

Option Strategies



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In order to simplify the computations, commissions have not been included in the examples used in these materials. Commission costs will impact the outcome of all stock and options transactions and must be considered prior to entering into any transactions. Multiple-leg strategies involve multiple commission charges.

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- ❖ Time Decay
- ❖ Covered Call
- ❖ Cash Secured Put
- ❖ Winged Spreads
- ❖ Buffett Put Trade

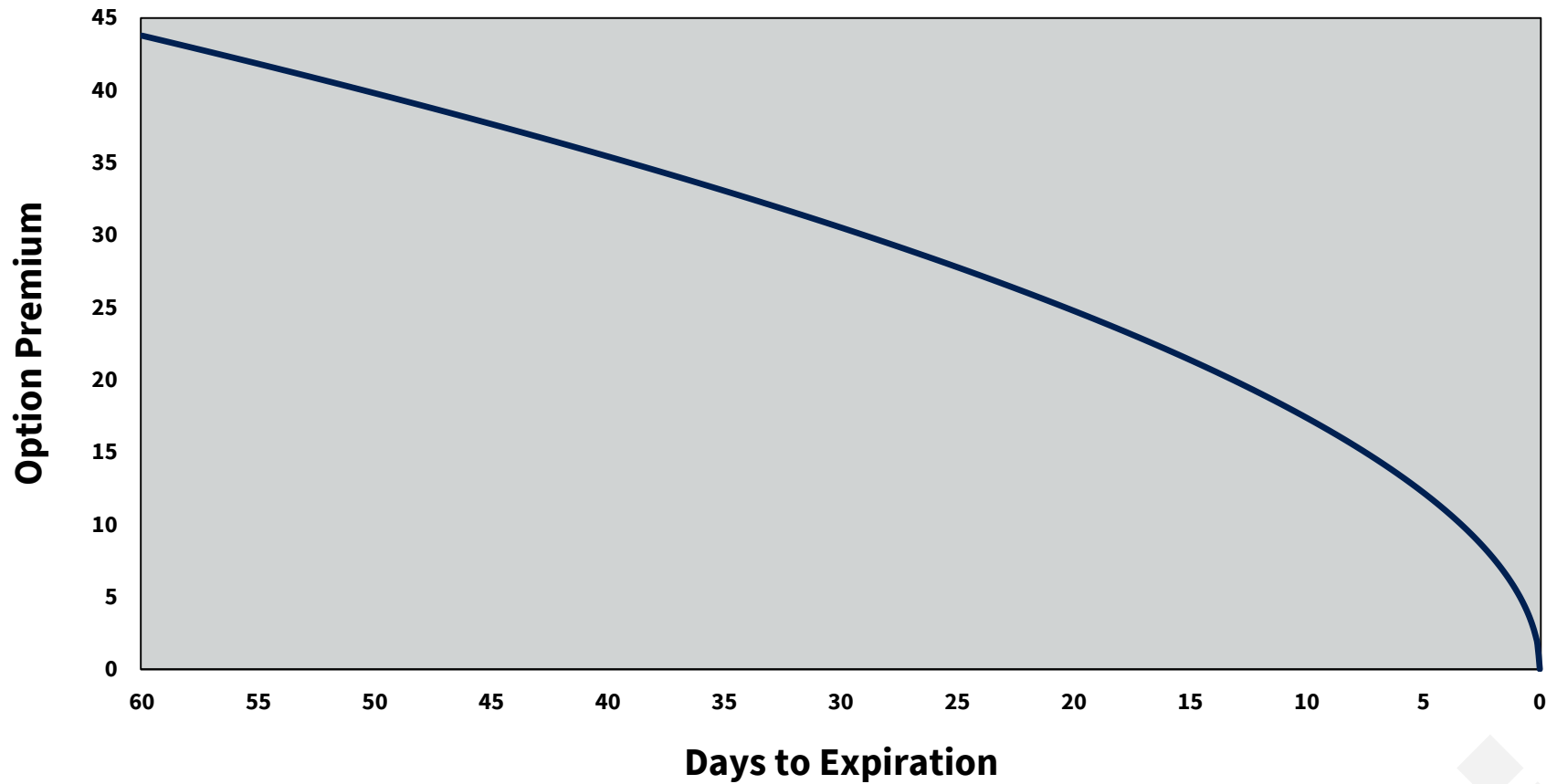


- ❖ A good portion of professional option trading is implemented by professionals selling calls or puts
- ❖ One of the goals behind these sorts of trades is to take advantage of the time decay of option prices
- ❖ Not all time decay is the same and the biggest ‘bang for the buck’ comes from selling at-the-money options



Time Decay

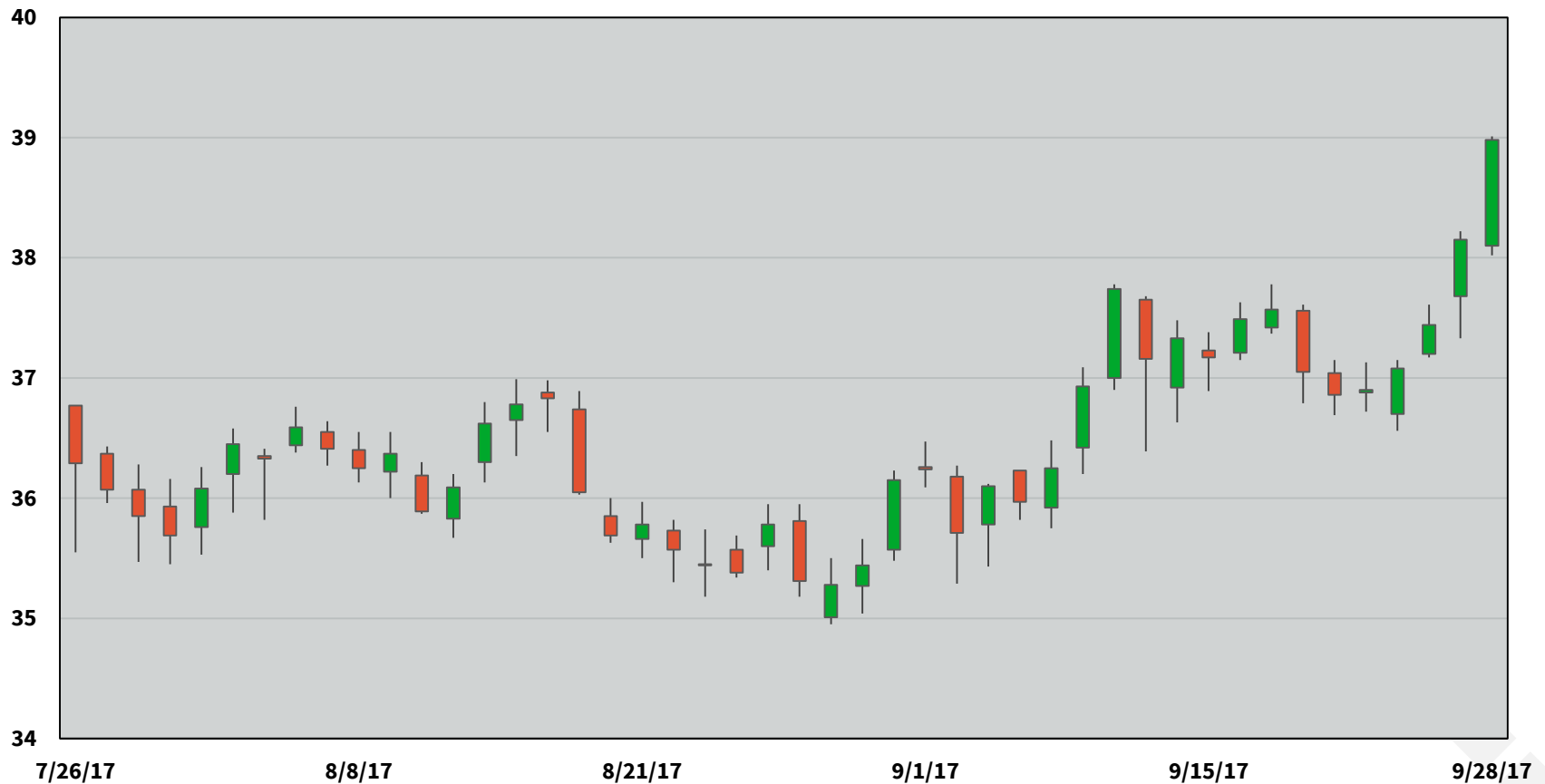
60 Days of Time Decay



- ❖ The covered call is one of the most common uses of the options market by all levels of market participants
- ❖ This trade combines a long stock position with a short call option
- ❖ The obligation to sell shares is ‘covered’ by the long stock position
- ❖ There are two potential motivations creating a covered call, as an exit strategy or to increase performance intending to hold shares



DR Horton (DHI) Daily Price Action



- ❖ DHI may be considered a little extended rising over 5% in the last four days
- ❖ As a holder of 100 shares of DHI we either believe the move is overdone or would be happy selling just over current levels
- ❖ Based on this outlook we decide to explore selling a call option against our shares



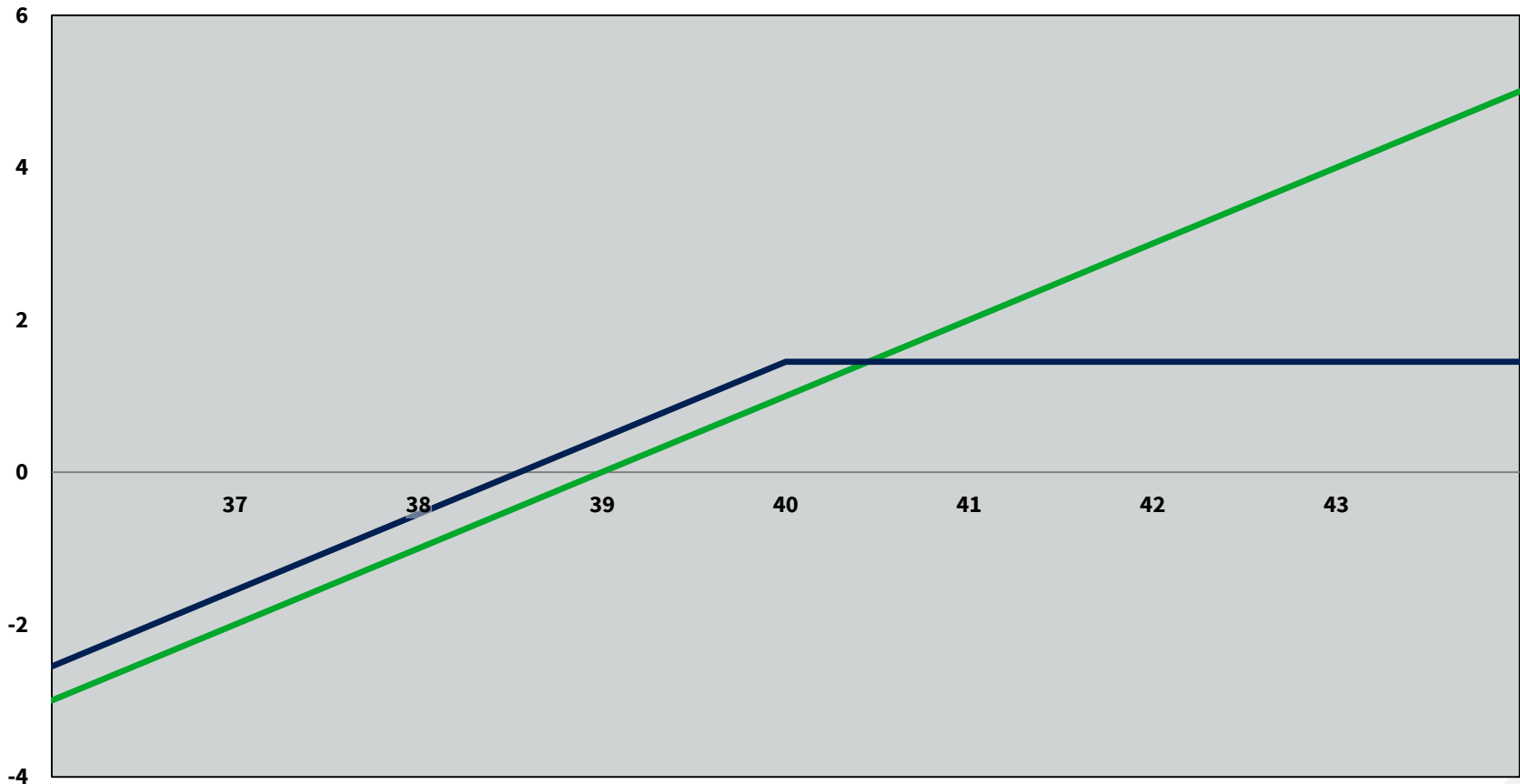
DHI @ 39.00

Expiration Date	Trading Days	39.00 Call	40.00 Call
6-Oct	6	0.40	0.10
13-Oct	11	0.55	0.20
20-Oct	16	0.75	0.30
27-Oct	21	0.85	0.45
3-Nov	26	0.95	0.55
10-Nov	31	1.35	0.90
17-Nov	36	1.45	1.05

Sell 1 DHI Oct 27th 40.00 Call at 0.45



Long 100 DHI at 39.00 + Short 1 Oct 27th 40.00 Call at 0.45



- ❖ The cash secured put has been rising in popularity over the past few years as investor knowledge of the option market has increased
- ❖ A cash secured put combines a short put position with cash
- ❖ The cash portion of this spread results in the position holder having the ability to make good on the obligation to buy shares that accompanies a short put
- ❖ Two potential motivations behind a cash secured put may be either to purchase shares at a discount to current prices or receive income from selling the put with out purchasing shares



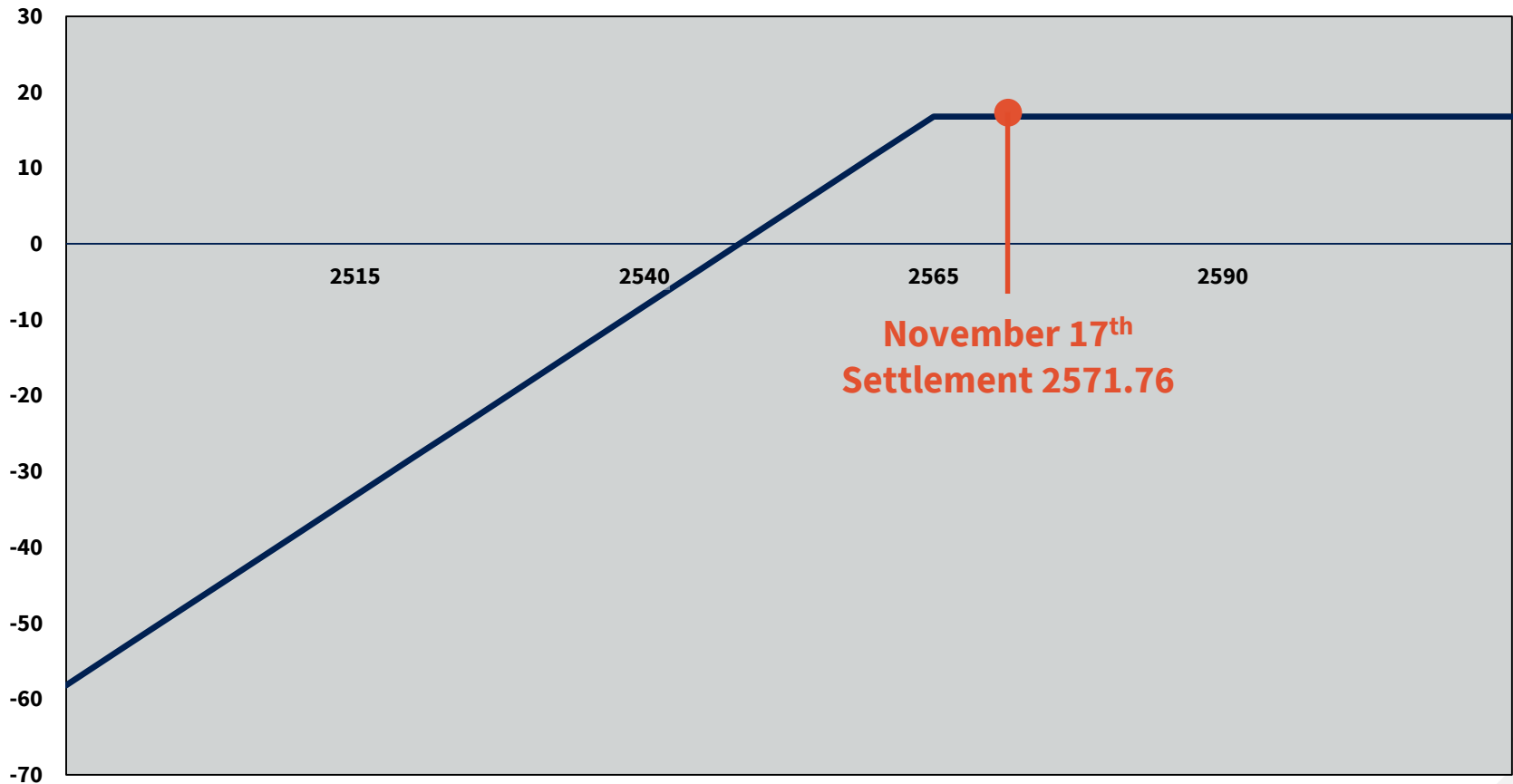
October 20, 2017

SPX at 2568.88

Sell SPX Nov 17th 2565 Put at 16.80



Cash + Short Nov 2565 Put Payoff At Expiration



- ❖ Iron butterflies and iron condors are a type of spread known as a winged spread
- ❖ These trades target a range of price levels for the underlying stock or index
- ❖ Typically these are neutral trades, but can be directional as well
- ❖ In order to realize the full profit of a condor or butterfly it will need to be held until just before or through expiration



Iron Butterfly Example

11/29/2017 – SPX @ 2626.07

Buy SPX Dec 22nd 2600 Put at 13.60

Sell SPX Dec 22nd 2625 Put at 21.30

Sell SPX Dec 22nd 2625 Call at 22.10

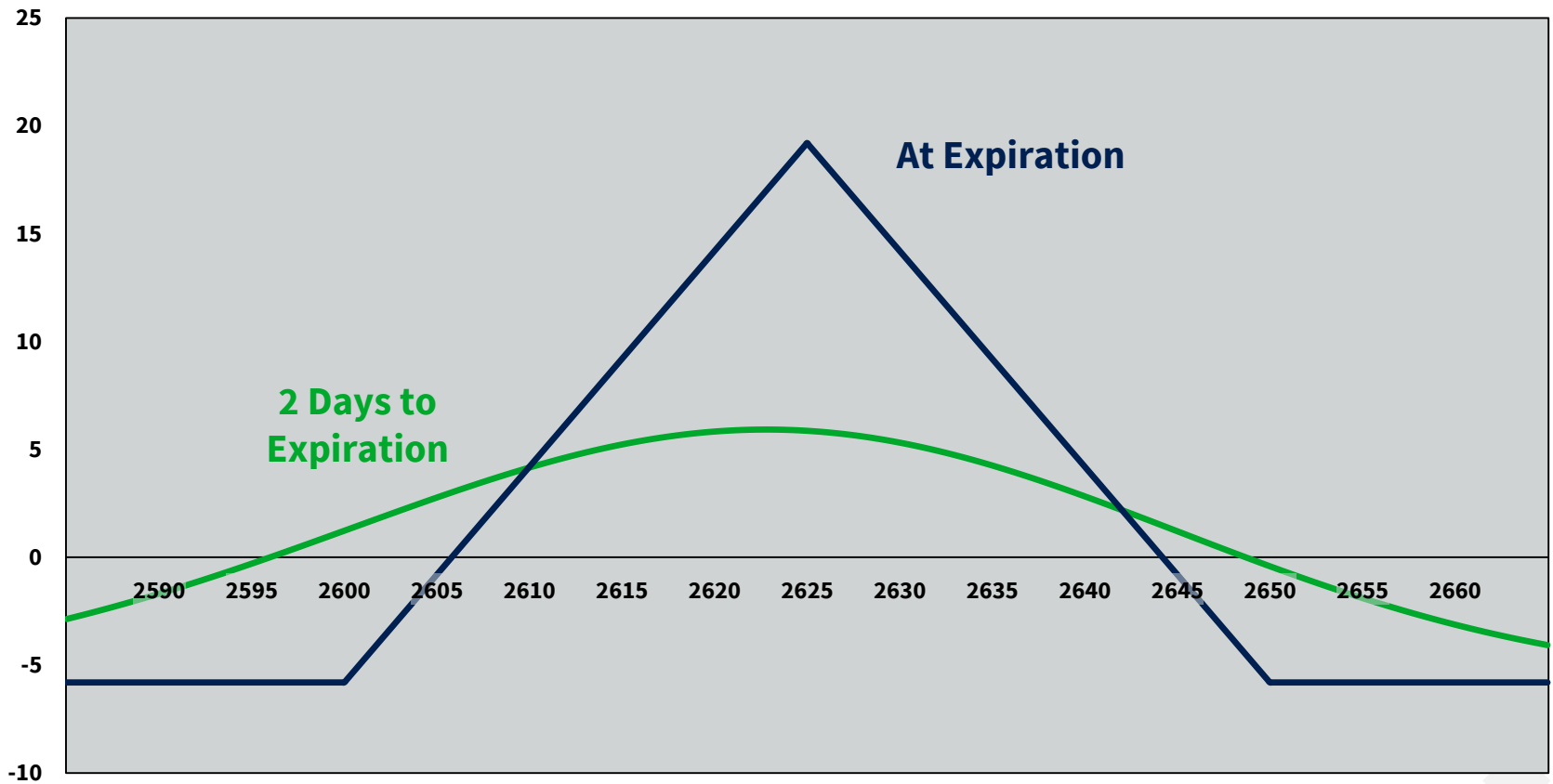
Buy SPX Dec 22nd 2650 Call at 10.60

Net Credit = 19.20



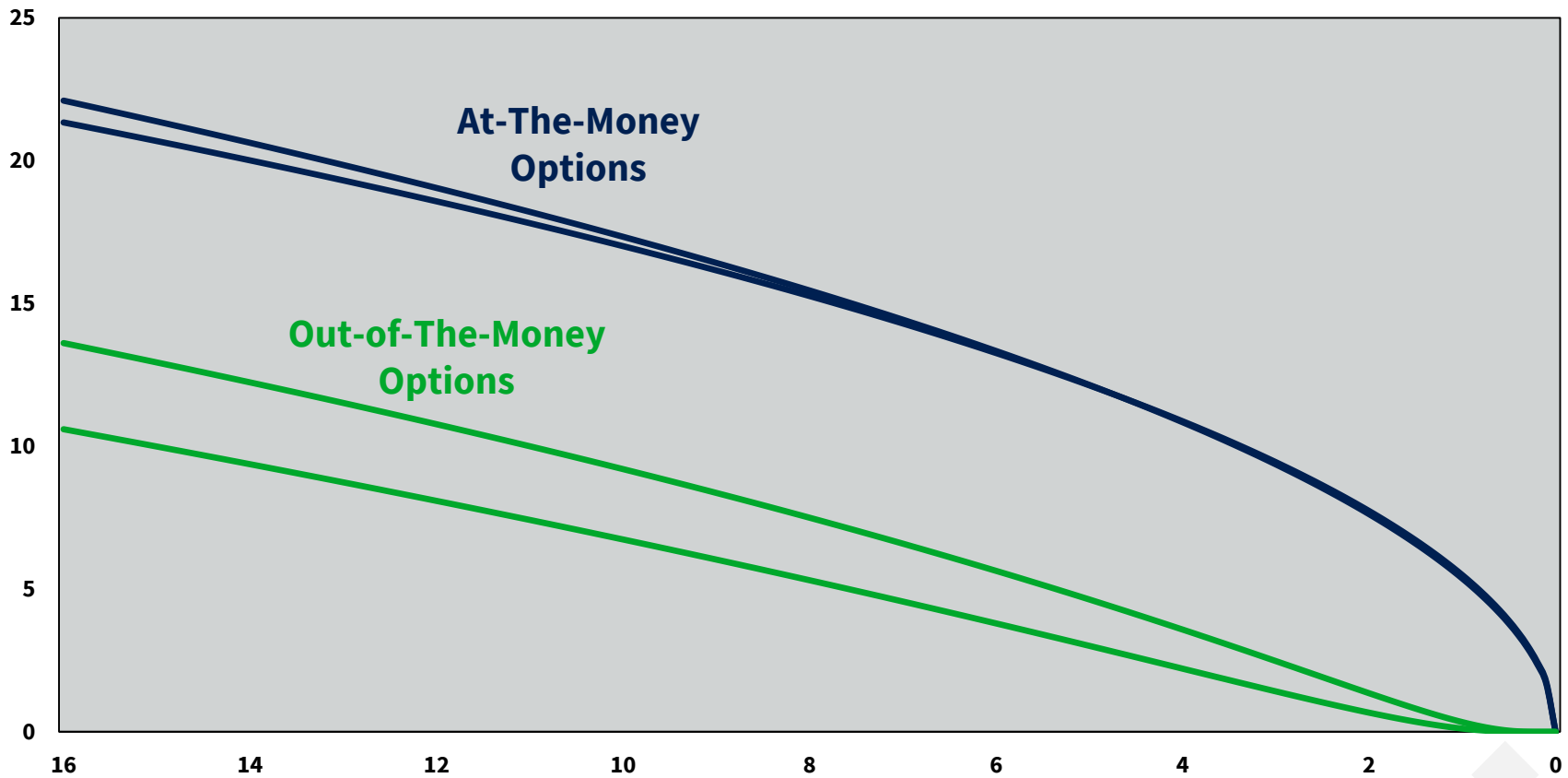
Winged Spreads

SPX Dec 22nd 2600 – 2625 – 2650 Iron Butterfly Payoff Diagram



Winged Spreads

SPX Dec 22nd 2600 – 2625 – 2650 Iron Butterfly Time Decay



Iron Condor Example

11/29/2017 – RUT @ 1542.30

Buy RUT Dec 22nd 1520 Put at 13.80

Sell RUT Dec 22nd 1530 Put at 16.80

Sell RUT Dec 22nd 1555 Call at 15.30

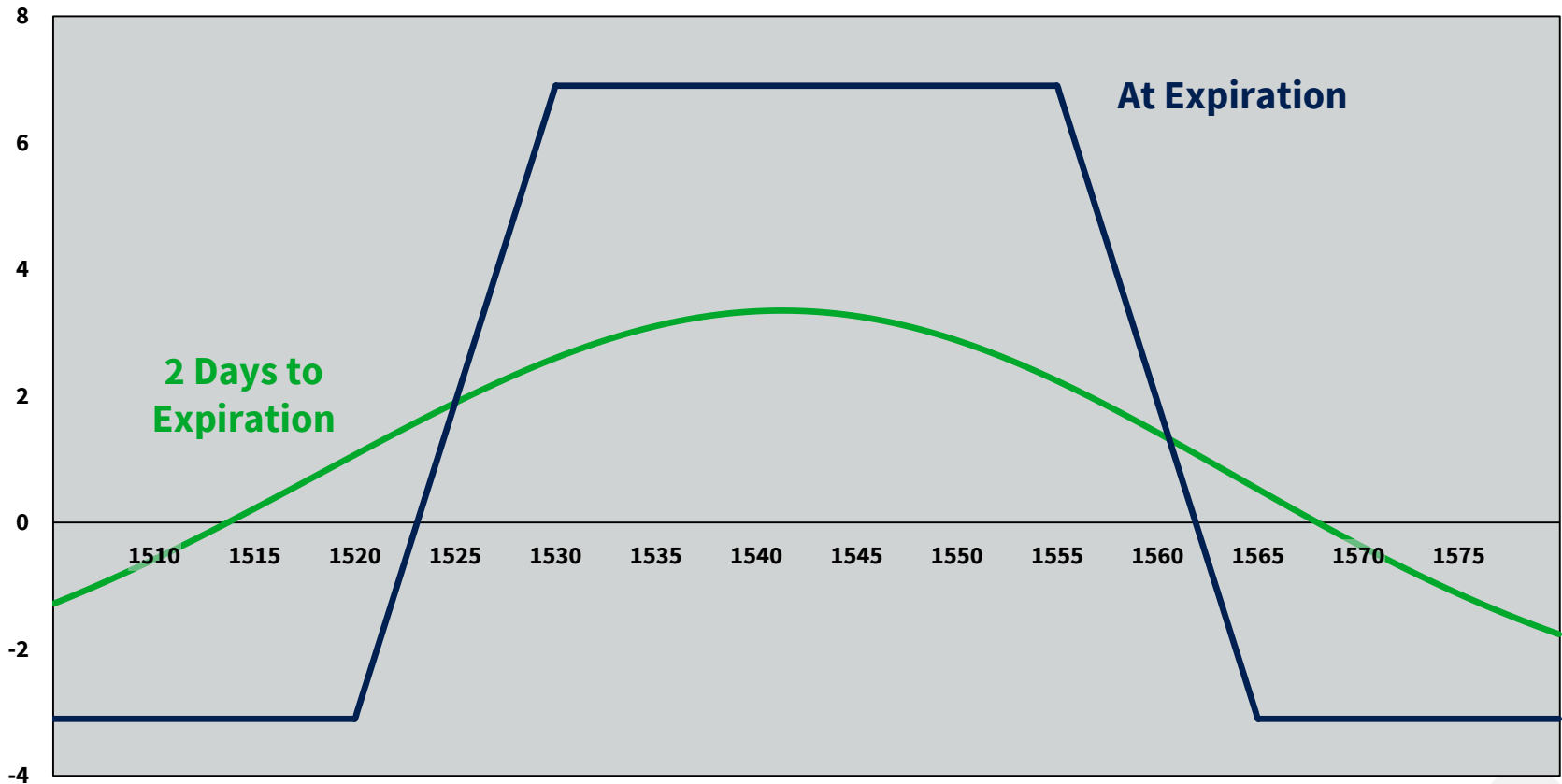
Buy RUT Dec 22nd 1565 Call at 11.40

Net Credit = 6.90



Winged Spreads

RUT Dec 22nd 1520 – 1530 – 1555 – 1565 Iron Condor Payoff



The Warren Buffett Put Trade

In his 2002 annual letter Warren Buffett stated this,

“In our view, however, derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal”

And ever since it has been used incorrectly by the financial press.



The Warren Buffett Put Trade

In the 2008 annual letter Buffett let us know this,

From 2004 and 2008 Berkshire Hathaway entered into a few dozen over the counter option trades.

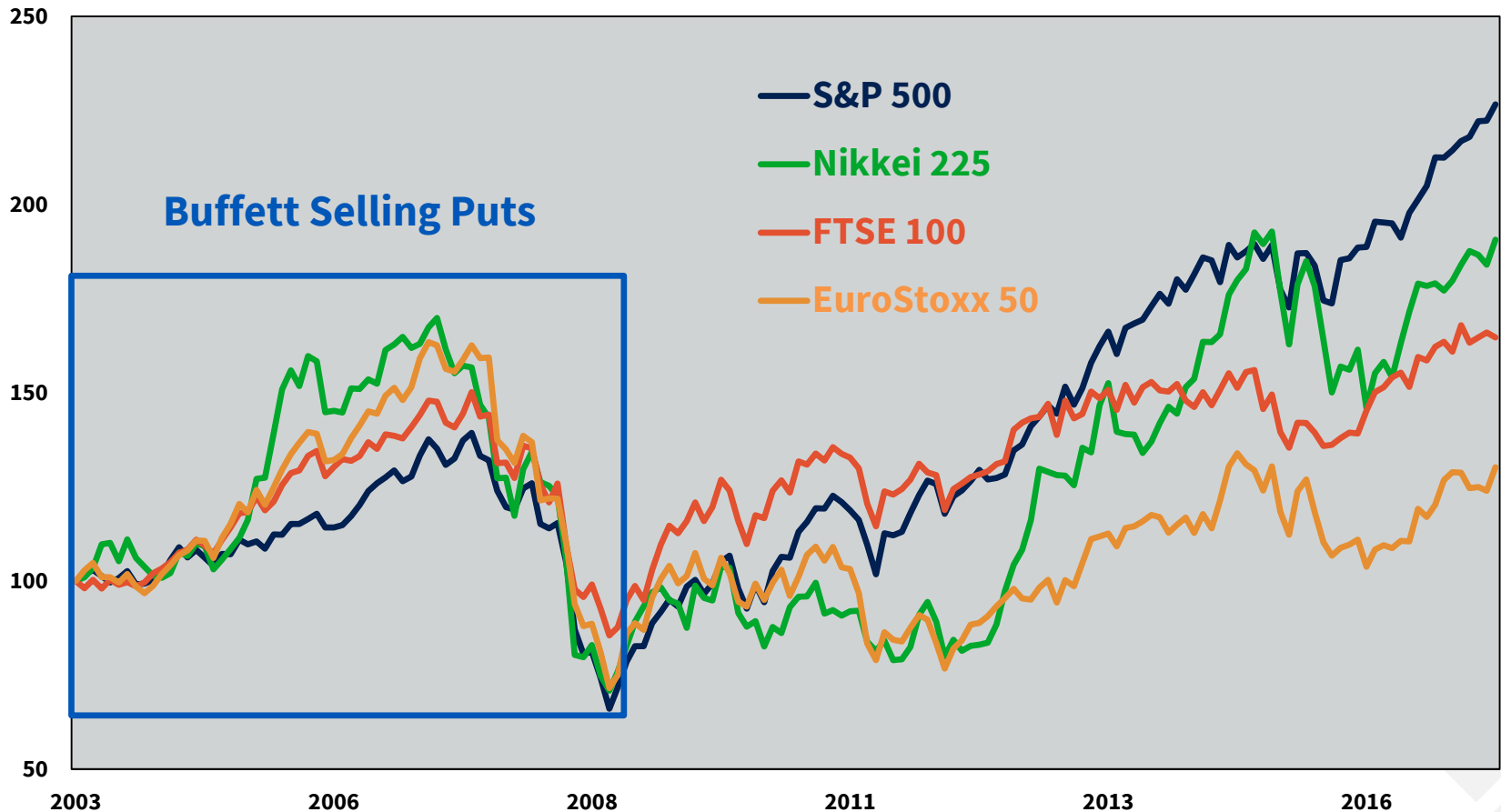
They sold at the money puts on four broad based equity market indexes; the S&P 500, FTSE 100, Euro Stoxx 50, and Nikkei 225 taking in a total of \$4.5 billion in premiums.

The financial press sort of missed this one.



The Warren Buffett Put Trade

Index Price Chart



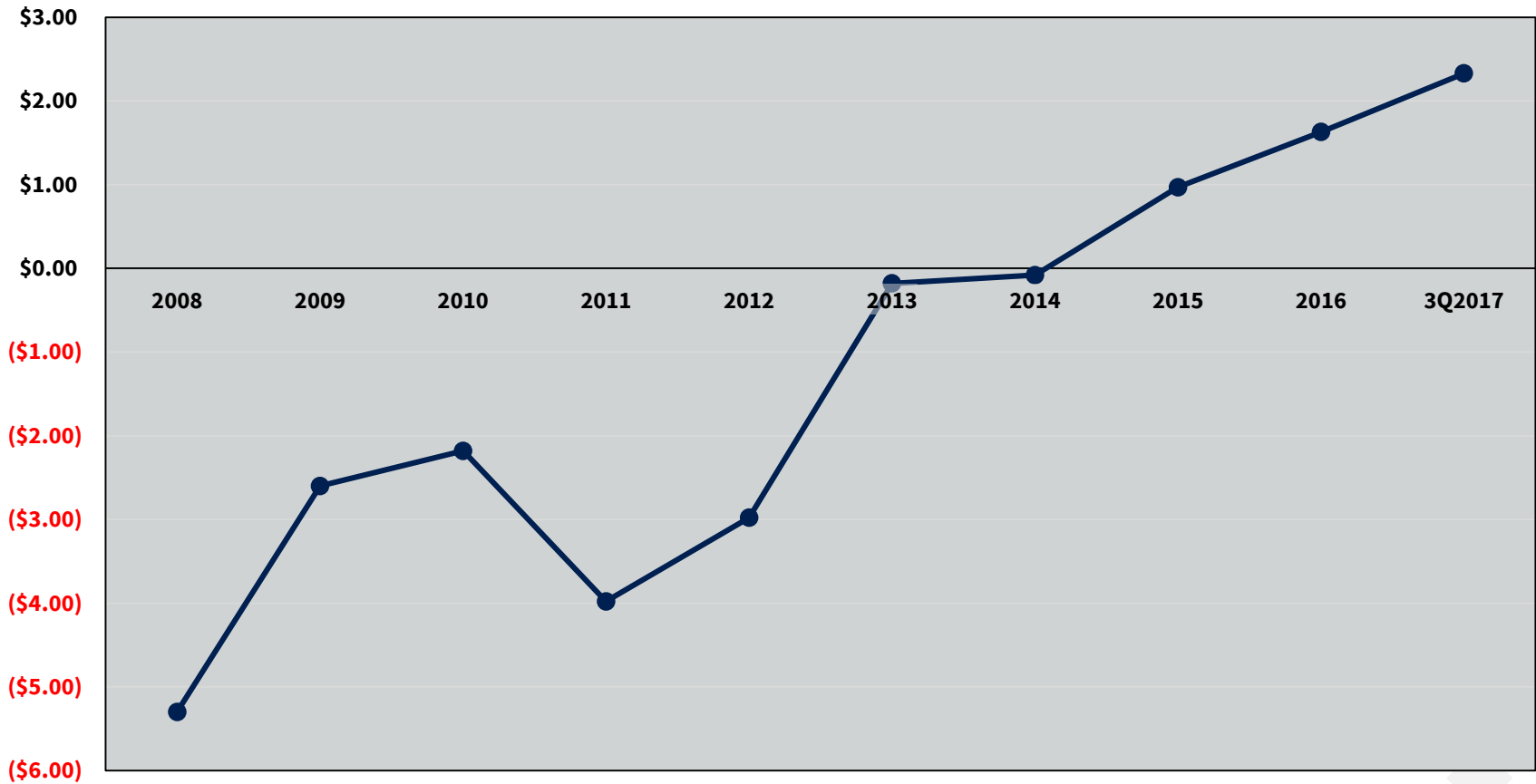
The Warren Buffett Put Trade

- ❖ A few years ago some of the trades were taken off and a profit of \$222 million was realized
- ❖ Currently index puts that were sold for \$4.2 billion remain outstanding
- ❖ As of the end of the 3rd quarter the value of the remaining options, using a pricing model, was \$2.19 billion placing the unrealized profit at about \$2 billion
- ❖ The intrinsic value of these options is down to \$640 million
- ❖ These options begin to expire on June 2018



The Warren Buffett Put Trade

Put Trade Performance



- ❖ All levels of successful option traders find a way to have time decay work for them
- ❖ Cboe has several indexes that show how these strategies have worked over time, but also in certain market environments
- ❖ Option strategies are appropriate for all levels of traders, even older gentlemen living in Nebraska

Contact for future questions

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