileges, investors who buy options pay a premium to the investors who sell options. And in times of stock-market volatility, options sellers demand higher premiums to compensate for the increased risk of being forced to sell their stock or compelled to purchase additional shares.

With stock prices making substantial moves, both up and down, in recent weeks, premiums have increased substantially. The average premium for one type of call option jumped 14% between Oct. 6 and Oct. 27, according to estimates by the Chicago Board Options Exchange, while the average premium for one type of put option increased by more than 20%.

Those bigger premiums can mean extra income for investors who follow a cautious approach. One strategy suggested by options-market professionals: a 'covered strangle sale,' sometimes referred to as a 'combination write.'

While it sounds arcane, a covered strangle is simply the sale of call and put options on a stock you already own. Harrison Roth, the senior options strategist at Cowen & Co. in New York, says a covered strangle might be a good strategy now for investors who aren't options experts -- so long as they understand the obligations.

Sellers of call options must be prepared to deliver the stock at the agreed strike price if the stock rises to that level and the owner of the call exercises the option. The premium paid for the option increases the effective price received for the shares. If the stock's price never exceeds the strike price of the option, the stock won't be called away. In that event, the call will expire worthless, and the premium is simply additional income.

Sellers of puts must be prepared to buy additional stock at the strike price if the stock declines sufficiently in price and the put owner exercises the option. In this case, the premium income effectively reduces the cost of the additional shares the put seller must buy. If the stock doesn't drop below the put's strike price, the put won't be exercised. Again, the put will expire worthless, and the premium is simply additional income.

Mr. Roth says the covered strangle is a particularly appealing strategy for investors who are interested in takeover stocks. For example, suppose an investor had bought NCR Corp. stock in July at $53 a share as an attractive investment and as a stock that has been mentioned in takeover rumors. The stock is now selling for around $60. A covered strangle could now be written on this stock by selling a March 65 call option for $238 per 100 shares, while simultaneously selling a March 55 put option for $125 per 100 shares. The total premium taken in would be $363.

If the stock rallies above the call option's $65 strike price, and stays there between now and the options' expiration in March, the stock will be called away from the investor. The effective price the investor receives will be $68.63 a share ($65 plus premium income of $3.63 a share).

If the stock drops below the put option's $55 strike price, and remains there, the investor will be asked to purchase an additional 100 shares for each put sold. The effective buy price would be the $55 strike price less the $3.63-a-share premium, or $51.37. Since the investor thought the stock a good buy at $53, he or she is likely to think it a good investment at $51.37.

A danger with using a covered strangle is that investors who sell call options may not enjoy the full run-up in the price of a hot stock. That's because the shares will be called away before the stock's market price peaks, leaving call-option sellers with only part of the gain they would have realized if they hadn't been forced to sell.

Another risk is that investors who sell puts have to purchase the additional shares at the agreed price, even if the stock's market price keeps falling after it declines below the strike price. Thus, investors could end up paying more for the shares than if they had waited and simply bought them in the market.

Richard Sheiner, author of a recent book on options strategies and an options broker, says it is important for an investor to have the right mind set in using the covered-strangle strategy. 'He has to be willing to give up his stock at an attractive price if the stock rallies and be willing to add to his position if it declines. If he is not mentally prepared to do both, this is the wrong strategy for him.'

But these risks are minor compared with those involved when investors sell call or put options on stocks they don't own. That strategy, called 'naked selling,' is another way investors sometimes try to profit from option premiums. It's a different, higher-risk game because investors risk having to purchase stock to deliver to a call buyer in a rising market, as well as purchase stock at the put's strike price in a falling market. Even if sellers don't have to purchase or deliver any stock, in a volatile market they will be asked to put up additional funds, or margin, to collateralize their options positions.

Investors who sell covered strangles are taking much less risk and are unlikely to have any major surprises. Moreover, if the stock against which the options are sold is fully paid for, that is, not owned on margin, then the strategy can usually be done without having to supply additional funds.

No good-faith money is required to sell a call, because the stock against which it is sold is in the account and available for delivery in the event its price increases and the stock is called away. The good-faith money to secure the selling of a put is usually around 25% of the value of the underlying stock. Because the stock is being held 'unmargined,' it also can act as the collateral for the sale of the put.

How Covered Strangles Work

Investors can profit from the increased premiums options command in times of volatility by selling put and call options on stocks they already own.

But they risk having to sell their shares -- possibly for less than the market price -- if the prices of their stocks rise high enough, or buy additional shares -- perhaps for more than the market price -- if the prices of their stocks fall far enough.

STOCK 52-WEEK PRICE RANGE	PRICE PAID MONTH BOUGHT	SELL CALL	SELL PUT
		PREMIUM INCOME PER 100 SHARES	
NCR Corp. $51.38-$66.63	$53.00 July	March 65 $238	March 55 $125
Chevron Corp. $43.13-$69.38	$55.00 August	Dec. 70 $375	Dec. 60 $112
Paramount Com. $37.25-$66.38	$55.00 October	Dec. 60 $300	Dec. 50 $75
USX Corp. $26.00-$39.50	$32.00 March	Jan. 40 $75	Jan. 30 $56
IBM Corp. $97.75-$130.88	$98.00 November	Jan. 105 $244	Jan. 95 $237

RESULT IF STOCK PRICE...

	IS STATIC PROFIT/100 SHARES RETURN	RISES ABOVE STRIKE PRICE STOCK CALLED AWAY (Effective price)	FALLS BELOW STRIKE PRICE ADDITIONAL SHRS. BOUGHT (Effective price)
NCR Corp.	$363 6.8%	$68.63	$51.37
Chevron Corp.	$487 8.8%	$74.87	$55.13
Paramount Com.	$375 6.8%	$63.75	$46.25
USX Corp.	$131 4.1%	$41.31	$28.69
IBM Corp.	$481 4.9%	$109.81	$90.19

NOTE: All prices as of Nov. 1, 1989