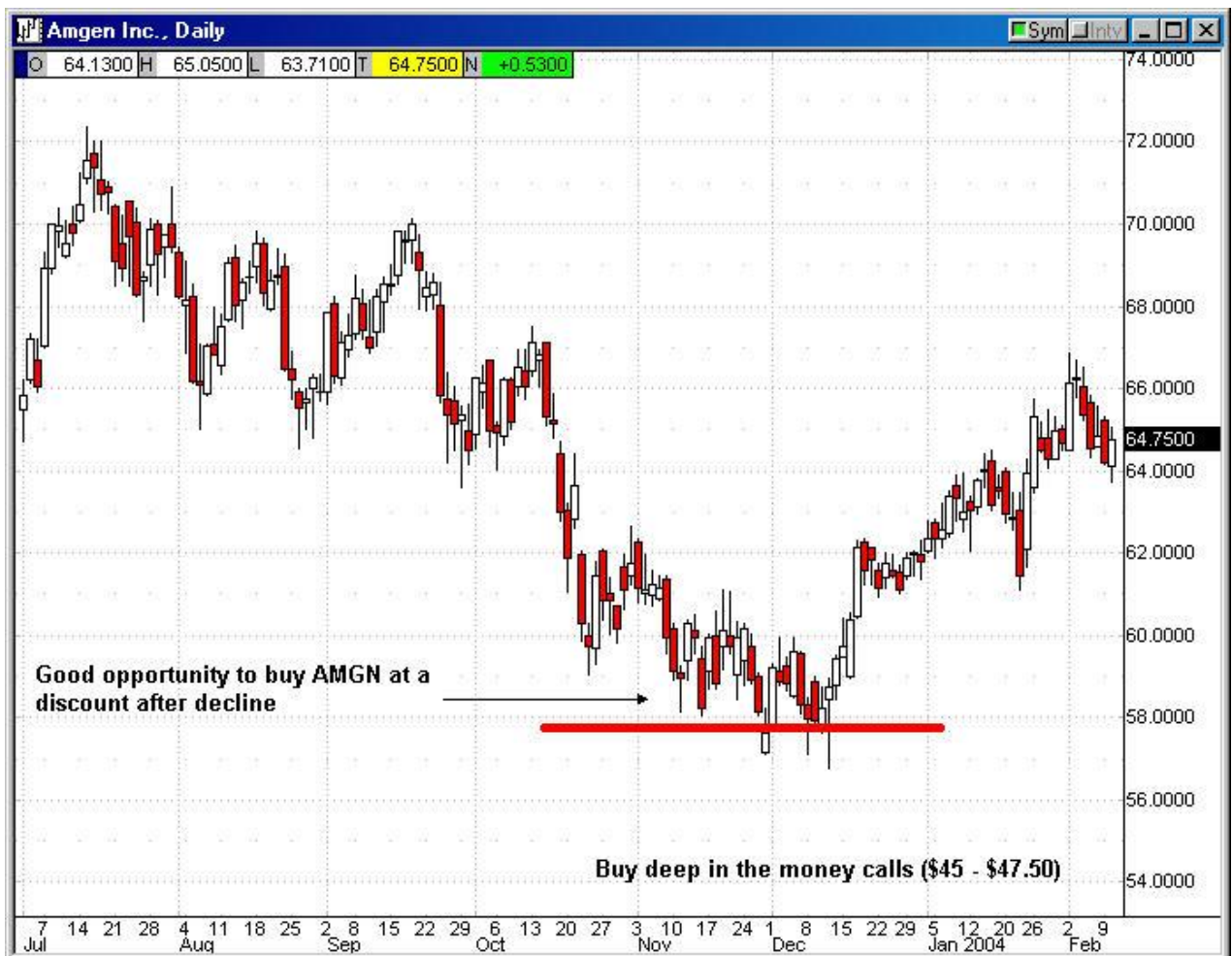


## Advanced Strategies

### The Stock Replacement Covered Call Strategy

Recently, (October and November '03), the giant biotech Amgen (AMGN) came under some intense pressure, trading down about \$12.00 before it found what appeared to be a decent level of support, and began to consolidate. At this level, anyone interested in going long Amgen at a discounted price would be advised to do so. Implied volatility was high coming off this precipitous drop, which caused premiums in the options to increase considerably.

This scenario can be a very attractive for covered call sellers or buy-writers. On Tuesday, December 2, 2003, Amgen was trading at \$58.90, the December 60 call was trading at \$1.30, and there were only two weeks left until expiration.



Let's assume that you wanted to take advantage of this opportunity but you would be unable to participate in it due to capital requirements. The stock was trading at \$58.90 and you did not have sufficient funds to support buying the stock at that price. After all, the purchase of just 1000 shares would cost \$58,900.00.

This is the time to consider using a strategy called stock replacement. In many instances, an insufficient amount of funds in the investors account can mean the loss of a golden opportunity when dealing with high dollar priced stocks.

So, an alternative to purchasing the stock outright is to find a way to replace the actual stock with something else which is not as expensive. In this case, a deep in-the-money call would do just that.

When a call is deep in-the-money, meaning that the strike price of the call is much lower than the stock price, the delta of the call approaches 100. This means that there is close to a 100% chance that this option will finish in-the-money.

Because of this, the option will trade just like the stock; penny for penny, dollar for dollar (in a theoretical 100 delta scenario.) If you recall, the term delta was mentioned when describing the option in question. Delta is the first derivative of the stock and it has a three pronged definition. The first is percentage change.

The delta is given as a percentage change, meaning how much in percentage terms the option price will change with a movement in the stock. A 50 delta option will move 50% the amount the stock does. If the stock moves \$1.00, than the option moves \$.50. A 30 delta option moves \$.30 on a \$1.00 movement in the stock, and so on.

Delta can also be defined as percent chance. This is used to describe the percentage chance that the option will end up in-the-money. A 90 delta option has a 90% chance of finishing in-the-money.

Finally, delta can also be defined as hedge ratio which is the amount of deltas needed to properly hedge a position. These concepts will be discussed in more detail in future Options University courses, but for now it is sufficient to just understand these basic concepts.

It was important to explain the meaning of delta to understand that the

deep in-the-money call would perform and act just like the stock. One way to determine if the call you will select is in-the-money enough for your purpose is the delta. A delta in the mid or high 90's is an ideal candidate.

The selection of the proper in-the-money call to use is a critical element in the success of this strategy. In order to obtain an accurate delta of all options under consideration for stock replacement use, you can go to any number of web sites or consult your broker.

If all else fails, there is a little trick of the trade that can be used to aid in selecting a call that is deep enough in-the-money to suit the stock replacement criteria.

To do this, check the quote of the corresponding put (i.e. the December 47.5 put if you are looking at the December 47.5 call for stock replacement). If there is no bid quoted for the put, then the call is deep enough in the money to consider it for a stock surrogate. There are several reasons for this being an effective strategy, which we won't cover here, but for the purposes of this discussion, it is enough to know that this method does work.

So, with the stock at \$58.90, the December 47.5 calls met the criteria for stock replacement. This call had a mid to high 90's delta and its corresponding put had no bid. The December 47.5 call was trading at \$11.45 or \$.05 over parity. By purchasing this option, you would be equivalently buying the stock at \$58.95 (the strike price plus the option price).

Let's say that you bought the December 47.5 call for \$11.45. If a total of 10 calls were purchased (an equivalent of 1000 shares), you would lay out a total of \$11,450 to fulfill your stock requirement on this buy-write. If you had purchased the stock outright, you would have spent \$58,900. The difference between the capital needed to purchase the stock outright (\$58,900) and the capital needed to buy the in-the-money call (\$11,450) is the key to this trade.

Now that you have your stock (via the calls you bought above), it is time to sell covered calls against this position, which would be the December 60 calls for \$1.30. If the stock stays at its present level, you would then capture the \$1.30 premium that you sold the December 60 calls for because they finished out-of-the-money at expiration.

The \$1,300 profit in this scenario represents an 11.35% return in only two weeks. This well out-performs the return garnered on a \$58,900 investment which would only be a 2.21% return in the two weeks, if you purchased the



actual stock.

As we know, the maximum profit of \$2.35 will be attained if the stock reaches \$60.00 or above. This return comes from the \$1.30 you received in the premium for the sale of the now worthless December 60 call plus a \$1.05 profit from the December 47.5 call you purchased. With the stock now at \$60.00, the December 47.5 call is worth parity, which is \$12.50.

You purchased the call for \$11.45 thus you received a \$1.05 capital gain in the option. This profit of \$2350.00 represents a 20.5% return in two weeks verses a 3.98% return in two weeks, if you had purchased the actual stock.

As you can see, you are getting the same overall dollar return on much less money - which creates a much higher percentage rate of return. *This is one of the positive leverage effects that the proper usage of options can provide.*

When you initiate this trade, you are buying and selling two different options simultaneously which is known as a [spread](#). A spread is a trade which involves the buying of one option against the sale of a different option simultaneously and will be covered briefly in the next section.

By buying the December 47.5 calls for \$11.45 and then selling the December 60 calls at \$1.30, you are buying the December 47.5 December 60 call spread for \$10.15. This type of spread is known as a [vertical spread](#).

For more Information about option trading, please click here:  
[www.options-university.com](http://www.options-university.com)