

Naked Writing: A Risky Way to Get Income

Earning time decay dollars has its risks

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The naked call seller is interested in the same thing as the covered call seller – income. The difference is that the naked option seller does not own the underlying. If assigned, he has to buy shares on the open market to deliver. Of course, he has to pay the current market price, whatever it is.

The primary difference between being short a naked option and being short a covered option is that without the stock to complement the short call option, there is nothing to limit the position's risk if the stock goes up.

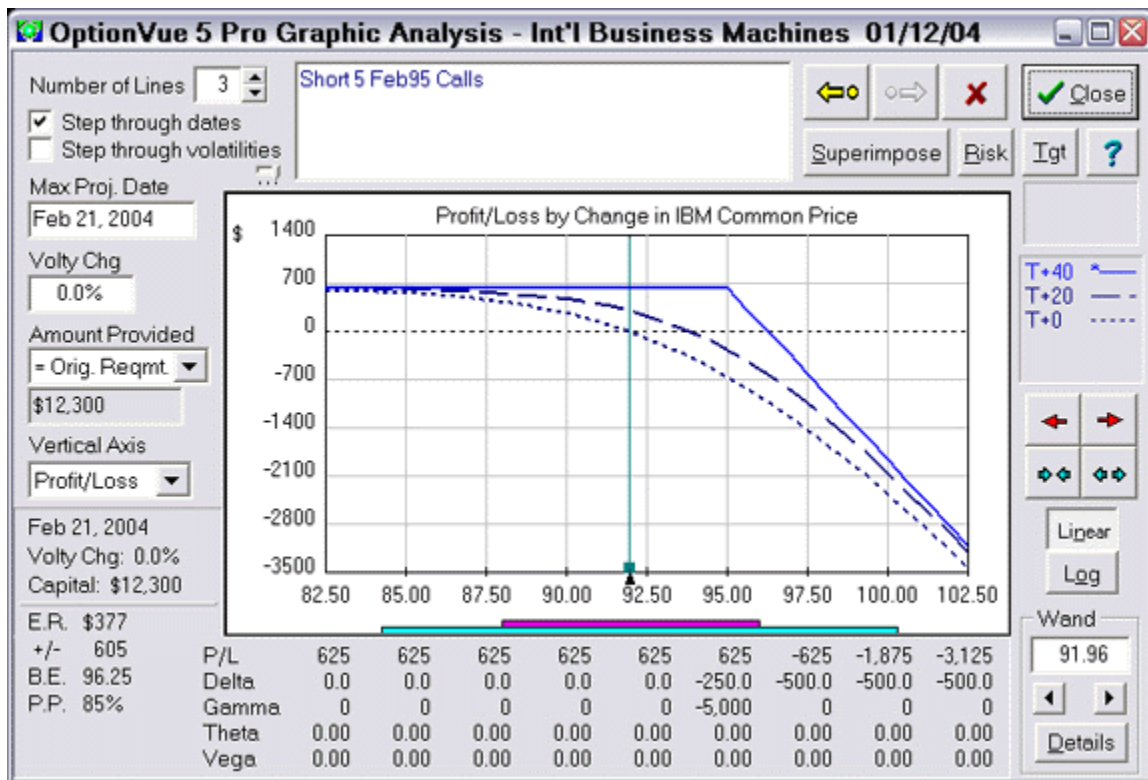
Selling a naked call gives you precisely the opposite performance characteristics from buying a call: unlimited risk and limited potential. The most an option seller can gain is the amount he was initially paid for the option; no more. At the same time, he has theoretically unlimited risk, as the call option's value goes up with the price of the stock. As losses mount, a point will be reached where you need to buy back the option to close the position (or be assigned and have to buy stock to deliver, resulting in almost the same monetary outcome).

Still, some investors are attracted to the prospect of earning time decay dollars, and the position costs less to put on than a covered write. In fact, your account is credited immediately after the sale of the option(s). So what stops traders from putting on large positions – as large as they want? They can't because brokerage firms require investors to keep money in their account to cover potential losses. This cash reserve is called the "margin requirement". (Actually, "margin requirement" is old terminology. The new term, "performance requirement", is closer to the mark, but the old term still lives on.)

There is a standard formula for computing the requirement for naked short options. Without going into details, the amount required is roughly 5 to 20 times the credit received from the sale of the option(s). For example, if you sell an option and receive a \$1,000 credit, you can count on having to put up anywhere from \$5,000 to \$20,000 collateral to support the position.

Naked option writers rely on stops to help them control the theoretically unlimited risk. That works well provided the underlying trades continuously; that is – its price never jumps dramatically. As many investors have seen, however, a stock can sometimes close the day at one price and open the next day at a very different price. This kind of risk cannot be controlled using stops. To limit this exposure, some traders stick to writing index options, since they don't possess nearly this degree of risk.

The performance graph for the Short Naked Call below illustrates this strategy's unlimited risk and limited potential. As you can see, it makes money as long as the underlying price does not go up, but losses quickly mount if the price goes against you:



Some words of warning about naked writing

I have seen traders who use naked writing post regular gains for months and even years on end, and then suddenly and spectacularly blow out. It happens at times when the market goes to an extreme that no one has ever seen before. (Of course, it probably has happened before; there is nothing new under the sun. People just don't remember it.)

This shouldn't have happened to them and it doesn't have to happen to you. If you use naked writing, have a pre-arranged plan on when you will exit and how you will hedge your position at certain stages.

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