

Traders' Library
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Insider Strategies for Profiting With Options

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PROFITABLE OPTION TECHNIQUES

I. BUY PUTS WHEN STOCKS LOOK VULNERABLE AND SELLING STOCKS IS INADVISABLE

A. Reasons Investor May Not Sell Stock even when Pessimistic

1. Low cost basis
2. Likes stock as long term investment
3. Recognizes they could be wrong about down turn

B. Puts Can Actually Provide Portfolio Insurance

1. Guarantee right to sell at fixed price
2. In effect puts go up as stocks go down
3. Relatively low cost for short term insurance

C. Selecting the Proper Put Strike Price

1. Puts have many strike prices
2. The lower the strike price the less expensive the put
3. Low strike price put like large deductible in auto insurance
4. Proper strike price trade off between cost and amount of deductible

D. Selecting the Proper Put Duration

1. Investor's thoughts about when down turn will arise
2. Cost per month for Put

E. Puts for an Entire Portfolio

1. There are no puts for many small cap stocks
2. Investors may want to take a single action which will assist entire portfolio
3. Stock index puts provide coverage for an entire selection of stocks

F. An example of Puts Providing Stock Insurance

TABLE 1

IBM at 104.95, at 8/10/01 close

Strike Price	Put Prices		April
	Nov	Dec	
100	2.15	3.90	6.60
95	1.15	2.55	4.90
90	0.60	1.50	3.60
85	0.30	1.10	2.55

Conclusion: Longer term puts generally less expensive on a per week basis. Lower strike prices are significantly less expensive

II. INCREASE CASH FLOW FROM STOCKS BY SELLING COVERED CALLS

- A. Selling Calls on Stocks Brings in Cash
- B. Provides limited hedge in case of down turn
- C. Is Profitable in range from up moderately to down moderately
- D. Must be willing to Sell Stock

E. Disadvantages

1. If stock rallies sharply, profit opportunity lost
2. If stock rallies sharply, selling next call requires difficult decision
3. May give illusion of downside protection
4. Stock often called away just before dividend

TABLE 2
Call Prices (Bids) IBM 102.11 August 16, 2001

Strike Price	Sept	Oct	Jan '02
100	4.70	6.70	10.00
105	2.05	4.10	7.40
110	.75	2.25	5.20
115	.25	1.05	3.50
120		.50	2.30
125			1.35
130			1.00

Ansbacher Option Program p. 4

III. BUYING CALLS AND/OR PUTS FOR LEVERAGE OR A VOLATILITY PLAY

- A. Buying calls offers unlimited profit with limited liability
- B. What is probability of making a profit?
- C. No record of success
- D. Must be very certain stock will go up significantly in short time period. Inside information problem.
- E. Better methods
 - 1. Buy more stock by using margin
 - 2. Sell puts
 - 3. Bull spreads
 - a. Buy lower strike price call, sell higher strike price
 - b. Lowers break even point
 - c. Basically buying a call

IV. UNCOVERED OPTION WRITING -- MY FAVORITE STRATEGY

- 1. Demographics of Options Usage Favor Writers
 - A. Speculators buy them to get rich quick
 - B. Equity portfolio holders buy puts to provide portfolio insurance

Ansbacher Option Program page 5

- C. Both of above usually lose money on options purchases
 - D. Market makers generally stay short options to capture theta
- E. Important upstairs traders tend to be short options
 - F. Over long term, options buyers lose, options writers profit
 - 1. Provided writers can avoid any very large losses
 - 2. See risk control program below at 4 B

2. Selecting Options which Favor the Writer

- A. Deep out-of-the-money.
- B. Nearest expiration month
- C. Stock index vs. individual stocks
- D. Deciding to Write Puts and/or Calls
 - 1. Inherent pricing differences
 - a. Natural demand for puts
 - b. Belief that markets fall faster than they rise
 - c. Easier to imagine a market falling to prior level than making new highs
 - 2. Impact on relative put/call prices of market consensus

Ansbacher Option Program page 6

3. Measuring price differential via Ansbacher Index

- A. Find put 40 points below OEX
- B. Create synthetic call equally far out of the money
- C. Divide call premium by put premium
- D. Contrary interpretation
- E. Smaller Ansbacher Index is more bullish

4. Limiting Risk by Taking Little Losses to Avoid Big Ones

- A. Most important point for writers is to avoid large loss
- B. Four Point Risk Control Program
 - 1. Strictly limit number of positions
 - 2. Have stop-loss order entered for every position
 - 3. Write only short term deep out-of-the-money options
 - 4. Only write options when market value of outstanding options is less than 10% of equity
- C. Efficacy of Risk Control Program demonstrated in October 1997 market plunge

5. Constructing an Uncovered Option Position

Table 3

SPU Option Settlement Prices 8/17/01 SPU Settled 1165.50

September Strike Prices

Calls	Settlement Prices	Puts	Settlement Prices
1290	1.00	1110	13.40
1285	1.20	1105	12.40
1280	1.4	1100	11.50
1275	1.70	1095	10.60
1270	2.00	1090	9.80
1265	2.30	1085	9.10
1260	2.70	1080	8.40
1255	3.20	1075	7.80
1250	3.70	1070	7.20
1245	4.30	1065	6.75
1240	4.90	1060	6.30
1235	5.60	1055	5.80
1230	6.50	1050	5.30
1225	7.60	1045	4.95
1220	8.70	1040	4.60
1215	10.00	1035	4.30
1210	11.40	1030	4.00
1205	13.00	1025	3.70
1200	14.80	1020	3.40
		1000	2.60
		990	2.30
		980	2.00

Ansbacher Option Program page 8

6. Opening an Uncovered Options Brokerage Account

A. Special Requirements for Naked Option Writing

1. Age

2. Net Worth, Income

3. Minimum Account Size

B. Margin Requirements

1. Typically 20% of the stock or index minus amount out of the money

2. Minimum Requirement of 10%

C. Using Spreads as An Alternative

1. Lower Requirements to Open Account

2. Risk Is Limited Instead of Unlimited

3. Margin Requirements May be Easier

4. May Not Be As Profitable

7. A New Class of Investment Asset

A. Unique investment characteristics

1. Gives investor large upside potential

2. Substantial profits likely in flat markets

3. Can be profitable in down as well as up trending markets

4. No "add-on" hedges needed

Ansbacher Option Program page 9

B. Excellent performance track record

1. Average annual return
2. Highest Return of any Manager in 1997

C. Non-correlated with:

1. Many traditional managers
2. Equities markets

D. Conclusion

1. Underutilized by funds of funds
2. Significant benefits to investors
3. Profit on options writing bears similarity to business style of insurance companies and banks
4. High performance based on continuing purpose of options

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THE ANSBACHER INDEX

The Ansbacher Index is an indicator of the bullish or bearish sentiment of options traders which can be useful in forecasting the future direction of the stock market. This sentiment is measured by comparing the price of a put approximately 40 points below the current price of the Standard & Poor's 100 Index (OEX) with the price of a call the same amount above the OEX. The price of the call is then divided by the price of the put to obtain the current Ansbacher Index.

How it Works

A 1.00 reading of The Index is the theoretical neutral. In practice, perhaps because so many owners of stock are natural buyers of puts to hedge their positions, neutral appears to be between 0.70 and 0.90. A Figure less than 0.70 is regarded as bullish for the stock market, with The Index becoming more bullish as the number decreases. An Index of over 90 is bearish, with The Index becoming more bearish as it moves higher.

The relevance of the Index to future moves in the stock market is based upon the contrarian theory that when most people are bullish the stock market is likely to go down, and when they are bearish it is likely to go up. This is ascribed to the fact that when a person is really bullish, he has already bought all the stock and calls he or she is likely to buy, and therefore there is not much more the person can do to cause the market to rally. If, however, the market goes down, there is a lot of selling the investor will probably do which will intensify the downturn. The reverse is true when a person is really bearish.

In The Ansbacher Index, the higher the price of the put is compared to the price of the call, the lower The Index will be. For example, if a put were 2 and the call were 1, The Index would be 0.5. If the put and call were equal, The Index would be 1.0, and if the put were 1 and the call 2, The Index would be 2. Thus, the more people are willing to pay for puts, which is a way of indicating that they are bearish, the lower The Index will be, and based upon the contrarian theory, the more bullish The Index is.

Calculating The Index

To calculate The Index one starts with the current price of the OEX. Then one goes down approximately 40 points to the put with a strike price at that level. Then one

THE ANSBACHER INDEX PAGE 2

goes up 40 points from the OEX and finds the price of the call there. Next, divide the price of the put into the price of the call. The options which have between three and seven weeks left until their expiration are the ones which are used.

Here is a simplified example: OEX is 800. Going down 40 points we come to the 760 put which is $2 \frac{1}{8}$. Going up 40 points we come to the 840 call which is $1 \frac{3}{4}$. All fractions must be converted to decimals. $2 \frac{1}{8} = 2.125$. $1 \frac{3}{4} = 1.75$. We then divide 1.75 by 2.125, obtaining 0.82, which is within the neutral band.

In an actual example, the OEX is unlikely to be exactly 40 points away from a strike price, which requires another step. Let's assume that the OEX is 801.50, and that the 760 put is still $2 \frac{1}{8}$, that the 840 call is now 2 and the 845 call is $1 \frac{1}{8}$. By going down 40 points from the OEX we arrive at 761.5, which is not the strike price of any put. But it is nearest to the 760 put, so we will use that put at $2 \frac{1}{8}$. But note that we had to come down 1.5 points to get there. Now, when we want to find the appropriate call, we must add the same amount to the OEX as we subtracted to get to the put. In other words, to keep the index accurate, we must go exactly as far up for the call as we went down for the put.

Adding 41.5 to 801.50 gives us 843.00. Of course there is no 843 strike price call. What we must now do is to compute what the price would be if there were such a call. We do this by taking the appropriate average of the actual calls which are above and below this figure. Here the 840 call is 2, and the 845 call is $1 \frac{1}{8}$ (1.125)

To calculate the approximate value of a 843 call, we subtract the difference between the two prices, here $2 \text{ minus } 1.125 = 0.875$. Then divide this by 5, which gives 0.175. This is the average change in the price of the call for each one point change in the call's strike price. This figure is then multiplied by the amount by which our theoretical strike price is above the strike price of the lower call. Here we are looking for an 843 theoretical strike price, and the lower call is an 840, so the difference is 3. Multiply 3 by $0.175 = 0.525$. This is then subtracted from the price of the lower call. Here that is $2 \text{ minus } 0.525 = 1.475$. This is the price of a call with a theoretical strike price of 843, which is exactly the same amount above the OEX as the 760 put was below it.

Now we can find The Ansbacher Index by dividing the price of the theoretical 843 call, 1.475, by the price of the 860 put, 2.125. $1.475 \div 2.125 = 0.69$, which is just slightly bullish.

Rolling Out to the Next Month

One problem which arises if one keeps a record of the Index week after week is that the number of weeks left in the options' life has an impact on the result. The nearer-term options are likely to be more extreme in their reading, whether they are bullish or bearish, whereas the further out readings will be closer to neutral. Therefore, when one moves out from one month to the next, there is likely to be a large change in the Index.

In order to smooth this out, we must constantly take readings further out each week. Here's how this is done: Let's assume that we are seven weeks away from an expiration date, and we are using January options. The following week, instead of using only January options, we compute the Index using both the January and February options. Then we combine the two numbers, giving a 75% weight to the January figure, and bringing in the February figure with a 25% weighting. The following week, we decrease the weighting of the shorter term options by 25% to 50% and we increase the weighting of the further out option by 25% to 50%. This continues each week, so that the next week the January is weighted only 25% and the February is weighted 75%.

This method of constant forward rolling reduces the large changes which occur when one month is used for four weeks and then scrapped for the next month. Once a quarter there is no change, to allow for the fact that there are 52 weeks in the year rather than 48.

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