Personal Business

A BUSINESS WEEK SUPPLEMENT

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HOW TO TRADE OPTIONS

When the 1973 stock market drop took a huge bite out of her stock portfolio, Wilma F. Beshoar turned to options "as a more conservative way of investing." In the past three years the 50-year-old widow from Chicago has earned a 20% annual return on her cautious investments in options. "I wake up early every morning to dive for the financial section of the paper," she confesses, and admits to talking with her broker more than her family.

Options also excite Bill J. Stajos, partner in a Lansing (Mich.) restaurant. Stajos, who finds that options hold the same appeal as betting on horses, says that by trading options, he is slowly recouping the $57,000 he lost in the stock

Bobbe Wolf

Chicago's Beshoar: She sees options "as a more conservative way of investing."

market a few years ago. Still, he likens options to "playing with gasoline next door to a match factory."

In fact, options make for a complex market in which almost any investment objective, from staidly conservative to wildly aggressive, can be pursued. You can buy an option on good, gray American Telephone & Telegraph Co. or on wild and woolly National Semiconductor Corp. An investor can buy options—or try to wring some extra profit from a portfolio by writing (selling) them. "The great beauty of options is that there are so many different approaches," says Edward F. Keenan Jr., vice-president for option sales at Merrill Lynch, Pierce, Fenner & Smith Inc.

The basics. The range of possibilities, the huge leverage available, and the potential for return—all combined with the average investor's disillusionment with the stock market—have made options the fastest growing investment market since the Chicago Board Options Exchange opened its doors in 1973. Since then, four other exchanges, the American, Pacific, Philadelphia, and Midwest, have joined the CBOE in trading call options on listed stock. The number of stocks on which options are traded has jumped from 16 to 202. Even the crusty New York Stock Exchange wants to join the action, and a number of exchanges are eager to expand options beyond stocks into such areas as bonds and commodities.

For all their glamour and versatility, however, options are still not for everyone. Before you decide to invest in options, you should have:

- An interest in stocks. "I ask one question of each client—do you intend to own common stocks?" says Ronald M. Leek, an options broker at Paine, Webber, Jackson & Curtis Inc. Adds Keenan: "If you don't have an opinion on the stock, you're walking in a blizzard."
- A clear understanding of how the options markets work. Says Keenan: "You won't be a good options customer if you only can say a strategy 'sounds good,' but you don't really know."
- A good-sized investment portfolio. "A small investor probably can't afford to buy the underlying stocks, can't afford the commissions, and can't afford the risks," says John F. Connor, president of C&M Investment Corp. in Chicago. Connor suggests that investors have a minimum of $50,000 to invest, but he would prefer to see people with at least $100,000. Even then, he would tell them to put only 5% or 10% of that into options.
- The right temperament for options. Mathew L. Gladstein, vice-president for options at Donaldson, Lufkin & Jenrette Securities Corp., says, "Though an options buyer may win big in two trades out of 10, he has to have the stomach to lose the other eight times." Even the seller of options, says Gladstein, who may win eight times out of 10, "is going to hit lots of singles and doubles, but he's not going to have any home runs."

A late 1975 survey prepared for the Amex by Louis Harris & Associates found that the typical options investor was a 44-year-old male with an annual income of about $35,000. Options comprised about 5% of his portfolio.

LEARNING THE BASICS OF PUTS AND CALLS

While options are new to many investors, they are not a new concept. Say you were looking for a house and found one that you were interested in but were uncertain about buying. Rather than risk losing the chance to buy it, you might pay the owner $1,000 to hold it off the market for one month. Whether or not you finally bought the house, you would have paid the $1,000 premium simply for the privilege of having a "call" or "option" on it for one month at a set price.

Basically, call options on stocks—the only options now traded on U. S. exchanges—work the same way. The option buyer pays a premium (the price of the option) for the right to buy a certain stock at a set price (called the striking price or exercise price) within a set time period. The premium fluctuates day-by-day, according to how the underlying shares are doing in the stock market. The reverse of a call option would be a put option, which gives the option buyer the right to sell stock at a certain price within a set period of time. Listed put options could become available this year if the Securities & Exchange Commission grants approval.

In the old over-the-counter, put-and-call options market run by dealers, which still exists, you had the freedom to establish any date for the expiration of the option, to fix the number of shares in which you were interested, and to set the price at which you would buy. Then the buyer and seller would agree on a price for this tailor-made option.

Liquidity. By bringing option trading into a few central marketplaces, the exchanges created much more liquid markets. Buyer and seller can now easily get into or out of option contracts, letting others in the market take on their positions. To achieve liquidity, the exchanges standardized the details of the options: the expiration date, striking price, and size of each option (100 shares of the underlying stock). Listed options now are available in three-month cycles for as long as nine months.

In the stock of International Business Machines Corp., for example, there are options expiring in April, July, and October. And when the April, 1977, option expires on Apr. 16, a January, 1978, option will be established. Option striking prices for stocks like IBM, which cost more than $100 a share, are set up at 20-point intervals close to the stock price. With IBM stock trading at around $270 a share, options are available at $260 a share and $280 a share. If IBM went to $290, an IBM option with a striking price of $300 a share would be established in each option month. Prices on option trades are reported publicly as they take place and summarized daily in *The Wall Street Journal* and other newspapers.

After reading some of the material on options prepared by the exchanges, the new investor should look next at movements in listed option prices reported in the newspapers to study how the market works. Says Leonard A. Cupingood, a Pennsylvania statistician and an options investor for the past two years: "Textbooks give you the vocabulary, but it really just takes a lot of hours reading the lousy numbers in the option tables to get a feel for what's going on."

After that, recommends Connor, "one of the best methods I found for training myself in options was investing on paper and then following my position." By methodically working out what would happen if the stock moves up or down by

A TV screen that tells the options story

IBM 1	CLOSE	LAST	B-BID B-ASK	SIZE	MKT-QUOTE
A APR260	20 3/8	19 1/2	19-20 1/2	3×2	19 1/2-19 3/4
B APR280	7 1/2	7 1/8	6 7/8-7 1/2	1×5	7-7 1/4
C JUL260	26 5/8	26	24-28 1/8	2×5	26-26 1/8
D JUL280	13 5/8	13 1/2	12 1/2-14	2×1	13 3/8-13 5/8
E OCT260	31 1/2	30 5/8	28 1/2-32	4×5	30 1/2-31
F OCT280	18 1/2	17 7/8	16-18 7/8	1×1	17 7/8-18 1/8
G					
H					
I					
J					
K					
L					
M					
N					
O					
P					

IBM-270 5/8-3/4 B 270 3/8 A 270 3/4 O 271 5/8 H 272 1/4 L 270 3/8 V 45,400≥

Large television screens—one for each of the 93 stocks on which the CBOE trades a call option—keep a constant tally of the numbers that an investor in options needs to know.

The screen simulated here is following IBM—the most active of the CBOE options, with 1.6 million 100-share options traded in 1976. The numbers at the top left list the various options available: 100-share options on IBM expiring in April, July, and October at both $260 and $280 a share for each of those three months.

To the right of those six options are the premiums, or prices per individual share, that they commanded on one recent trading day: from 7⅛ for each of the 100 shares in the April 280 option to 30⅝ for each share in the October 260 option. Had you purchased the 260 option that day, you would have paid $3,063 plus a commission of about $54, while the April 280 option would have cost $713 plus a $25 commission. The three columns on the far right have to do with limit orders placed by customers and market orders on the floor.

The bottom line is indeed the bottom line: the actual price of a share of IBM on the New York Stock Exchange. On this particular day, IBM was selling for 270⅝—down ¾ from the previous day's close, down also from the opening that morning and from the intraday high.

The bet. Anyone who buys a call option is betting that the bottom line (the Big Board price of IBM) will move far enough above the striking price—either 260 or 280—to make it worthwhile to exercise the option when it expires, or (more often the case) to sell the option at a profit before it expires. The 280 April option would provide you with 100 IBM shares for $28,000 plus a brokerage commission. The option itself cost you $713.

Should IBM reach 300 by the Apr. 16 expiration date of the contract, you could buy the 100 shares for $28,000 and sell them at once for $30,000, for a $2,000 profit less the $713 you spent on the option and less the various commissions. Or as IBM approached 300, you could sell the option to someone else at a nice profit, without buying the stock and without paying commissions on a stock purchase and sale.

The reason that the April 280 option cost only $713 is because most investors were betting that the Big Board price of IBM would not go appreciably above 280 before April. The October 260 option sold for $3,063 on this particular day because investors thought there was a good chance that IBM will move significantly above 260 between now and Oct. 22. Each move in the NYSE price of IBM shares between now and October will, in turn, push the premium of the October option (and of every other IBM option) up or down.

different amounts, you can get a picture of the risks and potential rewards involved in each position and, in turn, a finer sense of the market.

No handholding. A good broker can help in the education process, too. "We'd be willing to work with a client for about three to six months," says Charles B. Milligan Jr., options vice-president at Drysdale Securities Corp. "We would want to bring you to the point," he adds, "where we could show you different situations and you'd understand them, since we don't have the time to spend half an hour explaining some basic strategy each time we call you."

Indeed, Washington management consultant Jerrold M. Grochow found himself calling his broker daily after he got into options. "That lasted about a month," says Grochow," and then I found it less necessary."

When you do begin to develop ideas for specific option plays on your own, you can bounce them off your broker, who should be able to point out problems you have missed. Brokers in most major firms also have access to sophisticated daily computer runs that screen option possibilities to search for stocks with high dividend rates, options that are considered overpriced or underpriced based on the expected volatility of the stock (based, in turn, on past performance), the risk involved in buying the option, yield per unit of risk, and so forth. While such models can be helpful, however, neither the broker nor the investor should rely on them for making final investment decisions. "Discretion is the better part of valor; you can't rely blindly on a model," warns Peter J. Power, a vice-president at Becker Securities Corp. in New York.

Nor should you rely blindly on your broker, either to decide when to put you into a position or when to take you out. "It's difficult for a broker to follow all positions of each client," explains Samuel R. MacArthur, a vice-president at Drysdale. He suggests that investors be able to follow their own positions while keeping in touch with their broker.

Personal plan. A broker can be particularly helpful in developing a framework for option trading. Together, you should determine which side of the market you want to participate in. If you're interested in options as a relatively inexpensive way to get a lot of leverage in the stock market, you'll probably be interested in option buying. If you're interested in a more consistent return on your portfolio of stocks, you'll probably be drawn to selling options on the stock you own.

In buying options, you'll need to consider many of the same factors as in buying stocks, and then some. As one options investor, California corporate attorney William De Garmo, points out: "You are not only saying that a stock is going to go up, but that it will do so in a relatively short time." If a stock makes a big move in June and your option on it