Buy S&P 500® LEAPS® Calls - Bullish

Market Assumption
Bullish

Situation
An investor buys Treasury notes, and is of the opinion that the stock market will rise over the next three years.

Possible Market Action
Buy S&P 500 LEAPS calls.

Discussion
Assume an investor buys $50,000 of two-year Treasury notes with an annual yield of 5-1/2%. Over the next two years this investment would earn $5,500. This investor would lock in this 5-1/2% return but would not have the opportunity to increase that return if the stock market rises. If this investor were bullish on the market over the next two years, he might be willing to risk slightly over 35% of the return on the notes in exchange for an opportunity to increase his overall return. This could be accomplished by investing the $2,000 that would otherwise be invested at 5-1/2% in index LEAPS (Long-term Equity AnticiPation Securities™) calls. The balance of the money ($48,000) would still be invested in Treasury notes.

Assume that the S&P 500 LEAPS (SPX/LSY) 1/10th reduced value index is currently valued at 120, (implying a SPX index level of 1200) and that the $2,000 would be used to purchase SPX LEAP at-the-money calls. If the two-year December 120 calls cost approximately $10 per contract, the investor could buy two contracts for $2000 (10 x $100 x 2) plus commissions. If the index were to rise 15% per year for the next two years, that would translate into the SPX having a value of 158.70 at expiration. Therefore, the calls with a 120 strike price would be worth about 38 points at expiration.

Original cost: 10 x 2 x 100 = ($2,000.00)

Value at expiration: 38 x 2 x 100 = $7,600.00

Total profit: $5,600.00

The combined return from the Treasury note and option positions would be as follows:

Interest income: ($48,000 x 5-1/2% x 2 yrs.) = $5,280.00

Earnings from SPX position: = $5,600.00
Total earnings: = $10,880.00

Annual return on $50,000: = 10%

The SPX LEAPS position, with the market rising 15% per year, increased the return over two years from $5,500 (if all the funds had been invested in Treasury notes) to $10,880.00 or an extra 4.5% per year.

The return from the SPX LEAPS calls obviously depends on stock market movement. If the market rose at more than 15%, in this example, the improvement in total return would be even greater. In this example, the combined return from the Treasury note and SPX LEAPS investment will be greater than a straight money market investment if the selected index increases an average of 6.0% or more per year over the next two years.

No matter how poorly the stock market performs, the worst that the investments could perform would be a loss of the $2,000 used to purchase SPX LEAP calls while still earning 5-1/2% on the $48,000 invested in Treasury notes. This results in a minimum return on the original $50,000 of about 3.5% annually.

Purchasing the SPX LEAPS calls in this example reduces the assured rate of return from 5.5% to about 3.5% in exchange for the opportunity to earn more than 5.5% if the stock market rises by more than an average of 6.0% per year over the two years.

For more information on the S&P 500 options, please visit http://www.cboe.com/spx

For more examples of options strategies, please visit http://www.cboe.com/strategies/

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