STOCKS | Yes, options can be risky. But you can use them in conservative ways, too.

By David Landis

How to WIN in any kind of market

IF YOU'RE LIKE most shareholders, your repertoire of money-making moves is limited. You buy, maybe you collect dividends, and you wait for the price to rise. It's a safe strategy that works well in bull markets, not so well in bear markets.

Jennifer Duce felt she needed to be more aggressive, especially after her employer of 16 years, United Airlines, defaulted on its pension obligations early this year. Duce, a pilot who lives in Miami, has been trading options, hoping she can rebuild her retirement savings more quickly. "As long as stocks are moving, you can make money with options," says Duce, 40.

Until recently, options were considered the province of professional traders, too complicated and risky for most individual investors. But the growth of online trading has begun to demystify options investing. Many online brokerages offer options trading, and commissions are comparable to those charged for stock trades.

But trading options is more complex than buying and selling stocks. It can be risky, too, although it doesn't have to be. "Just because people speculate in real estate should not stop you from buying a home," says David Kalt, chief executive of OptionsXpress, a brokerage that specializes in options trading. "The same goes for options." Buying puts, for example, is a way to immunize your portfolio against falling prices. And selling covered calls is a fairly safe way to generate income. We take a close look at these strategies and a couple of others below. To dig deeper, check out Web sites offered by the Options Industry Council (www.optionscentral.com) and OptionsXpress (www.optionsxpress.com).

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NUTS AND BOLTS

LET'S START with the basics. Options come in two flavors: calls and puts. A *call* gives you the right to buy a stock at a prearranged price, known as the strike price. It's a bet that a stock will rise in value. A *put,* on the other hand, allows you to sell a stock at a predetermined price. It's a bet that a stock will fall in value.

Here's an example of how you can use calls: After a 45% tumble earlier this year, eBay shares had recovered to $40 in mid August. If you think eBay (symbol EBAY) is likely to continue to advance, you could buy a call with a $40 strike price that expires in January 2006 (options always expire the third Friday of the expiration month). In August, that call was selling for $4 (although by the time you read this the price will have changed; option values fluctuate as expiration approaches and as the underlying stock price changes). Because a call option is the right to buy 100 shares, your investment is $400.

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Let's say eBay shares rise to $45 just before expiration. Your call entitles you to buy 100 shares of eBay at $40—a $5-a-share discount from the new price—so the total value of your call is $500. You could exercise the option and receive 100 shares of eBay for $40 each or you could simply sell the call for $500. Remember, you bought the call for $400, so your profit is $100, or 25% of your original investment. Not bad for an investment held for just a month or two. (In the real world, you need to consider commissions and taxes; for information on the tax treatment of options gains and losses, see www.888options.com/store/taxguide_new.pdf.)

What if you had simply bought 100 shares of eBay at $40 instead of the options? Your gain would be $500. But your profit would equal just 12.5% of your original $4,000 investment before commissions.

That's the attraction of options: You get much more bang for your buck. "It allows me to spread my money out," says Duce. "I'm able to do many different things without having a million dollars in the bank." She adds that she has enjoyed "nice, modest returns" in the two and a half years she has been trading options.

The primary disadvantage of investing in options is that, like milk, they go sour after the expiration date. If your eBay calls, for example, were to expire with the shares below the $40 strike price, they would be worthless and you would lose your entire $400 investment.

Now let's see how you can put options to work in some simple, conservative strategies:

Buy protective puts. If you were smart enough to bid for 100 shares of Google at its initial offering price of $85 in August 2004, you are now sitting on a profit of more than 200%. But at $280, or 81 times trailing earnings, the stock could be due for a pullback. Here's how to lock in your gains.

Put options are the mirror image of calls. If you buy Google puts with a $280 strike price, they will rise in value as the price of Google shares falls. If Google (GOOG) falls to, say, $260 by expiration, your puts still give you the right to sell shares at $280. No matter how far Google shares tumble, your loss is limited to the cost of the puts. In this case, however, that cost is significant. Google $280 puts expiring in January 2006 cost $21.70 per share, or $2,170 for one contract. That means Google shares would have to fall by nearly $22 before your puts would begin to pay off (not accounting for commissions).

Why does the Google put cost so much more than the eBay call? For one thing, Google's price is seven times higher than eBay's, and Google can swing $5 or more in a single day. Also, Google is more volatile as a percentage of the share price—a valuable attribute for options investors. The more the share price moves, the likelier you are to make money on options.

There are cheaper ways to ensure the value of your shares. You could buy out-of-the-money puts, or those with strike prices below the price of Google stock. At a lower strike price of $240, the put costs just $7 per share. The downside: You could suffer a bigger loss before the put's price protection kicks in. Such a put wouldn't pay off until Google's price fell below $233 (the $240 strike price minus the $7). But the put would cost just $700.

You can also hedge an entire portfolio. But rather than buy puts on each stock—too difficult and prohibitively expensive—buy puts on a market index that best matches your portfolio. If, for example, your stock portfolio roughly tracks Standard & Poor's 500-stock index, you could buy puts on Spiders (SPY), an exchange-traded fund that tracks the S&P.

Spiders shares were trading at $122 each in August (one-tenth the 1220 level of the S&P 500 index). At that price you could hedge a $100,000 portfolio by buying eight put contracts with a $122 strike price expiring in December for $3.30 a share. Total investment: $2,640. This strategy would pay off if the overall market declines enough to offset the cost of buying the puts. Keep in mind, though, that to the extent that your portfolio doesn't match the S&P 500, your hedge will be less than perfect.

Sell out-of-the-money puts. If you're hoping to buy a stock the next time its price dips, you can pay yourself to wait by selling puts. It just requires a small change in perspective. Instead of buying puts, in this case you sell them and pocket the *premium,* which is industry jargon for the proceeds. Because about one-third of all options expire worthless, many

veteran traders say selling options is a better bet than buying them "I won't buy options," says Mike DeGeeter, a bond trader who likes to trade options in his own account. "I am a seller of options."

DeGeeter, who lives in suburban Detroit, thought stun-gun maker Taser, which traded for more than $30 a share last year, would be a good buy at $10. So he began selling $10 puts that were due to expire in July. That gave the buyer of those puts the right to sell shares of Taser (TASR) to DeGeeter for $10 each (and DeGeeter was obligated to buy them) if they slid below that level. In July, Taser shares dipped to $9.50, and now DeGeeter owns 1,000 of them at a net cost of $8.95 each ($10 minus the $1.05 he earned from selling the puts). Had they not dipped below $10, DeGeeter, 44, wouldn't have gotten the shares, but as consolation, he would have pocketed the $1.05 per share he got for selling the puts. Previously, in June, he had sold another round of $10 puts for $1 each, in effect earning a dividend on the shares while they remained above his purchase price. (Keep in mind that if you sell puts you should have enough money in your account to buy the shares, should it come to that.)

Sell covered calls. This is a popular options strategy, and it's also one of the safest. Selling covered calls is a good way to generate additional cash on shares you own that aren't expected to move much in the short term. Instead of selling puts on shares you *don't* own, you sell calls on shares you *do* own.

To illustrate, let's return to DeGeeter's Taser shares, which he acquired at $8.95 each. He immediately sold Taser calls with a $10 strike price that were due to expire in September and December. DeGeeter pocketed $1.10 to $1.65 per share for each call he sold. He'll keep that cash as profit if the shares remain below $10 until they expire. If Taser's stock rises above that strike price, he'll be obligated to sell Taser shares to the buyer for the bargain price of $10. That's not a problem because DeGeeter already owns the shares. In other words, he is "covered." (If he didn't own the shares, he would have sold "naked" calls, something brokerages won't allow beginners to do.) In exchange for his profits from selling the calls, though, DeGeeter is giving up any gains on Taser shares after they cross the $10 mark. Covered-call selling works best on stocks and indexes that are expected to rise, but not by much. The strategy will lag in a bull market because you are, in effect, selling away the potential for big gains for a fixed price. And selling covered calls won't provide much relief if your stock tanks.

Buy LEAPS. If you are scared off by the nine-month maximum life span of options, try LEAPS. They're long-term options that last up to 32 months. LEAPS are initially pricier because they last longer For example, calls on biotech giant Genentech with an $85 strike price and a January 2007 expiration recently cost $16.80 each. With the stock trading at $89 in mid August, a comparable short-term call expiring in December recently cost $9.20. In both cases, you are betting on the continued success of Genentech, which is up 60% this year and seems poised for further growth (see "Biotech Is Still Filled With Promise," June). But LEAPS let you share in an extra 13 months of potential gains at roughly one-fifth the cost of buying the share outright. **K** —*Research:* **AMY ESBENSHADE HEBERT**

TRADING TIPS

Getting **BETTER** results

Once you've mastered the basics, here are several tips that may help you improve your results from trading options:

Buy in-the-money options. The clock is always ticking on options. To lessen the impact of shriveling prices as the expiration approaches, buy calls with a strike price below the price of the stock, or buy puts with a strike price above the stock price. For example, if shares of Johnson & Johnson (symbol JNJ) are at $64, buy calls with a strike price of $60 rather than $65. The in-the-money calls cost more ($5.80 versus $2.25 for January 2006 expiration), but time value is a smaller portion of the price. If the stock is still at $64 at expiration, the $65 calls will be out of the money and worthless. Your loss: $2.25. But the $60 calls will still be in the money and worth $4. Your loss: just $1.80.

Focus on long-term options. The price of an option can plunge during the last 30 days before it expires. If you're buying options, "you have a much better chance if you stick with options longer than 90 days," says Tom Gentile, chief strategist for Optionetics, an options-education firm. You'll pay more for the extra time, but you'll also give your strategy longer to play out.

Check the bid-ask spread. Dealers sell options at the ask price and buy them at the bid price (just as they do when they buy and sell stocks). Look for a spread of about a dime on widely traded options; avoid options with spreads greater than 20 cents.

Be aware of special events. Option-price volatility may be unusually high before an earnings announcement or some other anticipated event. Be aware of such events, and don't overpay for such options unless your strategy hinges on those developments.