

Buying Calls in Lieu of Stock

Some thoughts on investing in technology now.

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I'm a great believer in technology. I realize that these became overvalued in the year 2000. Too bad they lost half their value before it started to come out that they were having a business slowdown. They lost half their value again since then, as business growth has apparently hit the brakes harder by the week.

Many of these businesses are more interdependent than I realized. It's like traveling on the freeway. In the distance, you see some brake lights. You start to break gradually, but the closer you come to the cars ahead of you, you find that you have to break harder, until, much to everyone's consternation, you're at a complete stop. Then, in a minute the clump begins to break up, and you accelerate gradually back up to normal speed again. What caused the clump? Usually you never find out. But this much we know. Some braked harder than they had to, with the result that everyone had to brake harder than they wanted.

What caused the tech slowdown? Does anybody really know? It seemed to come out of nowhere. The telecom companies seemed to run into trouble first. Demand slowed and competition caused them to lower prices, even to below breakeven. Another early problem was sluggish PC sales.

I read an article in the WSJ that compared the tech bubble burst with the great automobile stock bubble burst of the early 1920s; and it took a long time for the automobile stocks to recover after that. But a depression also followed that period. And surely we believe that Cisco, Nortel and the others have a *lot* of Internet infrastructure to build yet (and re-build, as bigger and bigger pipes are needed). The Internet is a worldwide, revolutionary phenomenon. Will Cisco become complacent and sloppy as GM did? I doubt it.

So how and when to step in?

Almost all of us who have bought stock recently that follow a 20% (or so) stop rule have seen our stop hit in just a week or two. Then we're out. I know this has happened to me many times recently. And it burns!

That's why I'm really skittish about stepping in and picking up any of these bargains. Tomorrow it might just be a 10% better bargain!

So that's the conundrum. The lower stocks go, the more attractive they are. Yet, so many stings have over-sensitized me, to the point where I'm overly afraid of being stung again. I'm like a moth drawn to the light, hoping that this time the zapper will be powered off. And they keep turning up the intensity of the light!

Some say that's no problem. Just stay out until a bottom has clearly been formed. The problem is, I'm a bottom fisher. I know myself, and I know that I just can't stand to be out of a rising market. So if I don't try to pick the bottom, I'll just end up paying more for stocks on their way up (and share prices may very well recover as swiftly as they did after the 1987 crash).

Ok then. Just buy now and hold for long term. What's the problem? The problem is, if these stocks go to half price again from here I'll be in anguish.

Can options help?

Yes they can. First, at the same time I buy stock, I can also buy puts. This conveys all the upside potential of owning the stock, and the puts serve as an insurance policy in case the stock keeps crashing.

It also occurs to me that buying calls creates the very same performance curve as buying stock and buying puts, but uses a lot less money. An appropriate number of calls can be bought that provides the same upside potential as owning the stock for a fraction of the cost. Thus most of your capital remains in cash.

"Investing" this way creates a built-in stop. For example, if the calls cost 15% of what buying the stock would have cost, then buying the calls is equivalent to buying the stock and setting a 15% downside stop. However, using the calls has one big advantage and one small advantage. The big advantage is that if the stock dips and then comes back, you're still in it. (With stock, you would have stopped out and then missed the recovery.) The small advantage is that your idle cash gets to earn interest in the meantime.

One caveat. If the stock ends up at the same price come expiration, the option will have lost all its time value. If this was an at-the-money or out-of-the-money option, that means losing all its value. (If you bought stock, you'd break even.)

The question arises, "What duration and what strike to pick?" This is an important question, because it can make the difference in the calls costing anywhere from 10%-50% of the equivalent quantity of stock. The duration depends on how long you expect the recovery to take. If you think it might take six months, for example, then get six-month options, or perhaps a little longer. Remember, if your first calls become worthless because the market drops another 20-50%, you can be thankful you didn't have shares, and buy calls again. As for the strike price, I would buy the at-the-money calls.

Why not use LEAPs? You can, but LEAPs cost more putting more of your capital at risk. If you use LEAPs, you probably want to set a stop loss point.

Buying a few calls is a great way to put your toe in the water now, rather than waiting for a clear bottom to have formed. Don't set a stop on the calls. You can just figure that the calls might become a complete loss. Or, they might get you in on the first leg of a new up-trend. Remember that the first gains off the bottom can be some of the largest percentage gains. I like the feeling of being "in", and yet having my losses limited automatically.