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Options central

IN THIS FALL 2005 ISSUE:

Buy a Spread? Sell a Spread? Take your pick.

By Bill Ryan

Here it is, the end of August and XYZ stock (yes, the infamous XYZ stock) is trading at $67.50. Our research indicates that XYZ should be priced around $75.00 (approximately a 10% increase). Being cost conscious, we decide that putting $67.50 at risk to make $6.75 is not for us. Still, we like the stock but we are looking for a less capital intense trading strategy, possibly one using options.

First we look at buying the October 70 call option for $2.75 per share or $275.00 per contract. Sure, this requires less capital than buying the stock outright and gives us unlimited upside potential above the break-even point of $72.75 until October expiration, but there might be an even less risky way to participate in the expected upward move in XYZ.

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continued from front

It's called the bull call spread strategy. A bull call spread involves buying a call at one strike price and selling a call on the same underlying stock at a higher strike price with the same expiration. If we buy the October 70 call for $2.75 and sell the October 75 call for .40 for a net debit of $2.35, we have less risk, but we've given away upside potential. This spread gives us the right to buy XYZ at $70.00 but obligates us to sell XYZ at $75.00. The 70 - 75 bull call spread that we would buy for $2.35 would give us a maximum possible gain of only $2.65 above the break-even point of $72.35. ***See Figure 1.1 below for a comparison of the various scenarios.***

The purchase of the 70 strike call looks the best so far, .40 more risk than the spread with much more upside potential. Is there any other strategy we should consider? What about a bull put spread? A bull put spread is simply buying the low strike put and selling a higher strike put on the same underlying stock with the long put expiring at the same time as the short put. Buy low, sell high, sound familiar? Let's take a look at the 70 - 75 bull put spread. If we buy the October 70 put for $4.90 and sell the October 75 put for $7.50, we would receive a credit of $2.60. We've now put $2.60 in our pocket rather than take money out of our pocket (margin is required, more on that later). We can take a bullish stance and receive a credit.

Here's how the bull put spread works. Buying the October 70 put gives us the right to sell XYZ stock at $70.00 and selling the October 75 put carries an obligation to buy XYZ at $75.00 if assigned an exercise notice. XYZ is currently trading at $67.50 and with our bullish outlook we feel that the stock should be trading above $75.00 by October expiration. If our forecast is correct and at expiration XYZ is above $75.00, both puts would expire worthless and we would keep the $2.60 premium received. If we were wrong and XYZ traded below $70.00 at expiration we would be assigned the XYZ 75 put option, obliging us to buy XYZ stock at $75.00 and we would put XYZ to someone else at $70.00 (exercising our right to sell XYZ at $70.00). This results in a loss of $5.00 per share. However, we received a credit of $2.60 when we sold the spread. So the $2.60 credit reduces the $5.00 loss from the exercise and assignment of both put positions, resulting in a net loss of $2.40 or $240.00 per spread.

Both debit call spreads (aka bull spread) and credit put spreads (aka bull spread) are limited risk/limited reward strategies appropriate for a moderately bullish stance. They share similar risk/reward profiles but there are some differences. ***Compare the debit call spread and the credit put spread in Figure 1.2.***

As you can see, the risk related to both spreads differs by only .05; $2.35 for the debit call spread and $2.40 for the credit put spread. Likewise, the difference between the maximum gains for both spreads is

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Bill has been involved with options for over 20 years beginning with EF Hutton in 1982 where he served on the retail trading desk. He has worked at various member firms including Shearson, Kidder Peabody, Lehman Brothers and SG Cowen. He also served on various exchange committees including the Retail Advisory Committees of the CBOE, and Pacific Exchange, the ISE Business Conduct Committee, the SIA Subcommittee for options best execution practices and OCC's Internet Roundtable.

In addition to his position with the AMEX, Mr. Ryan serves as an instructor for The Options Industry Council.

To simplify the computations, the examples in this article do not include commissions or transaction costs. Commissions and transaction costs will affect the outcome of all stock and options transactions and must be considered prior to entering into any transaction. Investors considering options should consult their tax advisors as to how taxes may affect the outcome of contemplated options transactions.

Figure 1.1

Strategy	Risk	Break-even	Maximum Reward	Account Type
Buy XYZ Stock	$67.50	$67.50	Unlimited	Cash or Margin
Buy 70 strike call	$2.75	$72.75	Unlimited until exp.	Cash
Bull Call Spread	$2.35	$72.35	$2.65	Margin

Figure 1.2

	Debit Call Spread	Credit Put Spread
Break-even	Long Strike (70) + Debit ($2.35) = $72.35	Short Strike (75) – Credit ($2.60) = 72.40
Maximum Gain	Difference Between Strike Prices (5) – Debit ($2.35) = $2.65	Premium Received = $2.60
Maximum Loss (Risk)	Debit Paid = $2.35	Difference Between Strikes (5) – Premium Received ($2.60) = $2.40

only .05; $2.65 for the call spread and $2.60 for the put spread. What about the break-even? Again only a .05 difference, $72.35 for the call spread and $72.40 for the put spread. Let's look at the profit and loss scenarios for both spreads with XYZ stock above $75.00 and below $70.00 at expiration. ***Please review Figure 1.3 and Figure 1.4.***

The profit and loss are almost identical. What's the difference? Although these spreads have similar risk/rewards, they reach their maximum gains and losses in different ways. Commissions will be different for each spread if XYZ increases or decreases in price.

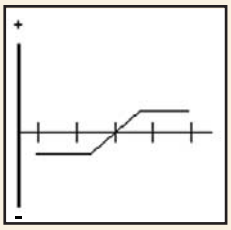
Yes, they are both bullish positions and therefore benefit from an increase above break-even in the underlying security. The debit call spread achieves its maximum gain when both calls are in-the-money. This means that the spread either must be closed (unwound) by selling the long 70 call and buying the short 75 call or by exercising the long side and letting the short side be assigned. Either way, additional commission charges are likely. The credit put spread however, reaches its maximum gain when both puts are out-of-the-money. Since both sides expire worthless, there are no additional commission charges.

Both positions also suffer from a decline in the underlying stock. Should XYZ stock drop below the low strike, the calls would expire worthless, and no additional commissions would be charged. The puts however would be in-the-money. Therefore, the put spread would be closed by either buying back the short put and selling the long put (unwinding the spread) or exercising the long put and letting assignment take place on the short side. Additional commissions are likely in either case.

So if XYZ increases in price, the profit potential may be greater for the put spread (no additional commissions), but if XYZ decreases in price, the loss on the put spread could be greater due to additional commissions charged. The margin for the debit call spread is usually the total debit paid, and generally speaking, the margin required for the credit put spread will be the difference between the strike prices less the premium received, excluding the credit received. Depending on the rules of your brokerage firm, you may be required to deposit more capital into your account for the credit spread than would be required to pay for the debit spread in full. Margin requirements differ from broker to broker so remember to check with your financial advisor for your particular requirements.

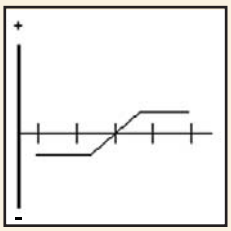
As you can see, neither spread is clearly superior to the other. Next time you consider doing a debit spread, explore the credit spread as an alternative.

Debit Call Spread



Below low strike, calls expire worthless, maximum loss occurs. Above high strike, spread reaches maximum value, maximum gain achieved.

Credit Put Spread



Above high strike, puts expire worthless, maximum gain achieved. Below low strike, spread reaches maximum value, maximum loss occurs.

Figure 1.3

	XYZ @ $76	
Debit Call Spread		Credit Put Spread
Long Oct 70 Call Value = $6.00		Long Oct 70 Put Value = $0.00
Short Oct 75 Call Value = ($1.00)		Short Oct 75 Put Value = $0.00
Net Spread Value = $5.00		Net Put Spread Value = $0.00
Initial cost = ($2.35)		Initial credit = +$2.60
Total Profit / (Loss)= $2.65		Total Profit/ (Loss)= $2.60

Figure 1.4

	XYZ @ $69	
Debit Call Spread		Credit Put Spread
Long Oct 70 Call Value = $0.00		Long Oct 70 Put Value = $1.00
Short Oct 75 Call Value = $0.00		Short Oct 75 Put Value = -$6.00
Net Spread Value = $0.00		Net Put Spread Value = -$5.00
Initial cost = -$2.35		Initial credit = +$2.60
Total Profit /(Loss)= -$2.35		Total Profit /(Loss)= -$2.40

common options terms

ADJUSTMENTS
Certain events such as a stock split or a stock dividend (e.g., a 3-for-2 stock split). An adjusted option may cover more than the usual one hundred shares.

BULL CALL SPREAD
The simultaneous purchase of one call option with a lower strike price and the writing of another call option with a higher strike price.

STOCK DIVIDEND
A dividend paid in shares of stock rather than cash.

STOCK SPLIT
An increase in the number of outstanding shares by a corporation, through the issuance of a set number of shares to a shareholder for a set number of shares that the shareholder already owns.

VERTICAL SPREAD
Most commonly used to describe the purchase of one option and writing of another where both are of the same type and of same expiration month, but have different strike prices.

888options.com Gets a New Look

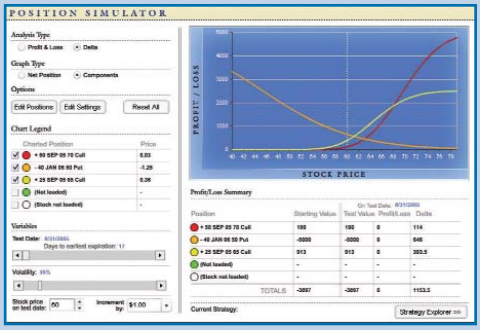
New design, more tools, expanded content

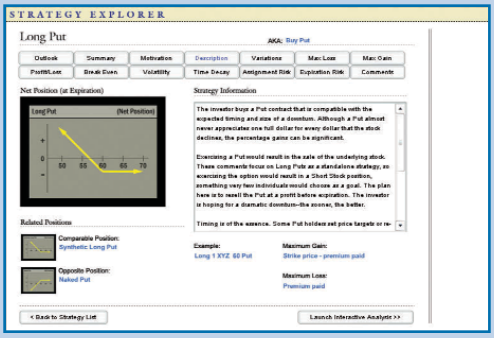
This September, OIC is launching the redesign of its Web site, www.888options.com, introducing improved navigation, design layout and new educational tools. The site aims to become "The Destination for Options Education" for investors just starting out as well as those who are actively trading options. Strategies, online classes and interactive tools are now much more prominent and easier to find. In addition, references to the 1-888-OPTIONS Investor Services Call Center are placed throughout the site so investors can get live help with options strategies, content and tools. Some of the main features of the new site include:

OIC's new online front page guides investors based on your knowledge level of options.

Comprehensive Quiz Application: Test your options IQ with the 888options Quiz. There are more than 20 modules covering the basics to advanced topics. You'll see quiz results and a roadmap of educational offerings to further your options knowledge.

Interactive Position Simulator: This "Test Before You Invest" tool allows you to enter options positions and chart various profit and loss outcomes based on changing market conditions. You can also change inputs for strike price, stock price, volatility, interest rates and dividends.





Strategy Explorer: The Strategy Explorer provides an in-depth overview of more than 40 options strategies. You can sort based on your market outlook or current market conditions. Areas covered include profit/loss scenarios, volatility, assignment and expiration risk, and a look at time decay effects of each strategy.

Moderated Message Boards: See what other options investors are asking or discussing. Share your experience and get information from our options experts. You can post questions to initiate discussion groups, or submit advice to existing notes on the message board. Various topics are covered and responded to during market trading hours.

Online Classes and Webinars: OIC has begun offering webinars for investors covering a wide variety of options topics. To get updates on upcoming seminars and special events, subscribe your email address at: http://oic.theocc.com/e_mail_alerts.jsp

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Check out www.888options.com for a complete description and schedule of OIC seminars.

SEPTEMBER

20 New York Midtown, NY - Covered Calls
21 New York Midtown, NY - Spreads
21 Long Island, NY - Basic
22 Long Island, NY - Advanced
27 Alexandria, VA - Covered Calls
28 Alexandria, VA - Spreads
28 Cambridge, MA - Covered Calls
29 Cambridge, MA - Spreads

OCTOBER

11 Chicago, IL - Covered Calls
12 Chicago, IL - Spreads
13 Cleveland, OH - Spreads
18 Parsippany, NJ - Covered Calls
19 Parsippany, NJ - Spreads
19 San Jose, CA - Covered Calls
20 San Jose, CA - Spreads
25 San Francisco, CA - Covered Calls
26 San Francisco, CA - Spreads
27 Sacramento, CA - Advanced

NOVEMBER

1 New York Downtown, NY - Spreads
2 New York Downtown, NY - Advanced
2 Troy (Detroit), MI - Covered Calls
3 Troy (Detroit), MI - Spreads

Registration is required. All seminars are FREE and held from 6 p.m. - 9 p.m. To register for a seminar or order educational materials, call 1-888-OPTIONS (678-4667) or visit www.888options.com.

bid and ask

Q: ARE OPTIONS ADJUSTED FOR CORPORATE EVENTS SUCH AS CASH DIVIDENDS, STOCK DIVIDENDS, MERGERS, TENDER OFFERS ETC., AND IF OPTIONS ARE ADJUSTED, HOW ARE THEY USUALLY ADJUSTED?

A: Adjustments may be made to certain of the standardized terms of outstanding stock options when certain events occur. While each adjustment is dealt with on a case-by-case basis, the following are general rules regarding when an option may be adjusted:

Ordinary Dividend - No adjustment.

Extraordinary Dividend - Adjustment (as of 9/05, this would be a cash dividend where the dividend amount equals or exceeds 10% of the market value of the underlying security on declaration date).

Stock Dividend, Stock Distribution and Stock Split - Adjustment, usually similar to the terms of the stock treatment.

Distribution of Property Other than the Underlying Security -- May require adjustment.

Mergers -- May result in adjustment. If all outstanding shares of an underlying security are acquired in a merger or consolidation, outstanding options, as a general rule, will be adjusted. In the case of an election/merger (where shareholders make a choice as to their wishes in a merger) options are typically adjusted to the non-electing merger consideration.

Tender Offer or Exchange Offer - No adjustment.

There are quite a few ways to obtain information regarding options adjustments. OIC's Web site, www.888options.com, offers an online course, Contract Adjustments, where investors are provided with general information on options adjustments. You can obtain more detailed information in *Characteristics and Risks of Standardized Options*, or in OCC's By-laws & Rules, located on OCC's Web site, www.optionsclearing.com.

Q: CAN OPTIONS BE TRADED ON ANY LISTED STOCK?

A: By the standards established by the options exchanges, options can only be listed on securities that meet the following criteria at the time of listing:

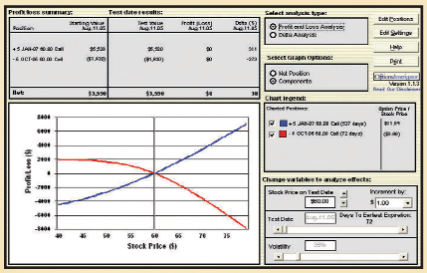
- The underlying equity must be listed on the NYSE, Amex, any national stock exchange or Nasdaq National Market.
- The closing stock price must have a minimum price per share for a majority of the trading days during at least five trading days.
- There must be at least seven million publicly-held shares outstanding excluding shares held by directors or holders of 10% or more of the underlying equity shares. (e.g. the public "float" must be seven million or more.)
- There must be at least 2,000 shareholders.

Generally, there would be a minimum of five days from the Initial Public Offering (IPO) date before options could be listed on any stock, but this criteria alone would not guarantee listing.

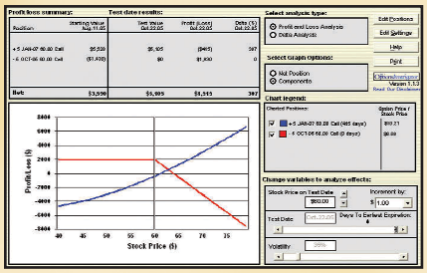
Q: ON A VERTICAL SPREAD IT'S POSSIBLE TO CALCULATE DEFINITE PROFIT/LOSS SCENARIOS AT EXPIRATION, BUT HOW CAN I DO THIS FOR A CALENDAR SPREAD?

A. You really can't calculate a definite "profit" scenario because the possible outcomes are virtually unlimited. Even the maximum loss scenario gets a little fuzzy. You have to make the assumption that if the "short" side of the spread is exercised, then the long side would also be exercised resulting in a known, quantifiable loss.

Now:



At October expiration:



You may see your options questions answered in *Options Central*. Send them to OIC at: options@theocc.com or One North Wacker Drive, Suite 500, Chicago, IL 60606.