Taking Stock: Options can be a tough call

by Malcolm_Berko

Dear Mr. Berko: Over the past 20 years, I've probably experimented with call options a dozen or so times because I could control 100 shares of a $50 stock up to nine months for about $200. The only time I ever profited was when I bought the May $55 GalxoSmithKline options in March of 2000. Glaxo was trading at $51 and I paid $175 for a call that would let me buy Glaxo at $55. Glaxo went up to $65 a month later and I sold my May $55 option (I had three of them) for $1,125 each and made $950 per option, or $2,850 total on my three options. My experience in the options market has been lousy. But a friend told me that he's making 40 percent to 75 percent annually with option spreads using a broker who designed a sophisticated computer program. I had an appointment to speak with this man in Chicago and he was a real dork and geek. He never took his eyes from his computer and was an unpleasant person so I left. How come you never write about options? Is it possible to make 40 percent to 75 percent annually with "option spreads"? What are option spreads? Are they safer than buying regular options? Can you educate me about option spreads or can you give me the name of an experienced option expert that would be willing to educate me and give me advice?

T.M.

Elgin, Ill.

Dear T.M.: I know just enough about options to be dangerous - but not enough about options to be good. Options can be as risky as walking a high wire without a safety net or walking that wire with a huge safety net. So the manner in which one utilizes options defines the risks.

Yes, it's possible to make 40 percent to 75 percent annually, but it's not probable. I don't know a single soul on this planet who earns 40 percent to 75 percent annually on anything. But average annual returns in excess of 10 percent to 15 percent with limited and modest risk are not uncommon. However, I'd wager my 607-piece vintage Barbie doll collection that your Chicago dork/geek isn't producing those returns. Rather I think your friend and his geek/dork got a little too excited over a few good trades.

So I asked my friend Don "Spreadman" Pressman, a Harvard MBA who has been trading options for over 31 years, to help me with a couple of answers. Don knows enough to be dangerous as well as good and his option account clients are a smiley, happy lot.

Don says that a spread occurs when you offset the purchase of one option by the sale of another option with the same expiration date. Let's use a call option as an example where one option represents 100 shares of stock.

Assume that AT&T is trading at $39.30, as it is at this writing. A July $35 call (allowing you to buy 100 shares of AT&T at $35 between now and the end of July) can be bought for $4.80, or $480. Now a July $37.50 call could be sold for $2.70, or $270. (When selling that call you are obligated to sell 100 shares of AT&T to the buyer for $37.50 between now and the end of July) The difference between the purchase of the July $25 CALL ($480) and the sale of the July $37.50 call ($270) is $210, which is your cost.

So here's what could happen:

1. If AT&T closes at $37.50, your profit is $40, or 19 percent, in three months between May and July. Yes, if AT&T falls $1.80, you still make 19 percent.

2. If AT&T is above $37.50, you will make a profit.

3. If AT&T falls below $35, you will lose your entire investment cost, or $210. Of course, if you had bought AT&T at $39.30, you would have lost (if AT&T is $35) $430, but as you can see, you have limited your loss to a maximum of $210.

Basically using this spread, you are theoretically buying AT&T at $2.20 a share less than the current market price.

That's an option spread in a handbasket. It can be a lot more complex using different expirations, permutations and combinations of calls and puts, which can produce some compelling profits but with enormous leverage and a high degree of risks.

I suspect this is how your Chicago geek/dork may have made those huge returns trading quirky spreads. Pressman prefers the "call to call" schematic because (1) You know exactly how much money is at risk, (2) annual returns can be between 10 percent and 25 percent, (3) the risks are easily identified and very low, (4) it's just as easy to make a 10 percent to 25 percent return in a falling market as it is in a rising market and (5) his system is uncomplicated and anyone with an extremely low triple-digit IQ can do it himself with a few practice trades.

If the Spreadman says so, then it must be so because he's a Harvard Master of Business Administration (big deal). Anyhow, I've sent you Don's phone number and you'll find him an engaging fellow. Though his Boston accent is quite charming he lives and works in Boca Raton, Fla. Talking with Don is like visiting with a next door neighbor and he'll be pleased as sweet peach punch to discuss spreads with you.

Please address your financial questions to Malcolm Berko, P.O. Box 1416, Boca Raton, FL 33429 or e-mail him at malber@adelphia.net.