

Redefining Leverage for Profit

How Successful Traders Are Calculating Risk Disparity & Making Options Work for Them

By Ron Ianieri

Many deem options riskier than stocks. This fallacy stems from a lack of understanding of leverage. There are two basic definitions for leverage as it pertains to options. The first defines it as using the same amount of money to capture a larger position. This description lands many investors into hot water. Investing the same dollar amount in a stock and an option does not equate to the same risk. The second definition characterizes leverage as maintaining a position, but spending less money doing so. A consistently successful trader incorporates this definition into their frame of reference

Too many investors believe that \$10,000 in \$10 options is better than \$10,000 in a \$50 stock. After all, investing \$10,000 in a \$10 option will allow you to buy 10 contracts that control 1,000 shares. Ten thousand dollars in a \$50 stock will only get you 200 shares. The disparity here is clear. An inexperienced investor sees this disparity as potential for profit. Another disparity, one of risk, lurks in the shadows.

Options proved riskier than stocks in the previous example. With stocks, your entire investment can be lost, but only with an improbable movement in the stock. The \$50 stock would have to trade down to \$0 for you to lose everything. In the option trade, you can lose your entire investment if the stock trades down to the long option's strike price. For example, if we owned the 40 strike, the stock need only to trade below 40 by expiration for the entire investment to be lost. That represents only a 20% downward move. There is a large risk disparity between stocks and options, but it exists because an improper definition and application of leverage. There are two ways to balance risk disparity while keeping the positions equally profitable.

Conventional Calculation

Go back to our stock trade. We were going to invest \$10,000 in a \$50 stock giving us 200 shares. Instead of purchasing the 200 shares, we can buy two call option contracts because one contract is worth one hundred shares of stock. By purchasing the options, we are spending less money but controlling the same number of shares. The number of shares that are purchasable with your investment capital determines the number of options.

Let's say, you decide to purchase 1,000 shares of eBay at \$41.75 per share for a cost of \$41,750. Instead of purchasing the stock at \$41.75, you can buy ten of the January 2008 30 strike calls for \$1,630 per contract. This option has an 86 delta, which means that it will mimic the performance of the stock to 86%. If the stock trades up \$1, the option will increase in value \$0.86. The option purchase will give us a total capital outlay of \$16,300 for the ten calls. This represents a total savings of \$25,450, or about a 60% of what we were going to invest into the stock.

An investor can use this \$25,450 savings in several ways. You can take advantage of other diversification opportunities. This extra savings can also sit in your trading account and gain money market rates. The collection of the interest from the cost savings can create what is known as a synthetic dividend.

Synthetic Dividend

During the course of the life of the option, the \$25,450 savings will gain 3% interest annually in a money market account. That represents \$763 in interest for the year, which is equivalent to about \$63, a month or about \$190 per quarter. Divide that \$190 per quarter by the 1000 shares and you have created the equivalent of a \$0.19 quarterly dividend. All of this occurs in a stock that does not even pay a dividend.

You are collecting, in a sense, a dividend on a stock that does not pay one while still seeing a very similar performance (86%) from your option position in relation to the stock movement. You accomplished this using less than one third of the funds you would have used if you purchased the stock.

Ron's Risk Calculation

You can also balance cost and size disparity based on risk. I have not seen this method in a book or at a seminar, so I have duly named it Ron's Risk Calculation. We previously stated that buying \$10,000 in stock is not the same as buying \$10,000 in options in terms of overall risk. We showed that the money invested in the options is a greater risk due to the potential of a greater loss with smaller stock movement. In order to level the playing field, we must devise a way to have a risk equivalent option position in relation to the stock position.

We will first start with your stock position by purchasing 1,000 shares of a \$41.75 stock for a total investment of \$41,750. You will also enter a stop loss order. Most market experts advise this prudent strategy. You set your stop order at a price that will limit your loss at 20% of your investment, \$8,350 of your total investment of \$41,750. If you are willing to lose this amount on the position, spend it on your option. You should only spend \$8,350 buying options. This way, you only have the same dollar amount at risk in the option position, as you are willing to lose in your stock position. We now have a scenario of equalized risk between the two potential investments. The option position becomes less risky than the stock position due to the nature of the stop order.

Stop orders do not protect us from gap openings. The difference with the option position is that once the stock opens below the strike that you own, you will have lost all that you could lose of your investment. The most you can lose is the total amount of money you spent purchasing the calls. If you own the stock, you can lose much more. Let's compare stocks and options. If you purchased a stock for \$60 and it gap-opened down at \$20 when the company's drug that was in Phase III clinical trials killed four test patients, your stop order is executed at \$20 that will lock your loss at a hefty \$40. A lot of good that stop order did you!

Consider that, instead of purchasing the stock, you bought the 3-month out \$50 calls for \$11.50. Your risk scenario changes dramatically. Remember, when you buy an option, you are only at risk for money that option cost you. When the stock opened at \$20, and all your friends lost \$40, you only lost \$11.50. When options are used properly, they become less risky than stocks.

In the eBay example, we will now make our option purchase using the appropriate amount of funds as determined by Ron's Risk Calculation. The choice of the correct option (month and strike) is essential. We will look for an in-the-money option with a delta of around 80-85. The eBay movement might be over the next couple of months, so I want to choose an expiration month that matches the period I anticipate the movement to take.

I have chosen the eBay April 37.5 calls with an 82 delta and trading at a price of \$5.20. Using Ron's Risk Calculation, I have calculated that I can spend up to \$8,350 or the amount of money I was willing to lose on a stock purchase as determined by my own stop limit. This will enable me to purchase 16 contracts. I derived the number of contracts by saying that, at a price of \$5.20 per share, it would cost me \$520 per contract. Divide the total amount (\$8,350) by the amount it costs to purchase one contract (\$520). That is 16.057692, meaning you can buy 16 contracts for a total expenditure of \$8,350.

When you compare your stock position and your option position, you now find that you have an equal amount of total dollar risk in both positions. Your option position cost you much less in terms of capital outlay. You control 1,600 shares instead of only 1,000 (a 60% increase), which will likely give you a

better percentage return while guaranteeing you of a fixed limited loss under any catastrophic situation. A stop order on your stock cannot do this.

The Conventional Method of Calculation and Ron's Risk Calculation will arm you to fully harness the power of leverage in options. Use it to keep a balance of total risk of the option position over a corresponding stock position.

***Ron Ianieri** enjoyed fourteen years of success as a floor trader on the Philadelphia Stock Exchange, including 4 years as the lead market maker in DELL computer options – one of the busiest books in history. He is currently Chief Options Strategist and Co-Founder of The Options University, an educational company that teaches investors how to make consistent profits using options while limiting risk. For more information about The Options University or options trading please visit www.optionsuniversity.com or call 866-561-8227.*