

WRITING STRADDLES

By Joe Ross



To the uninitiated, the words *straddle writing* are mysterious and confusing. In fact, these words may be more confusing than the words *put* and *call*.

However, because of advertising and public education by the various option exchanges and their associated brokerage firms, millions of investors have become familiar with and gained some understanding of how puts and calls are used in simple investment strategies. The level of understanding of most investors is usually how to simply buy put and call options. Buying them is done with the idea that large potential gains are available, while at the same time risk is predetermined, finite, and limited. The bias toward purchasing puts and calls is understandable, because it requires only a small amount of capital to test the strategy, offers a high degree of leverage, and it offers very high profit potential.

For most investors and traders, the *writing* of puts and call options is a much more difficult concept to understand. Getting into and out of various option writing positions is characterized by the following:

- It is often complex because it may involve both the stock and option markets.
- The capital requirements for writing options are substantially greater than for buying them.
- The profit potential for option writers is limited.
- The risk of loss is greater than the potential for gain.
- You will be “naked” unless the option is covered.
- You will have unlimited risk unless the option is covered.

So, why would anyone want to write options? In spite of the apparent deterrents, hundreds of thousands of investors and traders have become participants in the writing of puts and calls. Writing them is available for both stock markets and futures markets. For purposes of this article, I will discuss only straddles for conservative stock investors and futures traders. Investors are drawn to writing call options against underlying stock shares they own. Stock option writers (sellers) are able to write what has come to be termed a *covered call*. Futures option sellers may have an underlying futures position or plan to be in one as way to cover the option, but this is more the exception than the rule.

Investors and traders who write covered calls issue their contracts for a variety of reasons, among which are the following:

- To reduce somewhat the risk inherent in ownership of the underlying stock or futures.
- To achieve cash flow that substantially augments any cash dividend due them as share owners, or in the case of futures to achieve cash flow to lessen the impact of margin requirements, and to obtain a buffer against any loss in the futures position.
- To attempt to achieve an overall rate of return on the total capital invested in their stocks or futures that would be significantly higher than that which could be obtained from financial instruments such as bonds, notes, bills or commodities.

Once you have become experienced in writing covered calls and feel comfortable in the various strategies and the overall results obtained, you may begin looking for more sophisticated option writing strategies, such as straddle writing.

Straddle writing is an option strategy that involves the *issuance* of both a put and a call on the same underlying stock or futures when the strike prices in the put and call and the expiration date of the put and the call are the same.

Conservative stock investors who engage in writing straddles always own at least the number of underlying shares, or securities, necessary to deliver in the event the call portion of the straddle is exercised. They also reserve funds to completely pay for any shares or securities that they could be forced to buy as a result of a put exercise. Strangely to some, and unknown to most, there are futures traders who attempt to do the same by taking a position in the underlying futures contract.

The obvious reason for the conservative writing of straddles is to earn a very high return on capital. For the investor or trader who would like to own the underlying, the motivation is to be able to acquire a desired, stock for less than the current price at the time the straddle is written. The same may be said of a futures trader. He would like to acquire his futures position with less margin requirement than might otherwise be required.

As an example, let's take a look at some specific illustrations involving a conservative stock investor who is issuing straddles. Similar principles would apply for a futures trader writing straddles against the underlying futures. For the purposes of our illustration, let's assume that you are the investor or trader and that you have carefully researched XYZ and decided that you are willing to accept the risk of owning 1,000 shares.

- The current market price of XYZ is 25.
- XYZ July 25 calls are priced at 3 in early January
- XYZ pays quarterly dividends at .20 per share.

One course of action you could take would be simply to buy and pay for 1,000 XYZ at 25. In this case you will be bearing all the downside risk and becoming a participant in the unlimited profit potential above 25. You would be immediately out of pocket the stock commission, and profitable only if the stock moves above 25 sufficient to cover all commissions, plus what you might have earned if the money were put out at interest.

Another course of action would be to *write a straddle* by buying 500 XYZ at 25 and issuing 5 July puts at 3 each and 5 July calls at 3 each. Let's examine Table 1 to get a clearer picture of some possible results of straddle writing.

The possibility of XYZ being exactly 25 at the July expiration and both the puts and the calls expiring unexercised is quite unlikely. If that did happen, it would obviously benefit the writer of the puts and calls.

With "Outcome A" in Table 1, you have total cash of 27,906, which is your original starting capital plus earnings. You have a wide variety of reinvestment choices. Note the following:

- You can write puts on XYZ if you still favor that stock.
- You can repurchase some shares of XYZ and issue straddles against the new shares.
- You can reinvest in a different stock and write calls or straddles against the new shares.

After "Outcome B" in Table 1, you own the 1,000 shares of XYZ that you were willing to risk owning in January when the stock was priced at 25. You are ahead 3,416, and you can choose among the following:

- You can sell the shares if your opinion of XYZ has changed, thereby diminishing the earnings of 3,416 by any amount of loss that is acceptable to you.
- You can hold the shares un-optioned for future appreciation or for future call writing.
- You can write 10 new call options at the same 25 strike price if possible, thereby collecting additional premium to lessen any further downside risk and to enhance the overall return on your investment.

Buy 500 XYZ @ 30 Plus full service commission	12,500 + <u>255</u> 12,755	A. XYZ <i>above</i> 25, July 25 puts expire worthless. 5 July 25 calls will be exercised and 500 XYZ sold for 12,245 (including commission)	
Sell 5 July 30 calls @ 3 Sell 5 July 30 puts @ 3	1,500 <u>+1,500</u> 3,000		Net loss on stock sold Net profit on options

Less full service commission		Net profit	2,324
	<u>-166</u>		
	2,834	Two dividends received	+200
You maintain interest-earning cash reserve of 15,255 to pay for 500 XYZ if puts are exercised		Interest earnings on 12,755 @ 6%	<u>+382</u>
		Net earnings on total capital	2,906
		B. XYZ below 25, 5 July 25 calls expire worthless. 5 July 25 puts exercised and 500 XYZ bought @ 25 = 12,755 (including commission)	
		You now own 1,000 XYZ at a net cost of 25,510	
		You have earned from net option premium	2,834
		You have earned dividends	+200
		You have earned interest on put reserves	<u>+382</u>
		Total net earnings	3,416

When you buy XYZ at 25 and write 5 July 25 straddles as opposed to buying 1,000 XYZ and holding it un-optioned for whatever appreciation may occur, you are simply making a trade-off. You are accepting a large number of dollars paid cash in advance as protection against a downward movement in 500 XYZ by July. That position can be compared to no protection against risk in 1,000 XYZ with unlimited profit potential. Trading one *certainty* for two *maybes* makes sense to a lot of conservative investors.

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