

LEAPing for Success

By David MacFadyen

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One of the key tenets for investment success is diversification. As an active individual investor, even if your investment holdings amount to over \$100,000, it is hard to justify having more than 15 positions if only because of the effort in tracking and evaluating these positions, trading costs, and the cost of quality advisory services.

Most of us will avoid the time and effort of following individual positions and will likely choose mutual funds or ETFs. In the trending markets we saw in the 1990's, the ETF strategy, in particular, worked superbly well. Long-term, a well diversified, suitably fee-conscious approach should form the **core portfolio**. For instance, my core portfolio (i.e. approximately 80% of my current assets) will basically provide for my retirement goal. The clear implication is that my so-called "risk money" is 20% of my portfolio. These figures will vary from person to person according to their respective financial goals, time horizon and tolerance for risk.

For more seasoned investors looking to enhance their returns without sacrificing the core diversification, the main alternative will require the use of some form of **leverage**. After all, even if you are able to afford less than 20% or so in risk capital outside your core portfolio, you will still want to avoid putting all your eggs in one basket. However, to achieve a meaningful return you will need an edge to take full advantage of your positions. Happily, for the debt averse, leverage does not have to mean margin loans.

A **LEAP** is a derivative with a greater than usual time to expiry. In fact, the term L.E.A.P. is defined as "Long-term Equity Anticipation Security". They are available in two types; calls (the right to buy) and puts (the right to sell), with expiry dates up to three years in the future. To remind those of you who are not accustomed to options, the value of an option is composed of both **intrinsic value** and **time value**. For example:

	\$
ABC Stock	10
ABC'08 Jan 8 Call Option Intrinsic Value	2
ABC'08 Jan 8 Call Option Time Value	1
ABC'08 Jan 8 Call Option Total Value	3

We have an underlying stock position at \$10. As the option expires in January 2008, there are 2 years left to expiry. The intrinsic value of an equity call (the right to buy) equals the stock price less the strike price of \$8. As the call is worth \$3, there is obviously another price component, that is, a time value equal \$1 (i.e. \$3 minus \$2). This time value is the growth expectation built into the option

price. It will gradually decline as expiry nears, though **volatility** in the price of the underlying equity will also be a considerable factor.

Let us switch gears and consider my practical example of 10 TXU Corp. call options that I purchased in July 2003 with expiry in January 2006.

	\$
1000 shares of TXU, \$9.94 per share	9,940
10 TXU'06 Jan 12.5 leap call options Total Value	850

Note: each option represents 100 shares; all calculations exclude commissions

One of the primary advantages of buying options is the leverage value. That is, for a fraction of the price of an underlying security you have the right to the leveraged gain of that security *over the life of the option* (while the maximum loss is capped at zero). In this case, rather than paying \$9940 for 1000 shares of TXU, I bought the right to pay \$12.5 per share for 2.5 years at a total cost of \$850. As \$12.5 is clearly greater than the underlying equity's price of \$9.94, your next observation will be that my option position is clearly out-of-the-money. That is if my option has no intrinsic value and is entirely made up of time value.

As a result, the intrinsic break-even point of \$13.35 (i.e. strike price + option premium) will have to be met before I make any money. That is,

-Break-even Price = \$13.35 (12.5 + 0.85)

-Annual Growth to Meet Break Even = 13.7% $((13.35 - 9.94 / 9.94) / 2.5 \text{ years})$

The key in having obtained such a relatively modest premium of 13.7% is known to investors with access to charting software. That is, following the steep decline of October 2002, the volatility of TXU (as indicated by width of Bollinger Bands (BB)) was low in July 2003 and, with the exception of a period in the latter part of 2003, did not start to rise until February of 2004 (see **Chart 1**).

Chart 1. Price and Volatility (BB)



As this article is not meant to be a treatise on market-timing, I will resist the urge to engage in too much 20/20 hindsight (i.e. the kind that suggests):

- a) I might have had the foresight to resist having sold my position during the November 2003 downturn.
- b) I might have "bitten the bullet" and bought back into the position subsequent to the November 2003 price action and prior to the run-up.

What I will point out is that this position has had an **amazing leverage effect** with TXU rising from \$9.94 to \$50.19 as of December 30, 2005.

1000 shares of TXU

	\$
Jul 2003 at \$9.94 per share	9,940
Dec 2005 at \$50.19 per share	50,190
Return	404.9%

10 calls TXU'06 Jan 12.5

	\$
Jul 2003 at \$0.85	850
Dec 2005 at 37.5	37,500
Return	4,311.8%

Conclusion:

While the message of any responsible financial professional will always be to emphasize a well-diversified, risk-appropriate core portfolio, it is not a waste of time to prospect for the type of opportunity represented by LEAP options. The sort of manageable risk leveraging opportunity you are looking for in the non-core area of your portfolio can be as close as your friendly, neighborhood option exchange.

David MacFadyen is a veteran of such firms as Marathon Brokerage, Altamira Financial Services and Mackenzie Financial. In addition to having completed the CFA program, he has made it his business to complete a number of investment courses including the C.S.I.'s Derivatives and Fundamentals Course. David is looking forward to finding another LEAP, such as TXU, albeit one he will make money on.

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