Book Review

Winning with Options

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Given the recent volatility in the securities markets, investors are beginning to question long-held beliefs about what is safe and what is risky in terms of their investing strategies. According to Michael C. Thomsett, the author of *Winning with Options*, now is the appropriate time for investors to ask themselves if traditionally held convictions about the use of stock options, as an investment strategy, need to be replaced. The word *option*, in relation to the investment markets, usually brings to mind something that is dangerous, risky, or otherwise something to be avoided by anyone other than professional investors. Whether or not this perception is true is the focus of Mr. Thomsett's newest book.

To set the record straight, options can be very risky. Options can, on the other hand, sometimes be used to reduce risk – i.e., moderate the volatility of a diversified portfolio. Options can also be used to generate current income within a diversified portfolio. So, what is an option, and why do not more investors use options when managing portfolios? The first part of the question can best be answered with an example. An option is a contract that allows someone the right to make a transaction at a predetermined price. Although few people recognize the fact, option contracts are widely used both in the securities markets and in other daily business transactions.

Consider, for example, a young family that wants to own their own home. The family does not yet have enough money saved for a down payment, and they can not seem to save any money after paying rent. A lease option may provide this family with an opportunity to buy a home. Basically, in a lease option situation, the family rents a home from someone wanting to sell the house. The current owner and the family decide on a purchase price and a time in the future when the family must either buy the house, continue to rent, or move. The current homeowner then leases the house to the family and applies a portion of each month's rent towards the down payment. Once the family has accumulated enough of a down payment, they can either acquire the house with the current owner financing the purchase, or they can go to a lender and borrow the funds outright.

The lease option provides yet another "option" for the family. The family can decide to walk away after the lease period without purchasing the home. Why would they do this? Maybe because they decide to move to another city or they decide to buy another property. The family might also determine that the predetermined purchase price of the house exceeds its current fair market value. In effect, the lease option gives the family the *right,* but not the obligation, to purchase the property at a pre-determined price.

The same logic holds true for options in the securities markets. Investors can purchase an option to buy a stock in the future at a predetermined price today. These are known as "call options." A "put option" gives an investor the right to sell an asset at a predetermined price in the future. An investor who feels that the market or an individual security is set to increase in price ought to purchase a call option, while someone who thinks that the market or a security is going to fall in price should purchase a put option. It is also possible to be a seller, rather than a buyer, of options.

Selling a call option offers a unique way for investors to generate current income. The process, which appears to

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be complicated initially, is actually quite simple. For example, if an investor owns 100 shares of XYZ stock and would like to make some current income from the stock, the investor would sell one call option in the market. (One option controls 100 shares of stock.) Although it is intuitive, it is important to note that there is someone on the other side of the transaction who will buy the option. The investor who purchases the XYZ call option believes that the price of the stock will move up in the future.

If the call option was purchased for $3 (i.e., $3 per share or $300 for the contract) with an exercise price of $40, the buyer of the call option will be "in the money" if and when the actual price of XYZ stock exceeds $40 per share. So, say the price of the stock goes to $75 per share. The holder of the call option would "call away" the XYZ stock from the current owner by paying $40 per share for the stock. He or she could then immediately sell the stock in the open market for $75. The $35 difference, less the price of the option and commissions paid, is the call option buyer's profit. Usually, the person who sold the XYZ call option is hoping that the stock price does not exceed $40 per share. If the stock price remains stable or even declines a bit, the option will not be exercised, which will result in $300 in income for the investor and continued ownership of the stock.

This brings us to the answer to the second question posited at the outset of the review, namely, why do not more investors use options when managing portfolios? The answer to this question, as it turns out, is somewhat sobering. It is difficult to make money trading options. Not because the buying and selling of purchase rights are inherently more risky than other investment strategies, but because of two reasons – commissions and taxes – that receive mixed attention in Mr. Thomsett's book. To begin with, according to statistics provided in the book, 75% of all option contracts expire worthless. That means that the vast majority of call and put options are never exercised. Stated another way, you are guaranteed to lose a part or all of your investment 75% of the time. This, however, is not what makes options trading a money losing proposition for average investors. Losses are almost guaranteed for investors because the effect of commissions exacerbates the risk situation. It is on this very point where readers of the book will encounter the most difficulties.

Commission rates on option contracts are not discussed in the book. This is a glaring oversight considering that the target market for this slim manual is not the expert investor but the average owner of stocks who is managing a family portfolio. On the other hand, Mr. Thomsett does an excellent job detailing the impact taxes will have on an option strategy. In effect, options are taxed similarly to other capital assets, with a few major exceptions. To begin with, when an option is exercised, the net profit (loss) is considered the basis in the underlying stock. Also, when an option is sold (e.g., covered call), the seller is not taxed on the proceeds received. The seller is taxed when the option expires or is exercised. As these two examples illustrate, the taxation of options can be complicated. While *Winning with Options* may not provide all of the information needed to successfully trade in options, the book does a good job in showing how taxes can dramatically impact the levels of profit made in an options strategy.

Readers will most probably ask, "Is it possible to follow the basic strategies covered in the book sufficiently to make money, even after paying commissions and taxes?" Absolutely yes. Is it probable that a novice investor could pick up this manual, read and implement the strategies provided, pay commissions and taxes when buying and selling options contracts, and make money consistently? Not a chance. The book, while tight in its prose and peppered with interesting examples, assumes too much basic knowledge on the part of novice to moderately-knowledgeable investors. The book further lacks the depth and content to be of much practical use to expert or professional investors.

Saying all of this, the book is not without its merits. Mr. Thomsett has written a brief manual that is easy to read. The layout and flow of the book is excellent. The first three chapters review the basics of options, how to establish investment goals, and common definitions all investors need to know. The middle chapters go into greater detail on options trading, sophisticated spread and straddles strategies, and contingent purchase plans. The final four chapters examine short-term trading (i.e., speculating) approaches, tax issues, and diversification strategies. Even though the book lacks an index, a concise glossary of terms is provided at the end.

Anyone who is unfamiliar with options but has a basic knowledge of the stock market will find the book useful as a means to learn about options. Readers who would like a moderately in-depth description, with examples, of how writing covered-calls can generate immediate income will find the book particularly helpful. Whether or not readers of the book will gain enough knowledge and confidence to actually implement such a strategy is another question. It is reasonable to expect that once readers calculate the impact of commissions and short-term capital gain taxes on their transactions, they will decide that implementing an option's trading strategy may not be worth the time or effort. The risks associated with losing money 75% of the time may just be too high.