

The Covered Combo in Volatile Markets

Taking advantage of inflated options prices

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In tumultuous markets you would think there would be abundant options trading opportunities. Turns out, it's not that simple. In such an environment, options are very expensive. That would suggest finding a way of selling them, but what is a good, safe way of selling them? Covered writing is okay, but leaves you holding the bag in a swift decline. Naked writing is dangerous in a volatile environment.

Question: Would you enjoy picking up some good stocks just below current price levels? If so, the answer may very well be the covered combo.

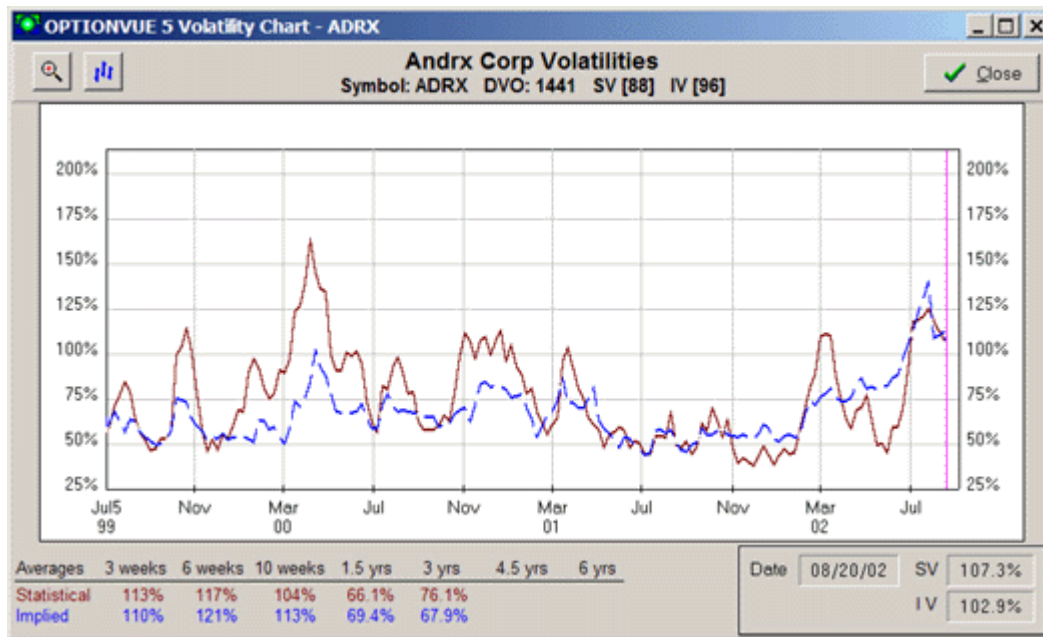
The covered combo strategy consists of a covered write (long stock and short call) plus a short put. In order to receive some good premium and downside protection, an at-the-money or just out-of-the-money call is typically selected to form the covered write.

The put is typically selected at a strike below the current stock price, at a price where you would be happy to buy more shares of this stock. Technically, this short put is a naked option. However, it's not a dangerous option. If the stock falls below the put's strike price you may be assigned, thus buying more shares. You simply need to be prepared to do this.

Since the covered combo has you selling options, this strategy takes full advantage of currently inflated option prices.

In a volatile market, literally hundreds of stocks can be ripe for covered combos. A key is to pick a stock you'd like to own, or perhaps one you own already. Then you figure out how many shares to buy (if any) and which calls and puts to sell.

Say, for example, we liked Andrx Corporation (Symbol: ADRX) which is currently trading at \$23.75 a share. The historical volatility chart shows IV (implied volatility) at extremely high levels currently. This means its options are expensive.



The following covered combo might be considered:

Buy 500 shares of Andrx stock	at 23.75
Sell 5 October 30 Calls	at 1.85
Sell 5 October 20 Puts	at 2.15

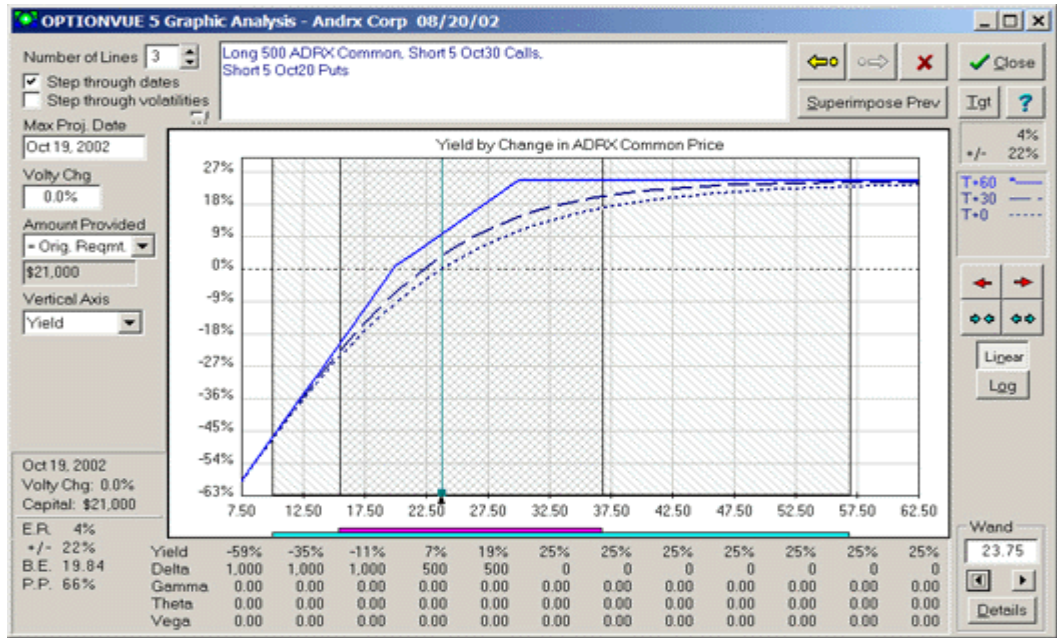
Let's analyze this trade. With the stock at 23.75, the proposed out-of-the-money call sale would give us 1.85 points of downside protection. In other words, the stock could drop to 21.90 before we incurred a loss. These expensive options give us a lot of downside protection!

Then add to that the credit received from selling the puts. Regardless of where the stock price goes, the extra 2.15 points received from selling the puts can be considered as helping us buy the original 500 shares of stock for 2.15 points less. Considering the proceeds from the puts and the calls together, we're effectively buying the stock for approximately \$19.75. That's \$4.00 below the current market value!

If the stock does fall below \$20.00, our then in-the-money puts would probably be assigned, and we'll be buying an additional 500 shares of stock at \$20.00. So the first 500 shares cost us \$19.75 each. The second 500 cost you \$20.00 each. That means we got 1,000 shares at an average price of \$19.88. Not bad when you consider that the current price of Microsoft is 23.75! Magic!

So what's the catch? The catch is that if the stock continues to fall, we're losing \$1,000 per point on our 1,000 share stock position. But presumably this was an acceptable risk for us as willing stock investors. If instead the stock soars, we make \$10,580 and no more, as our upside gains are capped by the short calls.

Here is a picture of the Andrx Corp covered combo:



Notice that the shaded areas – representing the 1st and 2nd standard deviation price moves -- extend to an extremely wide price range, reflecting the currently high volatility environment. The software used this high volatility in its projection of possible future stock price behavior. Even when we let the program assume this continued high volatility (which is unlikely through October 2002), this investment yields a very attractive 25% in 60 days (150% annualized).

Interestingly, the graphic does not show what happens in all circumstances. It is conservative. It only shows what happens if the stock goes straight from its current price to other prices represented along the horizontal axis. If the stock drops to 20 and you get assigned an extra 500 shares, and then the stock goes back up, your outcome is better than the graph depicts – much better.