LEAPS
Rethinking the Long View

Should stocks fall, don’t suffer the same plight as Humpty. Certain options strategies can help you reduce your capital risk of long stock, without compromising the potential upside.

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When it comes to hedging investor client stock portfolios, you know the drill: Don’t put all their eggs in one basket. It’s sage advice that’s as old as Humpty Dumpty himself. It’s also the fundamental reason why advisors not only look to build a well-diversified stock portfolio, but also make sure there’s a mix of other, non-correlated assets among their broader investments.

That’s great if you want to match broad market returns. However, there’s a twofold crack in the traditional diversification paradigm of stocks-bonds-cash. (Yes, there is a new paradigm.) First, you may be allocating too much capital to purchasing stocks when you could be making better use of it elsewhere. And second, you may have an unnecessary amount of capital exposed to industry and market risk, regardless of how many eggs you have.

Both problems highlight your desire to reduce capital risk in a long stock portfolio without compromising potential returns. This makes traditional stock buying all the more challenging today when searching for alpha—often forcing advisors to go into uncharted territory with “alternatives” and high-beta stocks outside of their comfort zone. Is there another way? Yes!

You need to find a cheaper way to buy stocks so there’s less capital exposed to risk, but you still participate in the potential upside of a rising market. There are a couple of methods for using listed options to meet that objective—purchasing long-term options at a fraction of the stock price or selling puts to lower your cost basis. Both can lower your underlying equity exposure risk and leverage your upside potential, with a different risk profile than an outright stock purchasing strategy. Let’s explore.

**LONG METHOD #1**
**BUYING LEAPS AS A STOCK SURROGATE**

Enter long-term options. No, not the short-term kind that make your stomach churn with every market swing, only to disappear when a stock moves just a few dollars from your strike. These longer-duration options are the choice of professional investors who are interested in complementing a long stock portfolio strategy.

**A NEW EGG**

Also called LEAPS® (Long-term Equity AnticiPation Securities®), these options can have expiration dates going out nearly three years (in some cases, five years). However, for the purposes of this article, we’re going to focus only on a one-year strategy for the tax benefits.

By considering the use of deep “in-the-money” LEAPS calls in lieu of stock, you enjoy a number of benefits:

1. **LEVERAGE.** Allow investors to participate in stocks for a fraction of the price without buying on margin. That frees up capital to use elsewhere.

2. **HEDGE TIME AND VOLATILITY.** Greatly reduce the impact of time decay and volatility risks normally associated with shorter-term options.

3. **TAX ADVANTAGES.** Gains on a LEAPS investment held 12 months and a day are considered long-term investments, and the tax code treats them as such.

**MAKING HUMPTY WHOLE AGAIN**

The idea that options are a “wasting” asset is only valid for certain types of speculative strategies using options—namely, those that are “at-the-money” or “out-of-the-money” (equal to the strike or above it, respectively). Such options are made entirely of time premium, and are vulnerable to rapid time decay and volatility reduction. However, by purchasing deep in-the-money LEAPS calls, you can structure your investment to nearly mimic the profit curve of a stock without the capital risk, while hedging the effects of time decay and volatility.

**LEAPS Call vs. Long Stock**

![Figure 1: How Do They Compare?](image-url)

How deep an option should you choose? Looking for an option with a “delta” of at least 85 is a good start. Delta is the amount an option moves for each dollar
the stock moves (between 0 and 100). With an 85 delta, the LEAPS option moves $0.85 for every $1 the stock moves. However, as you can see from Figure 1, that changes as the stock moves even deeper in-the-money.

All things being equal, deltas increase as the stock moves higher. And what’s more, the deltas decrease as the stock moves against you, meaning the losses slow down, as you can see in Figure 1, due to the convexity of the p/l curve of the trade placed at onset. This convexity relates to the amount of time premium (aka “extrinsic value”) built into the option. When there is time premium, the option’s gamma (velocity of an option’s change in price) is lower. As an option nears its expiration, gamma increases as well, and the same dollar move in the stock increases the option’s price change.

To give you a sense of just how little time value there is in an in-the-money LEAPS option, compare it to an “at-the-money” LEAPS option, in which the strike is the same as the stock price. The ATM LEAPS call option with one year to expiration on a $100 stock may trade for around $10, or about 10% of the stock price. Since the option is at-the-money, just about all of the $10 is likely to be time value.

But on that same $100 stock, you can buy a LEAPS call option at, say, the 75 strike. This option is so deep in-the-money that it may only have about $3 of time value. For an option like the 75-strike call, which is $25 in-the-money, this means that the total price of your option could top out at around $28. This is significantly less than the value of the stock.

Further, as you can see from Figure 2, the time decay in the first 12 months is very low—enough time for the stock to do something, at which point you could decide whether to maintain the position, “roll” into a new LEAPS option (sell the current position and buy a new one of the same or different strike), or exit altogether.

**CRACKS IN THE SHELL?**

Despite how this all sounds, you might think there are still some added benefits to owning stock that a LEAPS option could not provide—namely having to do with dividends and margin.

No dividends. It’s true that if your stock pays a dividend, the LEAPS call option on that stock does not. Therefore, in one sense, you’d be forgoing the dividend. On the other hand, call options are discounted to account for that difference. So, for example, if you look at options on two different stocks, only one of which pays a dividend, the LEAPS call option on the dividend-paying stock would be less expensive than the same LEAPS call option on the non-dividend-paying stock.

Margin is leverage, too. You might be asking, why not just buy stock on margin to get the leverage? Consider the total cost of stock ownership. When you buy a stock on margin, you put up an initial requirement, and of course, have to borrow the balance at high interest rates. And at multi-decade lows, interest rates have more room to go up than down, making margin purchases even more expensive down the road. Meanwhile, the cost of buying LEAPS will remain relatively the same.

LEAPS options represent an innovative way to gain exposure to the markets while limiting extreme market risks and allowing you the potential for long-term capital gains. By using deep in-the-money LEAPS calls as stock and ETF substitutes, you minimize time value and its associated risks. Furthermore, while you’ll miss out on the benefits of stock dividends, you’ll also do away with the potentially greater interest cost on your marginable debit balance.

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**STRIKE**—The price at which a put or call can be exercised (where the stock can be bought or sold).

**IN-THE-MONEY**—An option whose strike is inside the price of the underlying equity. For calls it’s the strike that is lower than the price of the underlying equity. For puts, it’s the strike that is higher.

**AT-THE-MONEY**—An option whose strike is the same as the price of the underlying equity.

**OUT-OF-THE-MONEY**—An option whose strike is away from the underlying equity. For calls, it’s the strike that is higher than the underlying. For puts, it’s the strike that’s lower.

**DELTA**—A measure of an option’s sensitivity to a $1 change in the underlying asset. All else being equal, an option with a 50 delta for example, would gain 50 cents per $1 move up in the underlying.

**GAMMA**—The velocity at which the option price changes relative a move in the underlying. More specifically, it measures the expected change in an option’s delta per $1 move in the underlying.

**ASSIGNMENT**—When the owner of an option exercises their rights, the broker “assigns,” or transfers ownership of the option to the seller, and all the obligations of that option. In the case of a call assignment on stocks or exchange-traded funds (ETFs), the seller is obligated to sell stock at the strike price of the sold option. For a put assignment, the seller is obligated to purchase the stock or ETF.
LONG METHOD #2
SELLING “NAKED” PUTS TO LOWER COST BASIS
Falling from a height of six feet or higher, Humpty is scrambled eggs. But were it a wee tumble off a three-foot wall, he might’ve cracked his shell, but he’d hardly require the efforts of all the king’s men to put him back together. Same goes for stocks. The lower the price you get into a stock, the less the impact if the stock should fall. But how do you get in at a discount to the listed stock price? Consider selling naked puts.

Now, you may have heard that selling puts naked (i.e., without a hedge) is scary and risky, right? Not so fast. It all depends on your strategy. As a pure speculative play, selling naked puts for income carries a different set of risks than utilizing the strategy to simply lower your cost basis on the purchase of an underlying security.

The speculative investor has no intention of buying the stock, and does not want to be assigned. But if your intention is to use the put-selling strategy to lower your cost basis on a an underlying security you intend to buy anyway, the risk is lower. In fact, it’s less risky than purchasing stock outright, because you’ll take in premium in the process. Here’s how.

BREAKING THE FALL
As you may already know, a put option gives the buyer the right to sell stock at a predetermined price (called the strike price) up until a predetermined date (option expiration). For this right, the buyer pays a premium. This premium then goes to the seller of the put option in exchange for incurring the obligation to buy the stock at the strike price any time between now and option expiration.

As a put seller, you collect a premium for your willingness to buy the stock at a price you already know, for a certain period of time, if so called upon. That said, there are some differences between selling puts and buying the stock outright. Consider the following example:

Suppose stock XYZ is trading at $63 per share but you don’t want to pay more than $60 for it. You could simply place a limit order to buy shares at $60. Then, if the stock dropped to $60 or lower, your limit order would be triggered and you’d likely own the shares somewhere around $60. If the stock never dropped, no harm done, you wouldn’t own anything.

But suppose that instead of placing that limit order, you sold the XYZ 60-strike put option that expires in 30 days. Further, say you sold the option at a price of $2.

If in 30 days the price of XYZ drops below $60 per share, you take delivery of the stock at $60. If the stock is above $60 at expiration, then just as with the stock limit order, you don’t get any stock. However, you do get to keep that $2 premium. And you can turn around and sell another month’s premium—perhaps for another $2.

Finally, if the stock should drop below $60 at expiration, you still keep the $2 premium, but your cost basis (i.e., effective stock purchase price) is $58 per share. Remember also that the put seller is obligated to buy at the strike price even if the security is lower than the strike price.

HOW DO YOU LIKE YOUR EGGS?
When it comes to determining which put options to sell, note that there are three flavors—out-of-the-money, at-the-money, and in-the-money. When choosing which one is right for you, consider the probabilities of assignment. You have to decide where you are willing to purchase the stock, the likelihood of that happening, and how much money you want to take in for that obligation. The farther out-of-the-money you sell a put, the less likely you will be assigned, and thus, the less premium you’ll take in.

Bear in mind, selling puts does require putting up margin. You’re not, however, paying interest on that margin since you’re not actually borrowing anything. You’re simply tying up a set amount of your client’s capital that’s “untouchable” until you exit the trade.

Selling put options to lower your cost basis can be a smarter way to buy stock outright. And further, put options provide tremendous flexibility when it comes to deciding at what price you are willing to buy the stock (your strike price), how long you want to be under that obligation (the expiration date), and how much you’d like to collect for your troubles (the option premium).

WHETHER BUYING LEAPS OPTIONS AS A STOCK SURROGATE,
or selling puts to lower cost basis on stock, in essence, you’re lowering the risk of an outright stock purchasing strategy. Less capital outlay means more capital to diversify and spread about elsewhere. And that’s a good thing when you’re dealing with clumsy eggs.

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