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# Situational Options Strategies

*Using options for specific investment objectives*



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Puget Sound Chapter  
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Handouts may be found at [www.betterinvesting.org/puget](http://www.betterinvesting.org/puget)  
under "News and Articles"

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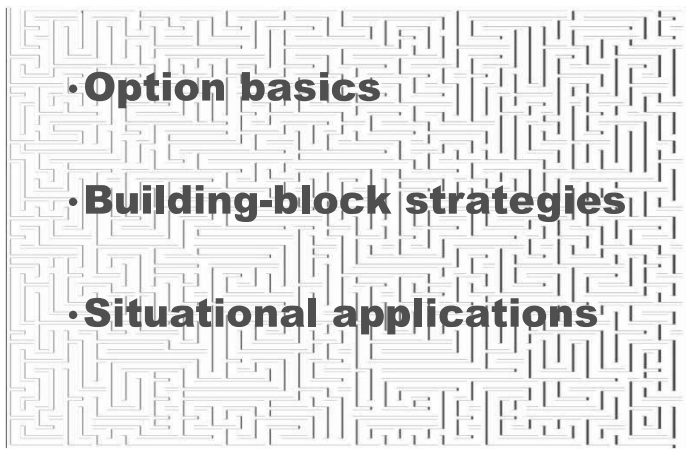
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## Topics



- **Option basics**
- **Building-block strategies**
- **Situational applications**

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## An unpleasant surprise!



- Versatile
- Powerful
- Handle with Care

<https://humbledollar.com/2020/01/risky-option/>

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### Garden to Kitchen

Tom grows tomato      Kate makes ketchup

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### Tomato Contract: Breaking it down

Tom: Right to Sell at \$5 even if market price is less  
 Obligation to Be Bought at \$5 even if market price is more

Kate: Right to Buy at \$5 even if market price is more  
 Obligation to Be Sold at \$5 even if market price is less

- The contract has no price - the rights and obligations offset each other
- The contract eliminates price uncertainty for both
- At maturity, it may benefit one party at the expense of the other

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### Tomato Contract: Second thought?

Tom: Right to Sell at \$5 even if market price is less  
 Obligation to Be Sold at \$5 even if market price is less

Kate: Right to Buy at \$5 even if market price is more  
 Obligation to Be Bought at \$5 even if market price is more

Tania      Kyle

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### Tomato Contracts: Outcomes

Tom	Tania	Kate	Kyle
Discretion to sell for <b>\$5/pound</b>	Obligated to honor Tom's contract	Discretion to buy for <b>\$5/pound</b>	Obligated to honor Kate's contract
Scenario 1: Tomato price next year is <b>\$5/pound</b>			
<b>-\$1</b>		<b>-\$1</b>	
Scenario 2: Tomato price next year is <b>\$8/pound</b>			
			<b>-\$2</b>
Scenario 3: Tomato price next year is <b>\$2/pound</b>			
	<b>-\$2</b>		

- Tom bought PUT options from Tania
- Kate bought CALL options from Kyle

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## Option Basics

Buy or sale a given quantity of an underlying asset

- CALL: Buy underlying
- PUT: Sell underlying

Discretionary

- Buy/Long/Hold: **Has right, but no obligation**
- Sell/Short/Write: **Has obligation, but no right**

Expiration date

Strike Price

**-TOMATO220831C5**  
**-TOMATO220831P5**

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## Option Premium

- **Intrinsic Value (exercise value)**
  - ITM: In the Money
  - OTM: Out of the Money
  - ATM: At the Money
- **Time value (speculative value)**
  - Price of "hope" that intrinsic value picks up by expiration

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## Type / Ownership Payoff

<p><b>Long Call 50</b></p>	<p><b>Long Put 50</b></p>
<p><b>Short Call 50</b></p>	<p><b>Short Put 50</b></p>

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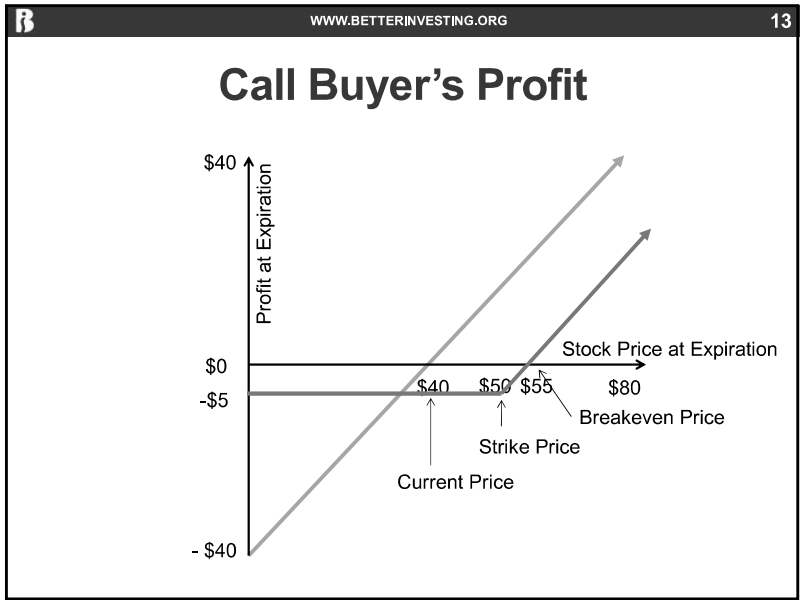
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## Option Trading Challenges

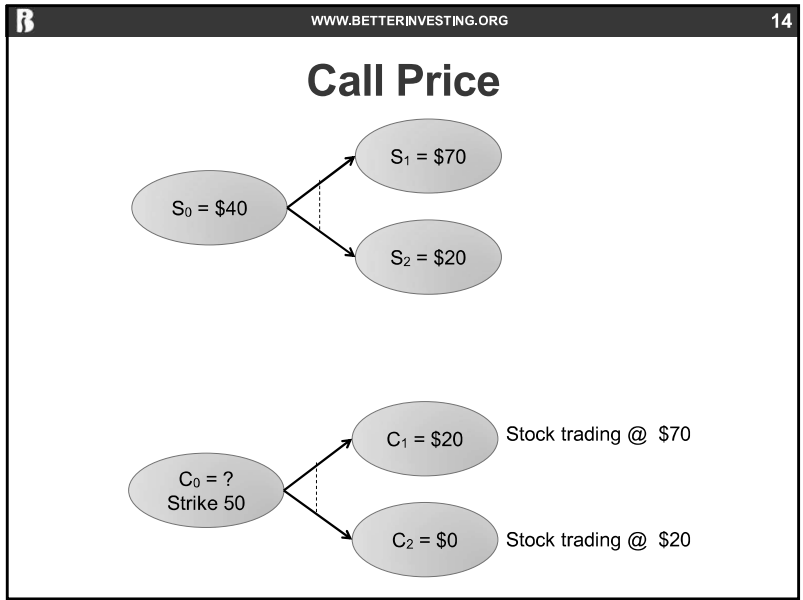
Direction	Extent	Time	Price

A large double-headed arrow is positioned below the four challenge categories, indicating their interconnected nature.

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### Call Replication Portfolio

B units of Bond +  $\partial$  shares of Stock, such that portfolio value at expiration is identical to the Call value in both scenarios

Portfolio value if stock ends at 70:      Portfolio Value if stock ends at 20:

$$B + \partial \times 70 = 20 \qquad B + \partial \times 20 = 0$$

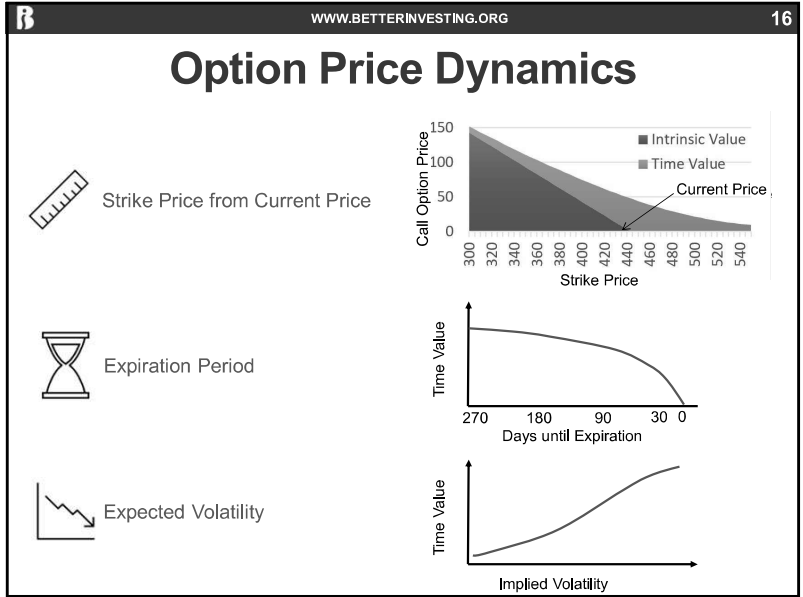
$$B = -8; \quad \partial = 0.40$$

Borrow \$8 at Risk-free rate and buy 0.4 shares of Stock

Cost of the Replication Portfolio =  $-\$8 + 0.4 \times \$40 = \$8$

Call Price: \$8

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## Option and Leverage

Investment	Purchase Price	Final Value	Gain	% Gain
Stock	40	70	+30	+75%
Call @ 50	8	20	+12	+150%

Investment	Purchase Price	Final Value	Loss	% Loss
Stock	40	20	-20	-50%
Call @ 50	8	0	-8	-100%

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## Situation – Speculative Itch

XLE Market Price  
 XLE JAN 2022 CALL @ STRIKE 55  
 Call Price (strike 55, Jan 2022)

XLE Jan 2022 Call @ Strike 55  
 ETF rose 130% from bottom  
 Call rose 1375% from bottom

Chart Source: Fidelity Research

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## Mimic Index Annuity

Amount to Invest:	\$40K
SPY Price:	\$400
Risk-free Annual Interest Rate:	2%
Guaranteed Rate of Return:	0%
SPY 400 Call:	\$20

<u>Ordinary Portfolio</u>	<u>IA-like Portfolio</u>
Buy 100 SPY shares for \$40,000  100% market participation in upside and downside	Buy Zero-coupon bond for \$39,200 Buy 40 SPY 400 Calls for \$800  40% (40/100) participation in upside 0% participation in downside

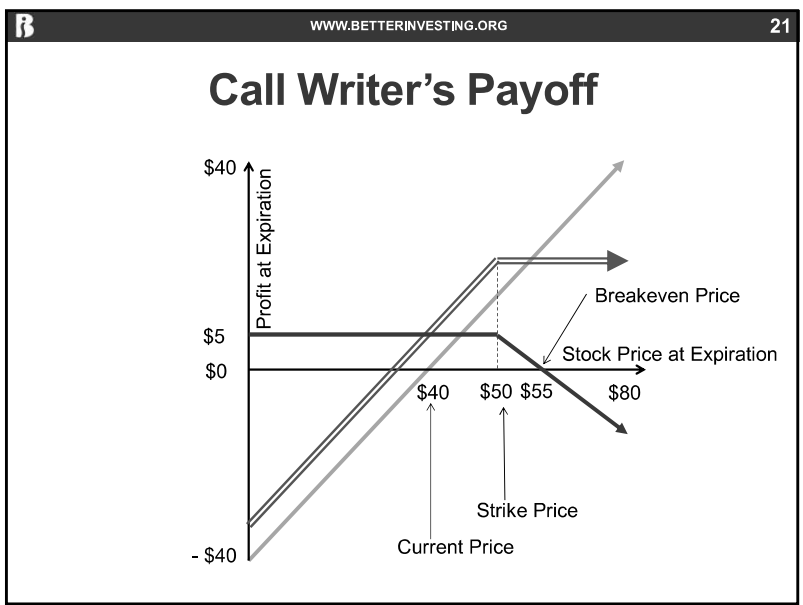
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## Outcomes

Market Rises 10%	Market Drops 10%
SPY closes at \$440 Each Call is worth \$40  Ordinary Portfolio: \$44,000  IA-like Portfolio: \$41,600 40 Calls (\$1,600) Bonds (\$40,000)	SPY closes at \$360 Calls expire worthless  Ordinary Portfolio: \$36,000  IA-like Portfolio: \$40,000 40 Calls (\$0) Bonds (\$40,000)

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### Caution! Selling Options

- Small profits at the risk of Large loss
- Requires Collateral - Cash, Margin or Underlying
- More profitable at fearful times

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### Situation – Stuck with tax liability

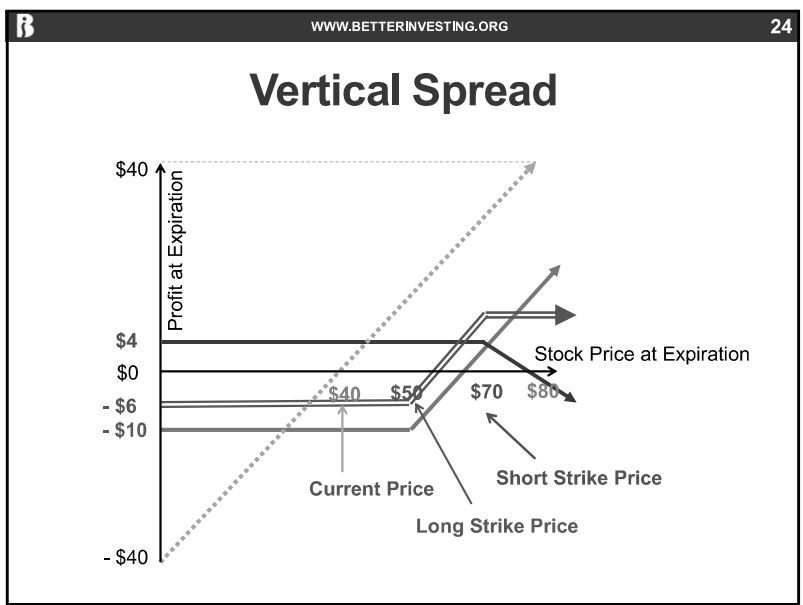
Covered Call as a disposal strategy

MSFT      Current Price: \$300  
 Tax liability: \$30 (15% LTCG on \$100 cost-basis)

Premium + Additional Gain >= \$30

Expiration in months	Strike	Additional Gain	Premium	Extra Profit if Assigned
2	330	30	2	32
3	330	30	3.25	33.25
4	325	25	6.25	31.25
6	320	20	12	32
9	310	10	22	32
12	300	0	31.5	31.5

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### Mimic Index Annuity – Full Participation

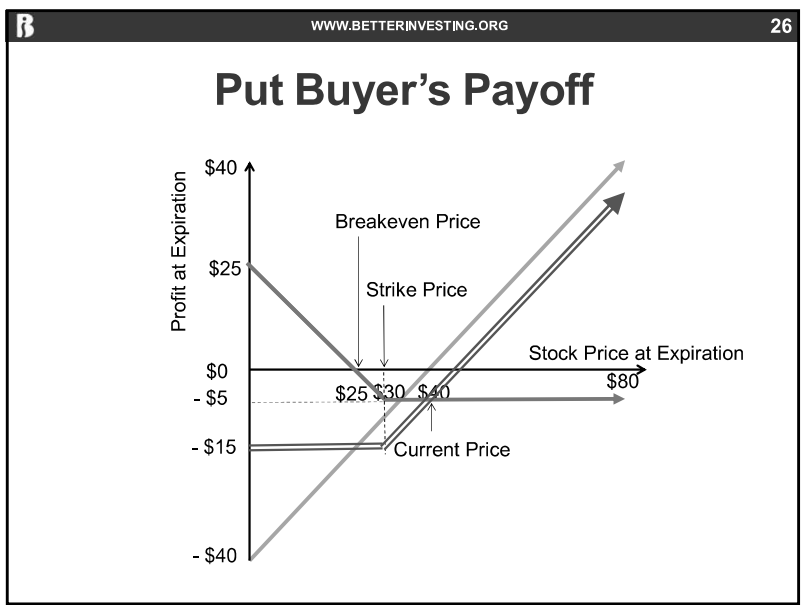
Amount to Invest:	\$40K
SPY Price:	\$400
Risk-free Annual Interest Rate:	2%
Guaranteed Rate of Return:	0%
SPY 400 Call:	\$20
SPY 420 Call:	\$12

<b>Old IA-like Portfolio</b>	<b>New IA-like Portfolio</b>
(40% participation, no cap)	( 100% participation, 5% cap)

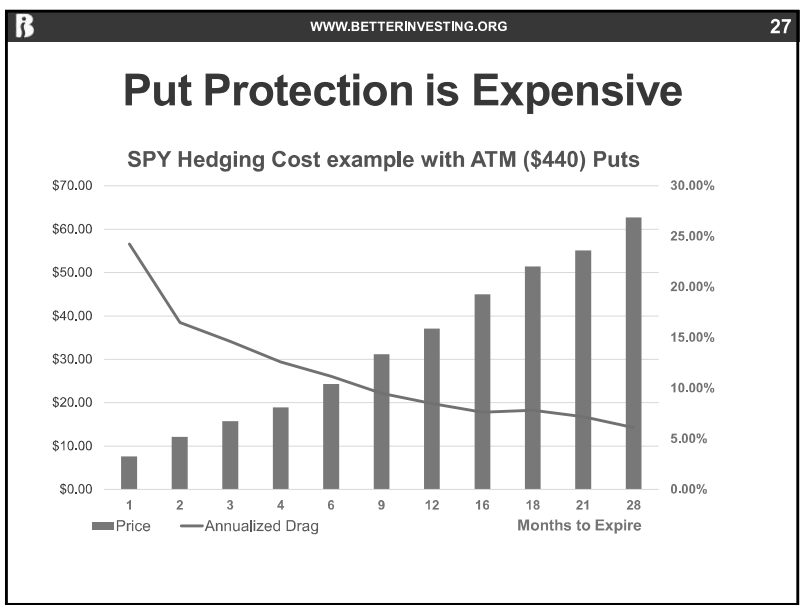
Buy Zero-coupon bond for \$39,200	Buy Zero-coupon Treasury for \$39,200
Buy 40 SPY 400 Calls for \$800	Buy 100 SPY 400-420 Call-spread

40% (40/100) participation in upside      100% upside participation with 5% cap  
 [(420-400) / 400 = 5%]

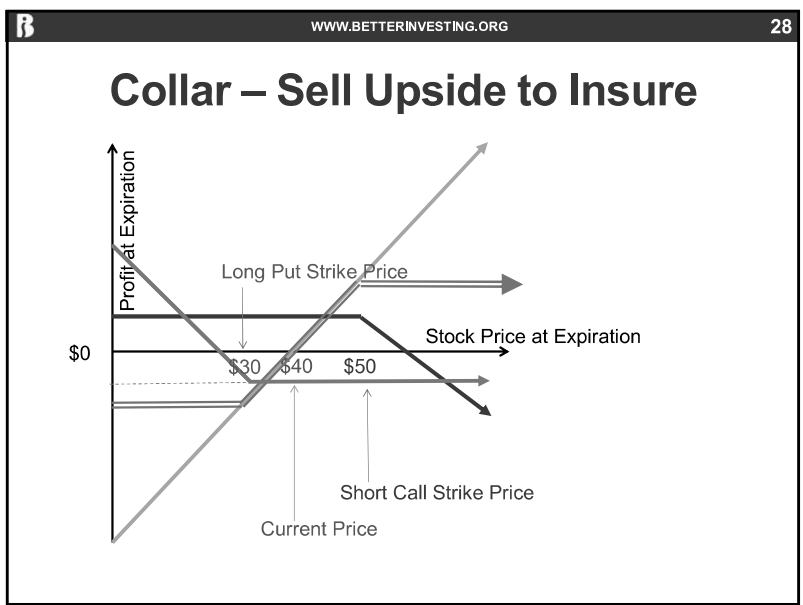
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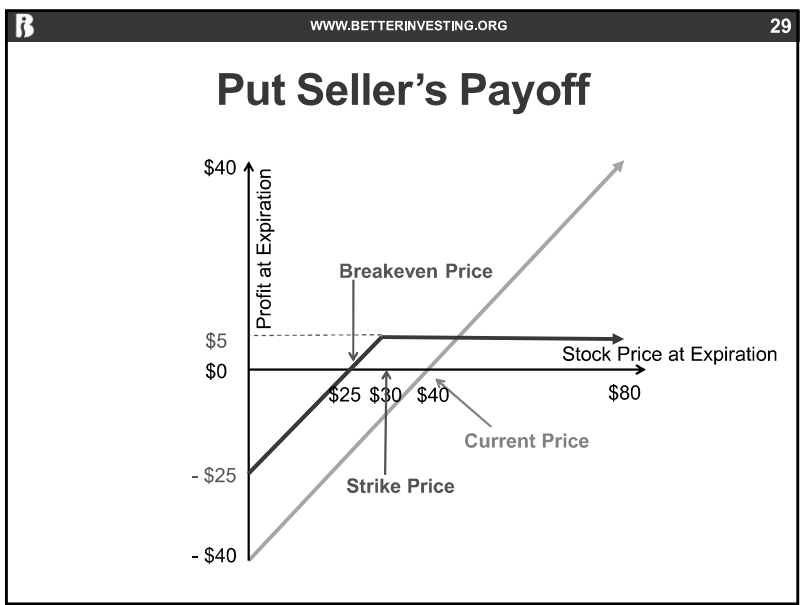
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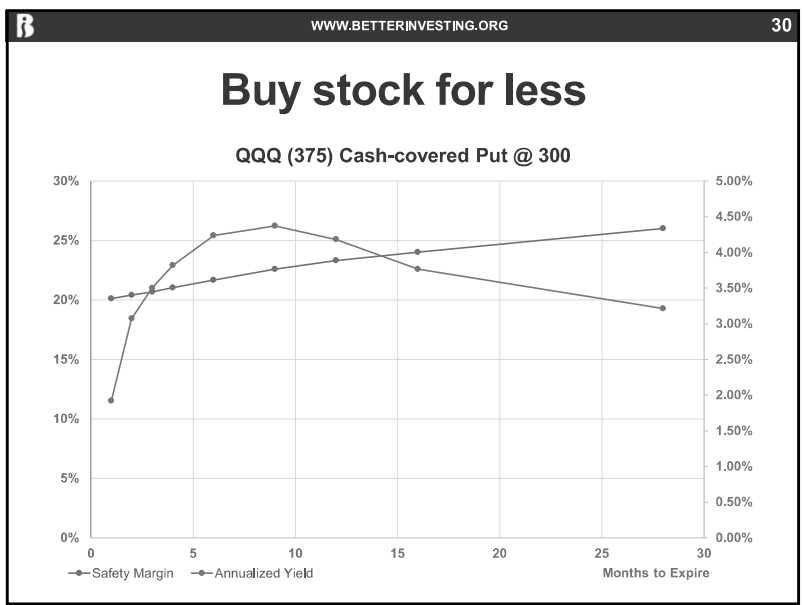
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### Shock-absorbing Buffer ETFs

Captures Index Gain

- Capped to X%

Absorbs Shock

- First Y% drop

- Long Deep ITM call (uncapped Index exposure)
- Long ATM put (unlimited downside protection)
- Short X% OTM call (caps upside to X%)
- Short Y% OTM put (pass on downside beyond Y%)

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### Resources

Options as a Strategic Investment by Lawrence G McMillan

<https://www.optionseducation.org/>

<https://www.investopedia.com/options-basics-tutorial-4583012>

[https://www.cboe.com/us/indices/benchmark\\_indices/](https://www.cboe.com/us/indices/benchmark_indices/)

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## Thank You



Questions / Comments:  
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