

Buy-Writers Beware!

By Ron Ianieri

Although the buy-write and covered call strategies are and have always been considered one and the same, I have always seen them as subtly different in a very important aspect. I have always seen covered call writers as investors who write (sell) calls on an existing stock position intended to be held for a time. This stock position was pre-existing. The stock was chosen for whatever reason (capital appreciation, chart driven, fad, stock in own company) but not because the stock had good buy-write potential.

For example, a friend of mine, like many executives, receives stock at discounted prices from his company as part of his compensation package. Because my friend likes his company's product and is very confident in the management team and their business strategy model, he wants to hold onto his shares through thick and thin for the long term.

However, while holding his stock, he ran into a long, stagnant period where the stock became wedged into a tight trading range. Eventually he became frustrated with the lack of return on his investment and started to worry about the potential downside. Not sure what to do, but wanting to do something, he approached me for advice. I suggested selling calls against his stock position. He did it religiously for several years and continues to do so today. Needless to say, he is extremely pleased with the results.

However, my point is that his stock was purchased and held without any thought or consideration about the potential returns of the buy-write strategy. In my mind, my friend's strategy was a covered call writing strategy: that is, writing calls on an existing stock position when the stock is purchased independently for reasons unrelated to writing calls.

Meanwhile, I have viewed buy-writers as mostly traders who have chosen to purchase a stock because they intended to sell calls against it. For a trader, this is usually done to capture the high implied volatility premiums that are sometimes offered in particular stocks, at a particular time

Having made the distinction between the covered call and the buy-write strategies, I would like to finish this discussion talking about the buy-write. The buy-write, unlike the covered call strategy, has two decisions involved. Whereas in the covered call strategy, as I have explained, you only choose which option to sell (you have already own the stock). In the buy-write, you make a dual decision, selecting a stock because of its attractiveness for call writing and choosing which option to sell.

There are many tools that can aid in the due diligence process that should accompany any investment decision. Research, including technical, analytic fundamental and logical should be also applied. As to how to select a buy-writable stock, there are now several web sites that have sprung up to help investors make those selections. But beware, because many of these services are not giving you the whole picture, and may not know what they are saying. Without mentioning names, some state directly on their sites that the secret to successful buy-writing rests solely in the hands of volatility. They suggest, as a matter of course, that you only buy-write high volatility stocks. Their reasoning is that the higher volatility stocks have much higher premium attached to their options. Their thought is that the more premium you bring in, the higher percentage return you will get.

While this idea has merit it does not address the whole situation. The buy-writer should beware! The reason those stocks have so much premium is that they are highly volatile; that is they have a tendency toward large movements in either direction. The percentage chance of this type stock being in the same place at expiration is highly unlikely. If that is the case, then the total return of the strategy is affected. The percentage return you expected to receive from the sale of the option will not be the return actualized. Just buying the stock with the most premium available to sell is not the whole answer.

A more complete answer is expected value. Expected value addresses what return can be expected from all components of the option transaction. According to some web sites, if you were given the choice between two buy-writes of equally priced stocks, you should choose the one giving you the most premium.

However, higher premium does not equate to better buy-write strategy. A stock with higher premium might not be the better one for you. For example, say the first stock offers you a total of a \$3.00 premium and the second offers you a \$5.00 premium, which one would you choose? It is suggested, by some, that you choose the one that offers the \$5.00 premium. Buy writer beware! The volatility that caused the stock's option premium to be \$5.00 can also affect the chance of collecting the entire premium involved in the strategy.

What if I told you that there was a 50% chance of receiving that \$5.00 premium while the stock that offers the \$3.00 premium has a 90% chance of you receiving the premium. The expected value of the \$5.00 premium buy-write is \$2.50 ($5.00 \times .50$) while the expected value of the 3.00 premium buy-writer is \$2.70 ($3.00 \times .90$). Now which buy-write is more attractive? As you can see, the selection of a buy-write is about more than total premium. It is what you can expect all the strategy components to produce. The expected value computation is actually quite simple. It does involve the total premium but the total premium is multiplied by the % chance of the option finishing at-the-money, in-the-money or slightly enough out-of-the-money to still make money. For example, you have just sold an option for two dollars. You estimate that the chance of you collecting that premium is 80%. Multiplying \$2.00 by .80 gives you \$1.60. Thus the expected value of the buy-write is \$1.60. Using the expected value method, two different buy-writes can be compared to each other.

You might be convinced and maybe even intrigued but you are wondering how you can figure out how to calculate the percentage chances of the buy-write being profitable. That is the secret, and you'll have to tune in next time to get the answer. All I can say is buy-writer beware! When selecting a buy-write, check and compare the expected value of all your candidates before making your decision. Don't just jump at the biggest premium.

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