Naked Came the Caller
(and Other Options Trading Tales)

Buying blue chip stocks and then selling options on them is often less risky than just buying the blue chips—and potentially a lot more profitable.

by Robert J. Klein

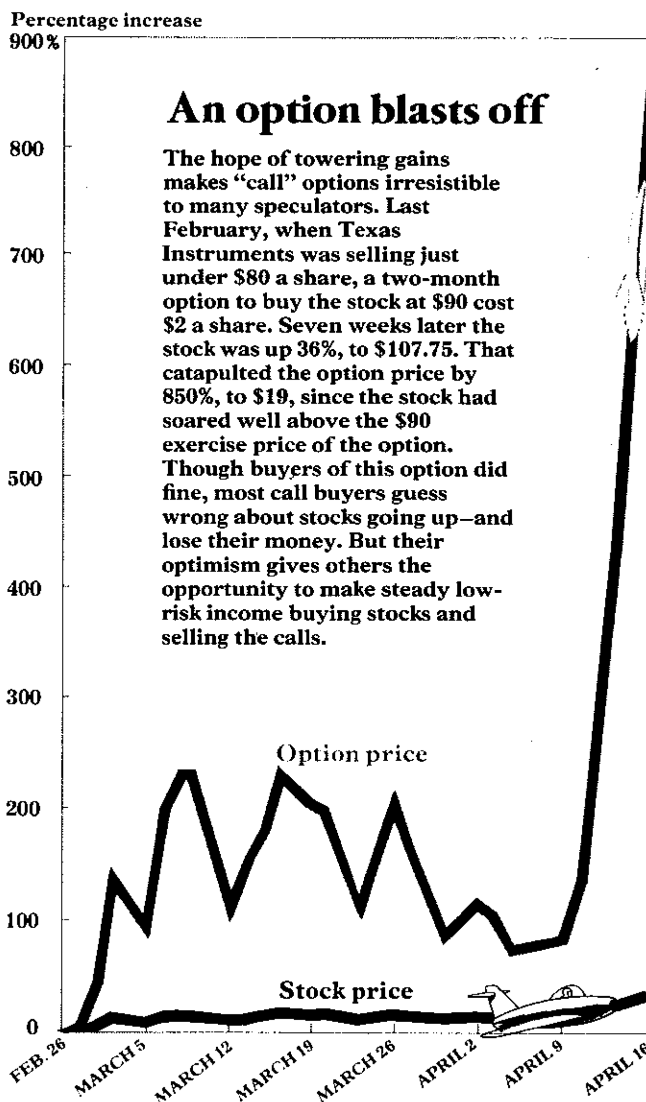
When Dr. John E. Houck of Snyder, N.Y. bought Polaroid stock last summer, he had an ambitious plan. If Polaroid's price rose just 4½%, he figured, he could turn a quick 28% profit, and if the stock went down, he could still make a little money. Dr. Houck, a psychiatrist, wasn't suffering from delusions of financial grandeur. He was simultaneously buying Polaroid stock and selling Polaroid "calls" in the fast-growing options market.

A call, available through any broker, is simply a slip of paper that gives its owner the right to buy 100 shares of stock at a set price for a limited time. The call costs only a fraction of the price of the stock but generally moves up and down in price faster than the stock does. Buyers of calls hope to make a killing on a sharp rise in the price of the stock. Sellers of calls try to turn this speculative urge to their own advantage. Theirs is the most conservative, and in most periods the most lucrative, way to invest in options. In fact, buying blue chip stocks that pay relatively high, regular dividends and selling options is less of a risk than buying the stocks and not selling the options.

Don't ask

Dr. Houck had a special strategy. He bought 200 shares of Polaroid and sold three calls. Two of them were covered by his shares; the third was what options traders call "naked," since he did not own stock to cover it. In the Gothic architecture of the options market, the doctor's arrangement wasn't at all flamboyant. Brokers and traders are forever setting up new devices for building surer profits on smaller risks. Their conversations buzz with the names of such more or less complex artifices as "walk ups," "vertical one-on-one bullish spreads," "calendar spreads" and "wing spreads." A wing spread, for example, involves three different calls on the same stock. "Don't ask me to explain it," begs David DeLozier, an options broker in E.F. Hutton & Co.'s Santa Ana, Calif. office. "It would take half an hour."

Ignoring most of the esoterica, ordinary investors have become the biggest customers of the three U.S. options exchanges—and many have done very well. Until recent years, a handful of options brokers mated a small coterie of buyers and sellers, and it was difficult to make options trades quickly. Then, in 1973, the Chicago Board Options Exchange (CBOE) brought calls to the common man. This year options trading also began on the American Stock Exchange and the PBW Stock Exchange in Philadelphia. Anyone who can afford to buy 100 shares of stock can sell calls on these exchanges. Buying calls costs even less; for $300 or so, the choice is immense.



An option blasts off

The hope of towering gains makes "call" options irresistible to many speculators. Last February, when Texas Instruments was selling just under $80 a share, a two-month option to buy the stock at $90 cost $2 a share. Seven weeks later the stock was up 36%, to $107.75. That catapulted the option price by 850%, to $19, since the stock had soared well above the $90 exercise price of the option. Though buyers of this option did fine, most call buyers guess wrong about stocks going up—and lose their money. But their optimism gives others the opportunity to make steady low-risk income buying stocks and selling the calls.

The options exchanges constitute a veritable supermarket of calls. Last month options were listed on 131 common stocks, ranging from blue chips like AT&T to volatile stocks like Disney. Hundreds of other companies were clamoring for admission.

Most calls come in several forms, multiplying the possibilities open to the options trader. Calls differ both in the price at which the buyer can purchase the stock—the exercise or "striking" price—and in the amount of time left before the option expires. Last month, for example, AT&T calls were being traded with $45 and $50 exercise prices and with expiration dates in October, January and April, giving buyers and sellers a choice of six calls. In brokers' jargon, an option with a $45 exercise price expiring in January is a "January $45 call."

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Speculators were electrified by the opening of options exchanges; they could now play the stock market with pin money. "You can deal in quality merchandise at 20% of the investment—and get the same ride," says Morris Danzger, a 54-year-old New York City accountant who leaped in at the beginning. Danzger says he's a little ahead, but it's his guess that 80% to 90% of buyers lose their money.

Lately, sellers have come to dominate the options market. At Bache & Co., 80% of the options customers used to be buyers. Today, says Terry Mayer, head of the options department, only about 20% of his clients speculate by buying calls. The majority—55%—are strictly sellers. The other 25% are naked sellers or "spreaders"—traders who look for small but nearly sure profits and hedge against big losses by buying and selling options on the same stock.

A case can be made for—and against—all four uses of calls. Here's the story on each:

THE SELLER

Brokers make a convincing case that selling calls is ideal for widows, orphans—and anyone else interested in earning 18% to 20% a year on blue chip stocks. Dr. Houck says he's making a steady 20% and so does Dwight Chamberlain, a retired Air Force colonel who is a client of David DeLozier's in California. Among many stocks that have recently done well for options sellers is International Harvester. Although Harvester was yielding only around 7½% of its price in dividends, the options market last month could have boosted that return to 18%. Here's how:

Buy 100 shares at $23	**$2,300**
Plus commission	**46**
Total cost	**$2,346**
Sell an April $25 call at $1.56 per share	**$156**
Less commission	**28**
Net proceeds	**$128**
Collect six months worth of dividends	**85**
Total return	**$213**
Percentage return in six months	**9%**
Potential annual return	**18%**

Brokers like to point out that call sellers reduce their risk if the price of their stock goes down, since the proceeds of the call in effect lower the price paid for the stock. The Harvester stockholder can consider himself protected against any capital loss on his stock until its price falls more than $1.28 a share—the amount he earned by selling the call. But he can't have it both ways. Either the call adds to his income or it shores up his investment.

One infernal possibility threatens the call seller: the price of his stock may soar. Once the stock price passes the exercise price, the call seller can touch no part of any further gain; he has sold future glory for present cash. There is, however, an escape from this particular hell. You can buy back the call—at a higher price—and keep your stock. Broker David DeLozier says he usually preserves his clients' gains that way. "But I did get trapped this year on a bunch of Gulf & Western calls," he admits. "The stock went from $23.50 to $44 and split, and I had to buy back the options at a very large price." His clients kept their Gulf & Western stock, but the loss on their calls was about equal to the gain on their stock.

The best stocks to buy if you're going to sell calls, most brokers say, are conservative ones. They usually define conservative stocks as those with high,

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reliable dividends and a low price in relation to the company's earnings (specifically, price/earnings ratios between four and nine). The stock's price should also be slower to change than the stock market price averages. Besides Harvester, brokers often mention American Electric Power, AT&T, Bethlehem Steel, Exxon and ITT.

THE NAKED SELLER

Snug abed, options traders probably dream at times of the ultimate opportunity—selling calls without putting up any money. If their dream came true, and if the price of the stock didn't go up, their profits would be infinite. If the stock did go up, however, the dream would turn into a nightmare of limitless losses. In the options market, the dream can never come true, but the nightmare can.

Naked sellers—those who sell calls on stock they do not own—must put up money or assets to cover their possible losses. The amount of money varies with the broker and the call, but it usually comes to 40% or 50% of the price of the stock. Even so, the potential return on this money is at least twice what it would be if the stock had to be bought and paid for.

Now, about that nightmare: if the price of the stock goes up sharply, the seller finds himself naked indeed. Not having bought the stock when the price was lower, he must either buy it now or buy back the naked calls, in each case at disastrously high prices. Unless he acts quickly, he may lose thousands of dollars. For this reason, brokers permit only experienced investors to sell naked, and even then brokers make sure that investors have enough assets to cover serious losses.

With skill and caution, an experienced investor can do well selling naked options. A cardinal rule is to give your broker a standing order, called a good-till-canceled stop order, to cut your losses at a specific point by purchasing a call like the one you sold. Some brokers suggest a second rule: only sell naked options on stocks you wouldn't mind owning—because if the stock rises, it is sometimes prudent to buy the stock rather than risk losing money on the call.

Dr. Houck, the naked seller of Polaroid, disdained most of this advice. Polaroid is no blue chip. It pays only a small, uncertain dividend, and it had plunged a catacysmic 129 points from its 1973 high toits 1975 low. "One of the beauties of options," Dr. Houck says, "is that you don't have to be concerned whether the market is going up or down. I was just looking for a volatile stock." In late August he acquired his 200 shares on margin, putting up half the price and borrowing the other half from his broker. At the same time he sold three calls expiring in October.

As wise and experienced options traders do, Dr. Houck had set up a hedge against losses. He would make money, after commissions and interest on his margin loan, within a fairly comfortable $13 price range. The money from the three calls would more than cover any losses on his stock until it fell from his purchase price of $33.50 a share to $29.75. If the stock went up more than he anticipated, the call money and the capital gain on his shares would offset losses on his naked call until Polaroid hit $42.75. As a further precaution, he gave his broker stop orders that would preserve a sliver of profit if Polaroid misbehaved. He figured he would make his best profit if the stock stood at $35 when the calls expired:

Profit on 200 shares	**$300**
Income from calls	**1,051**
Less commissions and interest	**196**
Net profit	**$1,155**
Return on $4,098 outlay	**28%**

Last month, as Dr. Houck's calls neared their expiration date, the stock rose enough to trigger his stop order. He wound up with only a 7% profit.

THE BUYER

"Never, never, never, never buy a call. Period. End of report." So wrote broker Max Ansbacher in his book *The New Options Market,* published early this year. "Poetic license," he concedes now. "Options prices have come down, and in certain circumstances it makes good sense to buy."

The lure of buying options is leverage: when a stock goes up, the price of its calls goes up faster in percentage terms. As Ansbacher puts it, "If you're only interested in the waves, you don't have to buy the ocean." In a classic example, charted on page 55, Texas Instruments stock registered a 36% gain in seven weeks early this year. Over the same period, the price of its April $90 call vaulted 850%. Hindsight shows that $1,000 worth of calls would have returned a stunning $8,500 profit, while $1,000 invested in the stock would have returned only $360. *continued*

However, putting big money into buying the calls of a single stock is the riskiest of option speculations. "Most people lose," says Terry Mayer of Bache & Co. "Even the man at the race track does better betting $2 on 50 favorites to show than putting $100 on the long shot's nose." Mayer thinks someone with $5,000 to invest can suitably speculate with $500 of it if he diversifies among three or four different options.

THE SPREADER

Glancing at the latest stock and option prices on his desk-top video monitor, Leon Pomerance spots what his practiced eye recognizes as an opportunity for "a bullish one-on-one vertical spread" in Honeywell calls. By selling a $30 call and buying a $25 call while the stock hovers around $29 a share, a spreader can make his maximum profit if the stock rises $1 or more, and he can't lose money unless it drops at least $1.13. Pomerance, head of the options department at Donaldson, Lufkin & Jenrette in New York and chairman of the CBOE, demonstrates on a pad how this spread can deliver 2⅛ points profit before commissions.

Spreaders are the option-trading elite. By selling and buying different calls in the same stock, they take fullest advantage of the flexibility made possible by the new options exchanges. Spreaders rely on their ability to predict when the price of one option will rise or fall faster than the price of another option in the same stock. But they don't always come out ahead. In fact, "the average spreader is going to lose," says Peter Mychaels, options chief at Paine, Webber, Jackson & Curtis.

As a further challenge to spreaders, in mid-1976 the CBOE expects to start trading "puts." A put gives its owner the right to sell stock at a set price, just as a call gives him the right to buy it. If the stock falls below that price, the put owner buys it cheap and sells it dear. When spreaders can buy or sell puts and calls on the same stock at the same time, they will have three new hedges—the "strip," the "strap" and the "naked straddle."

Morris Danzger, who usually keeps a dozen spreads going, is not thrilled. Besides being unfamiliar with puts, he explains, "I can't dance at two weddings at the same time." But brokers think they know better. Says Max Ansbacher: "When people become familiar with all the possibilities, it's going to be absolutely fascinating." **END**