

Option Strategy 1 – The Buy Write

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What is a Buy Write?

A Buy Write is an options investment strategy in which an investor simultaneously buys shares and writes (sells) call options over an equivalent number of shares.

Example

A Buy Write for 5,000 CBA shares would entail

1. Buying 5,000 shares and
2. Simultaneously selling 5 call option contracts in CBA shares.

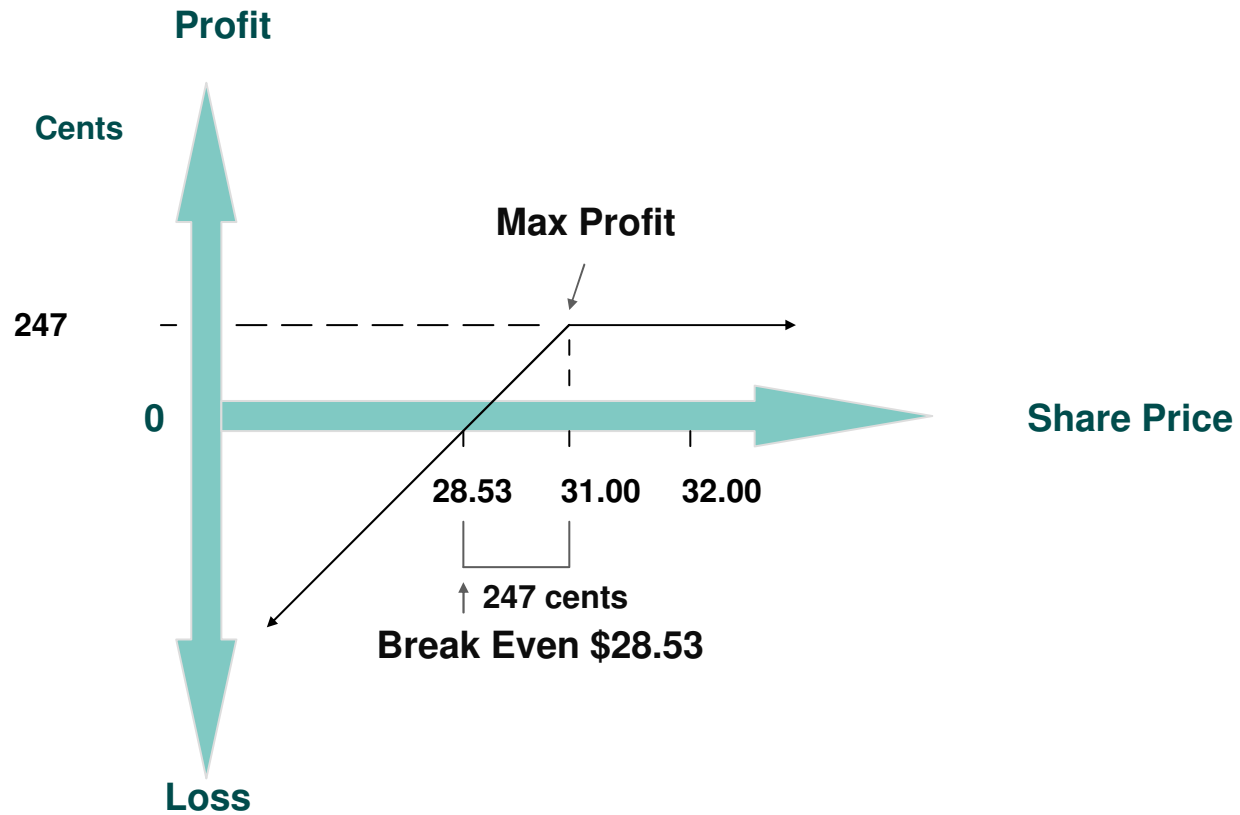
Please note that the standard options contract size for equity options is 1,000 shares per contract.

Thus, per this example you have potentially exposed yourself to selling 5,000 CBA shares.

Example cont - Diagram

Buy 5,000 CBA shares @ \$29.00

Sell 5 CBA Apr 09 \$31 Calls @ 47c



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Example cont - chart

Table A	
CBA Stock Price	Stock Change from \$29 purchase price
\$26.00	-\$3.00
\$27.00	-\$2.00
\$28.00	-\$1.00
\$28.50	-\$0.50
\$29.00	0
\$30.00	+\$1.00
\$31.00	+\$2.00
\$31.50	+\$2.50
\$32.00	+\$3.00
\$33.00	+\$4.00
\$34.00	+\$5.00
\$40.00	+\$11.00

Table B	
Call Option Profit / Loss	Buy/Write Strategy at Expiry (stock change + call option P/L)
+\$0.47	-\$2.53
+\$0.47	-\$1.53
+\$0.47	-\$0.53
+\$0.47	-\$0.03
+\$0.47	+\$0.47
+\$0.47	+\$1.47
+\$0.47	+\$2.47
-\$0.03	+\$2.47
-\$0.53	+\$2.47
-\$1.53	+\$2.47
-\$2.53	+\$2.47
-\$8.53	+\$2.47



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Benefits of Buy Write

- ▶ Generate Extra Income

When selling call options, the premium is collected. In the previous example this equates to \$0.47 or \$470 per contract (1,000 x \$0.47). As 5 contracts are traded, the premium income is \$2,350 (5,000 x \$0.47).

- ▶ Suitable for Self Managed Super Funds (SMSF's)

This is a permitted strategy in SMSF's provided it is allowed for in the funds investment strategy in the trust deed.

The stock should also be lodged as Collateral with the Australian Clearing House (ACH).

Risks of Buy Write

- ▶ DOES NOT provide downside protection

As noted in Table 1, the only protection of the Buy/Write to a falling share price is the option premium.

- ▶ If you compare column A and column B you will notice that the premium of \$0.47 cents is kept regardless of the share price movement. As an example, when the share price is \$26, the loss under the buy write strategy is \$2.53 whereas the loss had you simply bought the shares at \$29 would be a \$3 loss.



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Risks of Buy/Write

- ▶ Upside is Limited

The buy write strategy places a “ceiling” over the potential profit from the shareholding. As noted in the table the maximum profit from the buy/write strategy is \$2.47.

Why? Because if the share price goes above \$31 on or before expiry you may be assigned and forced to sell your shares.

As an example, if the share price of CBA is \$40, the maximum profit from the buy write strategy is \$2.47 (refer Table 1 Column B). If the shares were purchased at \$29 and the call was not sold over the shares, the profit would be \$11 (refer Table 1 Column A).



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Risks of Buy/Write

- ▶ Early Assignment

Most ASX equity options are American style, this means they may be assigned at anytime over the life of the option. This is particularly relevant to shares that are due to trade ex-dividend before the option expires.

When to use the Buy/Write strategy

- ▶ As the buy/write strategy gives limited downside protection and caps the profit potential on the upside, the best markets to trade this strategy is in a flat to mildly bullish (rising market) view.

With reference to Table 1, you will notice that the sold call gives protection down to \$28.53 (\$29 purchase price less \$0.47 option premium) before a loss is encountered. The maximum profit from the strategy is reached once the shares reach \$31 showing a profit of \$2.47.

Important Trading Points

- ▶ Settlement differences between shares and options
As options settle on the trading day plus one business day (T+1) and shares settle on T+3 there is a 2 business day period where alternative collateral will need to be used to cover margins. These margins may be covered by either cash or other shares that are sponsored.
- ▶ The higher the strike price of the call option, the lower the premium of the option.

Important Trading Points

- ▶ Most Buy/Write strategies utilise a call option that is “out of the money” i.e. strike price of options is $>$ share price, in our example $\$31 > \29 so the option premium is all time value. Hence, if there is no rise in the share price over the life of the option (i.e. the share price remains at $\$29$), the call option will expire worthless.
- ▶ “At the money” call options have the highest possible time value.
- ▶ Should the call option in the buy/write strategy expire, another call may be sold against the shares owned. If this action was taken, it would be referred to as covered call writing.

GLOSSARY

- ▶ **Call option-** gives the holder the right (but not the obligation) to buy a parcel of shares in the underlying stock at the strike price. The seller of a call is obligated to sell at the strike price should the buyer exercise their option.
- ▶ **Strike (exercise) Price-** is the price level where you may be called upon to buy or sell a parcel of shares.
- ▶ **Contract size-** in general 1 option contract represents obligations over 1000 shares of the underlying stock.
- ▶ **Premium-** the price of an option. For a sold call it is the amount of income per contract that you receive.
- ▶ **Expiry-** is the date at which the option expires. For equity options this is the last Thursday before the end of the month.
- ▶ **Write-** write is the term used to describe the selling of an option.
- ▶ **Exercise-** is the term used when the buyer of an option elects to 'exercise' the rights they have over the underlying shares. In the case of a call option, this is the right to buy the shares.
- ▶ **Assignment-** is the term used when a sold option position is exercised by the buyer of the option and 'assigned' to the seller. ie, when you're called upon to sell stock as a result of the assignment of a sold call option.



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