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Stocks And Covered Options

COVERED OPTIONS

PERSONAL INVESTING

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What do Aetna Life & Casualty, Dartmouth College, Stauffer Chemical, Continental-Illinois Bank and Letterman Transaction Services have in common? All of them are participating in the newest approach to conservative investing on Wall Street. They are using the listed options market to increase returns and reduce risk in their large investment portfolios.

The New Conservative Approach To Stocks

Why all the excitement? What are options, and what can the individual investor do with them?

Briefly, a call option is the right to buy 100 shares of a given stock at a predetermined "striking price" during a limited period of time. Like almost any investment, there is a speculative and a conservative side to the options market.

A buyer of the call option gambles on a sharp rise in the price of a stock by investing just a fraction of the cost of the actual security (the actual cost of the option is called the "premium"). The rewards can be extremely handsome if the stock rises during the "life" (or the specified time-period) of the option. Returns of 200-300% and more are not uncommon if the stock price can rise substantially during the period when the option is still valid. Sounds great, doesn't it?

Well, it is, if you've got the stomach for it. In the real world, the high return always brings the high risk, and the successful options buyer is the sophisticated analyst who can spend the full time over the tape watching for the occasional killing. Recent figures issued by the options exchanges indicate that 84% of all options purchased expire without being exercised.

Why would Stauffer Chemical, Aetna Life & Casualty, et. al., want to play that type of game? They wouldn't and they don't. Increasing numbers of institutional investors are writing options; that is, they are selling options on high quality stock they hold in their portfolios. They are selling options to the speculators who are interested in the high-risk, high-return business of option-buying. By holding the underlying security (100 shares of General Motors, for example), and selling a call option against that stock position, the portfolio manager not only keeps the "premium" for the option (which ranges between 10-20% of the stock price for a 6-month call), but also retains all dividends that are paid on the stock.

The premium income obtained enables the option seller to fare better than the straight stock investor (and the option-buyer) in a flat or declining market. The only time the option seller does worse is when the optioned stock's price rises sharply and quickly. In selling a call option, the writer gives up his right to a portion of the stock's potential price appreciation. His gain is limited to the amount of option premium and all stock dividends. The remainder of the stock rise goes to the call buyer.

Over the long-term, covered option-writing reduces the volatility (and thus, a large degree of risk) of common stock holdings. Not only does call writing protect positions in declining markets, it also reduces the maximum amount of gains in rapidly rising markets. Average rates of return for conservative call

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writing range from 12% to 18% per year on invested capital. If this doesn't sound exciting, let's look at some relative rates of return.

As investment of $1,000 in U.S. Treasury bonds in 1950 would have been worth approximately $2,400 in 1975. The same $1,000 invested in the Dow Jones 30 Industrials (or equivalent market average securities) in 1950 would now be worth about $10,940, including all dividends. Much better, but now let's look at covered option writing.

A recent study by Professor S. T. Kassouf of the University of California shows that had an investor written three-month call options on the same Dow portfolio, his $1,000 investment in 1950 would have grown to $57,559 by 1975. And this return would have been accomplished with less risk than owning common stock outright!

From a historical perspective, covered option-writing appears to have two major benefits:

1. A reduction of risk in the ownership of common stock.
2. A better-than-average rate of return on invested equity capital.

Conservative individuals and institutions, stung by the market collapses of 1969 and 1974, are turning more and more towards option-writing to provide their portfolios with a measure of downside protection that was previously nonexistent. Premiums earned from the writing of call options establish an extra "cushion" of cash, which can greatly offset periodic downtrends in the market place.

Many people feel that the volatility of the market during the past ten years is due, in large part, to institutional investment practices. Ironically, it is these same institutions that are actively participating in options market to help reduce the volatility of their portfolios.

Until recently, institutional investors would not have considered a foray into the world of options. But that attitude began to change in 1973 with the advent of the Chicago Board Options Exchange (CBOE). The CBOE pioneered the exchange trading of options and gave them a new respectability and ease of trading. In 1975, institutions accounted for over 10% of the more than $8.5 billion of combined options volume on the CBOE, American Stock Exchange and the Philadelphia-Baltimore Stock Exchange. Observers expect that institutional participation will continue to grow in the next few years.

One healthy impetus to institutional activity was the passage of the Rostenkowski bill in mid-1976. This legislation made it possible for tax-exempt institutions such as pension funds, endowments and charitable foundations to participate in option-writing without jeopardizing their tax-exempt status.

But aside from tax questions, the major reason for institutional (and individual) use of options is the lure of increased portfolio performance. The gains produced by option-writers in recent saw-toothed stock markets stand in sharp contrast to the relatively dismal results of other professional and individual investors.

In short, professional option-writing is far from being the plaything of a new generation of professional gunslingers in the stock market of the late 1970's. For the sophisticated investor, individual or institutional, it furnishes a conservative and calculated new tool to reduce risk and methodically build profits. As covered option-writing becomes better understood, it can be expected to come into increasing use by the smaller investors now returning to the market. ■■