



*This tutorial was originally titled  
“Fundamentals of Options - LEAPS®”*

# **LEAPS Strategies**

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## **LEAPS®**

- **Long-term Equity Anticipation Securities**  
Expiration dates up to 2 1/2 years away
  - January 2002 & 2003
- **Different symbols**
  - 2002 (W) & 2003 (V)
  - [www.cboe.com/tools/symbols/leaps](http://www.cboe.com/tools/symbols/leaps)
- **All types of strategies**



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## **Option Pricing**

- **Stock price**
- **Strike price**
- **Time to expiration**
- **Interest rate**
- **Dividends**
- **Volatility**



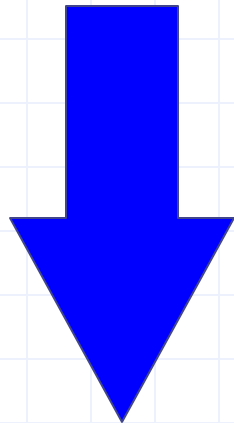
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## **Interest Rates**

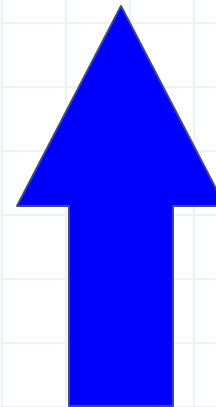
**How will short-term interest rates move over the next 2 years?**

**Increase in Interest Rates:**

**Put Premiums**



**Call Premiums**



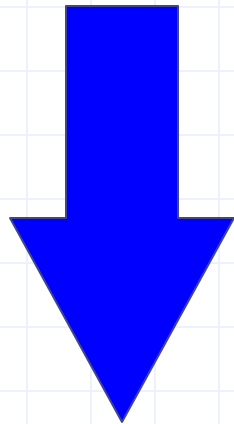


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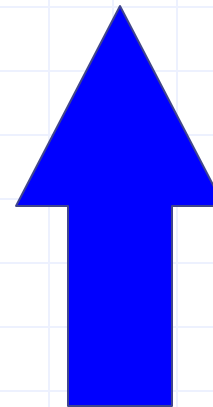
## **Dividends**

**Increase in Dividends:**

**Call Premiums**



**Put Premiums**





## Time Decay of Options

### LEAPS Time Decay



\*\$100 stock, 100-strike call, 30% vol, 5% interest rate, no divs.



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## What if the Stock is a Dud?

- Compare at-the-money Calls on unchanged Stock (50 strike Calls on \$50 Stock):

	3-Month Option	2-Year LEAPS®
Now:	3.33	10.97
One month later:	2.67	10.69
Two months later:	1.84	10.42
Three months later:	0.00	10.13



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## What if You're Right?

- Compare the calls if the stock goes up 3 1/4:

	3-Month Option	2-Year LEAPS®
Now, Stock @ 50:	3.33	10.97
Stock Increases...		
Stock @ 53 1/4:	5.44	13.32
One month later:	4.81	13.04
Two months later:	4.04	12.75
Three months later:	3.25	12.45





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## **LEAPS<sup>®</sup> Strategies**

- **Bullish**  
*LEAPS<sup>®</sup> Calls as a stock alternative*
- **Bearish**  
*LEAPS<sup>®</sup> Puts to protect a stock position*
- **Neutral**  
*LEAPS<sup>®</sup> in covered writing*



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## **LEAPS<sup>®</sup> Bullish Strategy**

**Buy deep ITM LEAPS<sup>®</sup> Call as an alternative  
to buying Stock**

**Example:**

**Stock @ \_\_\_\_\_**

**Buy \_\_\_\_\_**



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## **LEAPS<sup>®</sup> Bullish Strategy**

### **Stock on Margin**

- Buy 100 shares \_\_\_\_\_
- Cash down \_\_\_\_\_
- Finance \_\_\_\_\_
- X\_\_% margin \_\_\_\_\_ mo.
- “Cost of Carry” \_\_\_\_\_
- \$ Risk \_\_\_\_\_

### **LEAPS<sup>®</sup>**

- Buy 1 \_\_\_\_\_
- Cash down \_\_\_\_\_
- Invest \_\_\_\_\_ @\_\_%
- \_\_\_\_\_
- “Cost of Carry” \_\_\_\_\_
- \$ Risk \_\_\_\_\_



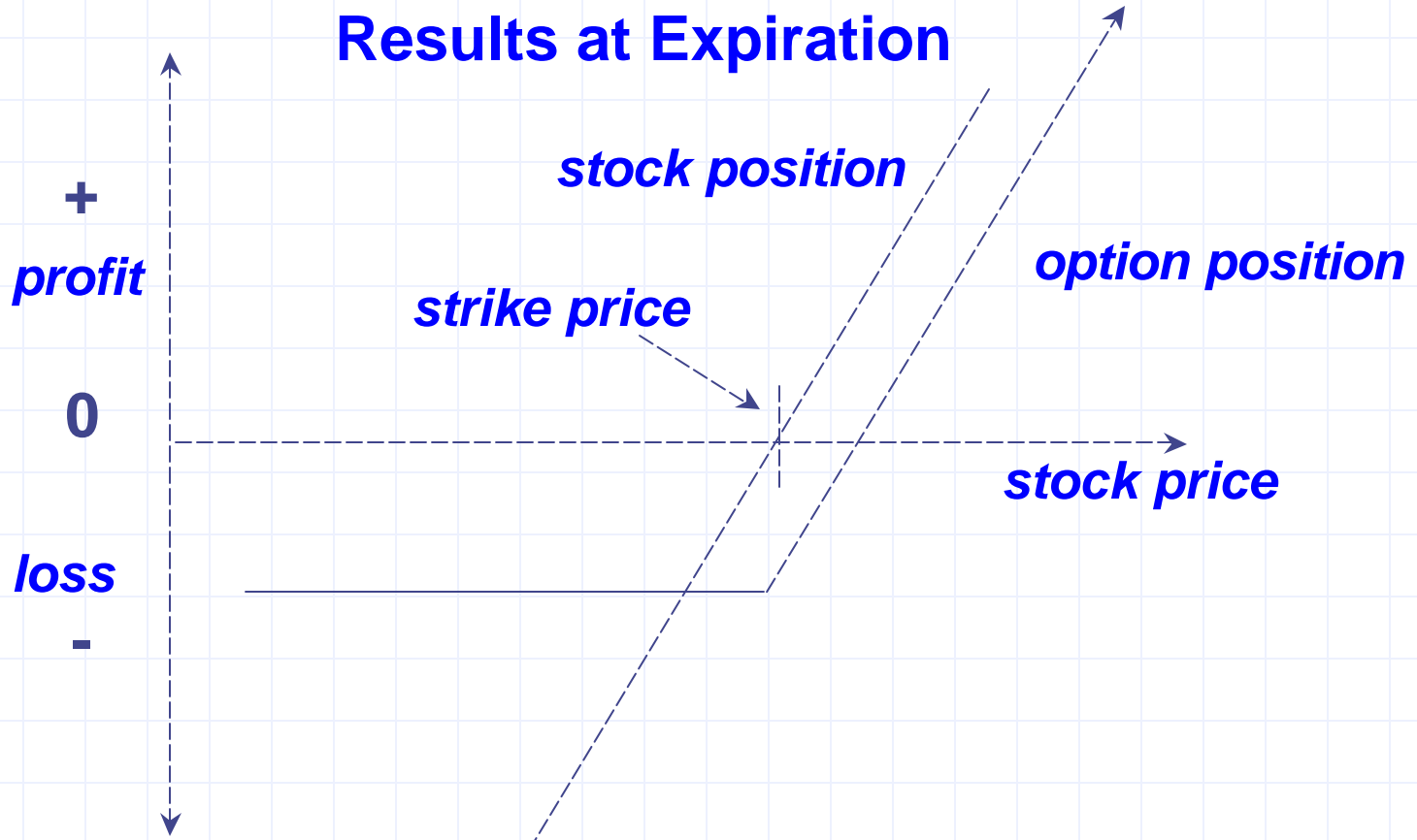
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## **LEAPS® Call Purchase**

- **Less cash required**
- **Can be lower cost of carry (dividends)**
- **Lower overall risk**
- **Options don't have dividends/votes**
- **Options expire - stock does not**
- **Your margin cost may be different**



## LEAPS® Call Purchase





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## **LEAPS® Protective Strategy**

**Purchase Put options against shares  
already owned**

**Example:**

**Stock @ \_\_\_\_\_**

**Buy \_\_\_\_\_**



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## **LEAPS® Put Purchase**

- **Already own shares**
- **Concerned about \_\_\_\_\_**
- **Don't wish to sell shares now**
- ***Tax considerations?***
- **LEAPS® Puts as a type of “term insurance”**



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## **LEAPS<sup>®</sup> Put Purchase**

Own 100 shares \_\_\_\_\_ @ \_\_\_\_\_

Purchase one \_\_\_\_\_ Option @ \_\_\_\_\_

Total investment per share \_\_\_\_\_

Put exercise price (strike price) \_\_\_\_\_

Total risk: \_\_\_\_\_





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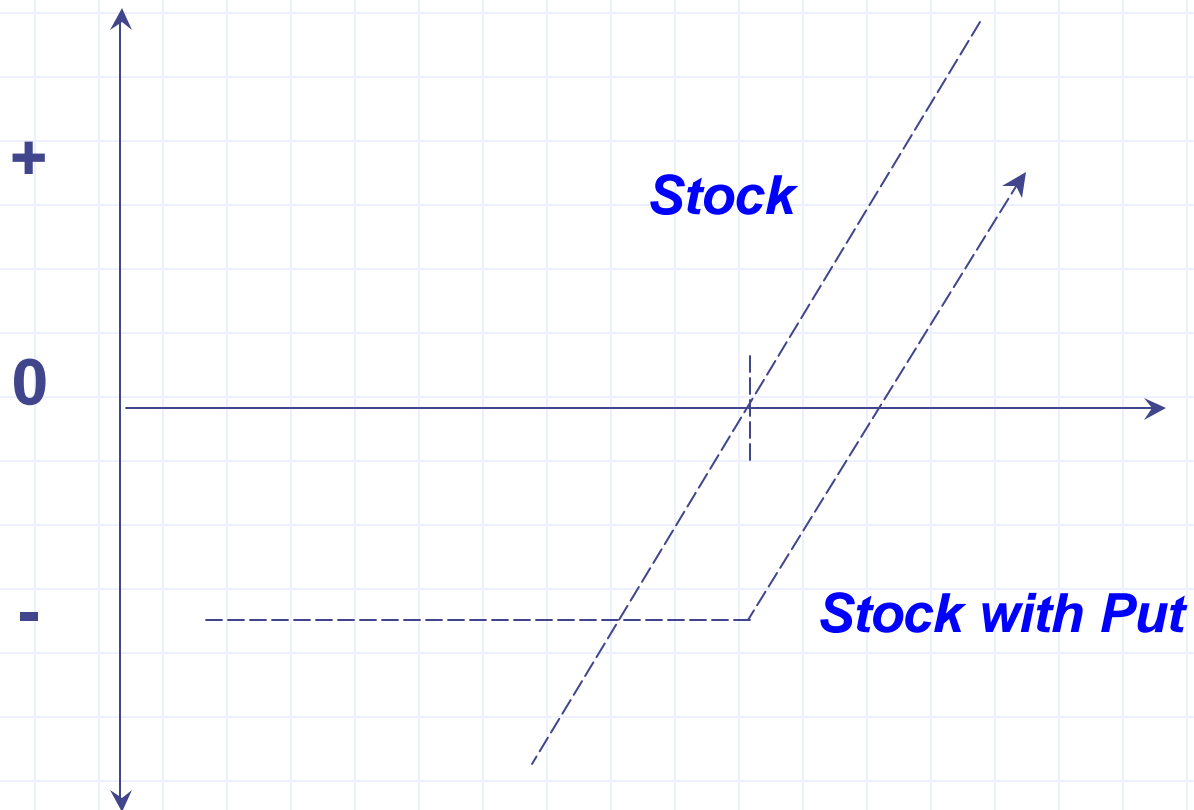
## **LEAPS<sup>®</sup> Puts – Pros & Cons**

- **Protection at a fixed cost**
- **Flexibility: keep the shares / keep the dividends**
- **Limited cost / limited risk**
- **Protection can be expensive**
- **Increases overall position cost/break-even**
- **Puts expire, stock does not**
- **Periodic check-up**



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## Stock Position with Put





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## LEAPS<sup>®</sup> Covered Writing

- Buy (own) shares
- Sell (write) LEAPS<sup>®</sup> OTM Calls against shares (1-1)

### WHY DO IT?

- Neutral to moderately bullish on stock, to a point
- Willing to sell at a price
- Want to increase returns over dividend income
- Want to lower break-even, and want some downside protection

*(protection is limited to premium received)*



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## **LEAPS<sup>®</sup> Covered Writing**

**Buy 100 Shares \_\_\_\_\_ Stock @ \_\_\_\_\_**

**Sell 1 \_\_\_\_\_ Call Option @ \_\_\_\_\_**

**Net Cost (break-even) \_\_\_\_\_**



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## At Expiration

### “If-called” Rate of Return

- If Stock above \_\_\_\_\_ (strike price)  
short Call will likely be assigned

You sell stock @ \_\_\_\_\_ (strike price)

Less cost \_\_\_\_\_

Profit = \$ \_\_\_\_\_ ROR = \_\_\_\_\_



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## Stock Unchanged At Expiration

### Static Rate of Return

★ Keep Stock position (Call not assigned)

▪ Keep premium \_\_\_\_\_

Investment \_\_\_\_\_

*(cost - premium)*

ROR = \_\_\_\_\_%

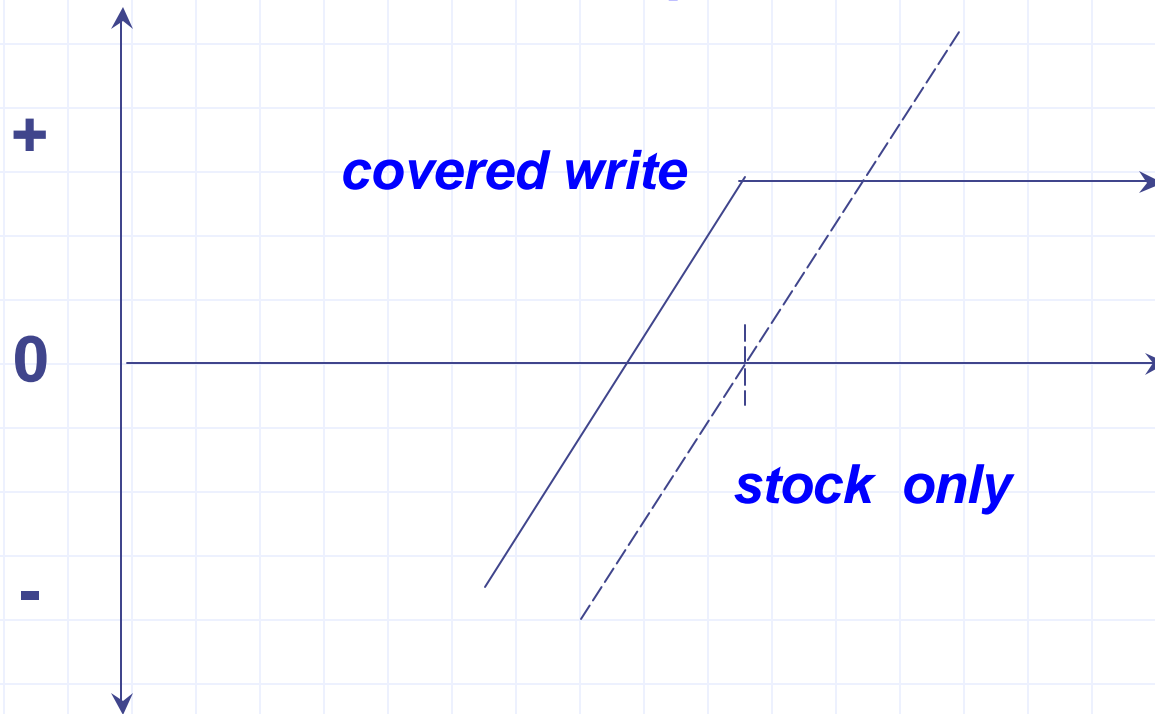
\* *NOTE: below break-even (\_\_\_\_) losses will occur*



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## **LEAPS<sup>®</sup> Covered Writing**

### **Results at Expiration**





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## **LEAPS<sup>®</sup> Covered Writing**

- **Increase returns in flat markets**
- **Provide some downside protection**
- **Makes time erosion work for you**
- **Disciplined approach to investing**
- **Limited upside**
- **Can be assigned early for dividend**
- **Limited downside protection**





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## **Covered Writing Using LEAPS®**

- **Can I write a short-term option against a LEAPS® Call?**



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## **Covered Writing Using LEAPS®**

**ZYX @ 60**

**Long ITM LEAPS® Call Instead of Stock:**

- Long 1 ZYX 18-month, 45 call @ 17.25

**Short (Short-term) Call:**

- Short 1 ZYX 3-Month, 65 call @ 2.25



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## Covered Writing Using LEAPS®

- ZYX @ 60
- Long 1 ZYX 18-month, 45 call @ 17.25
- Short 1 ZYX 3-month, 65 call @ 2.25

If ZYX rises above 65 by expiration of short call, the holder is obligated to sell ZYX stock at 65 no matter how high the stock has risen, however the holder would exercise the long call.

In exchange for the obligation, the seller is paid a premium, that reduces the breakeven on the long LEAPS® position.



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## Cost of Position

- ZYX @ 60
- Long 1 ZYX 18-month, 45 call @ 17.25
- Short 1 ZYX 3-month, 65 call @ 2.25

$$\begin{array}{r} 17.25 \text{ (Long LEAPS® premium)} \\ - \quad 2.25 \text{ (Short call premium)} \\ \hline 15.00 \text{ (Net cost)} \end{array}$$



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## Breakeven

- ZYX @ 60
- Long 1 ZYX 18-month, 45 call @ 17.25
- Short 1 ZYX 3-Month, 65 call @ 2.25

$$\begin{array}{r} 45 \quad (\text{Long Strike}) \\ + \quad 15 \quad (\text{Net Cost}) \\ \hline 60 \quad (\text{Breakeven}) \end{array}$$



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## **Covered Writing Using LEAPS®**

- **The investor hopes that the short-term call written against the LEAPS® will expire worthless.**
- **Investor can “roll” the short-term to further out months and collect additional premium and reduce this cost once more.**
- **The risk is assignment . . . . .**



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## **XYZ Above 65 (Short Call Strike)**

**Assigned on short Call and  
Exercise long Call**

<b>Sell ZYX</b>	<b>65</b>
<b>Long ZYX @</b>	<b>- 45</b>
<b>Cost of Spread</b>	<b>- 15</b>
<hr/>	
<b>Profit*</b>	<b>+ 5</b>

*\*Maximum profit through expiration of short call.*



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## **XYZ Below 65 (Short Call Strike)**

**Short Call expires worthless...**

**Long LEAPS<sup>®</sup> Call at 60 (breakeven)**

**Can sell another Call option**





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## Summary

- **Willing to place a cap on how much profit can be earned...**
- **In exchange for accepting a cap, the seller is paid a premium...**
- **Thereby lowering breakeven on long LEAPS® Call position.**



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## Summary

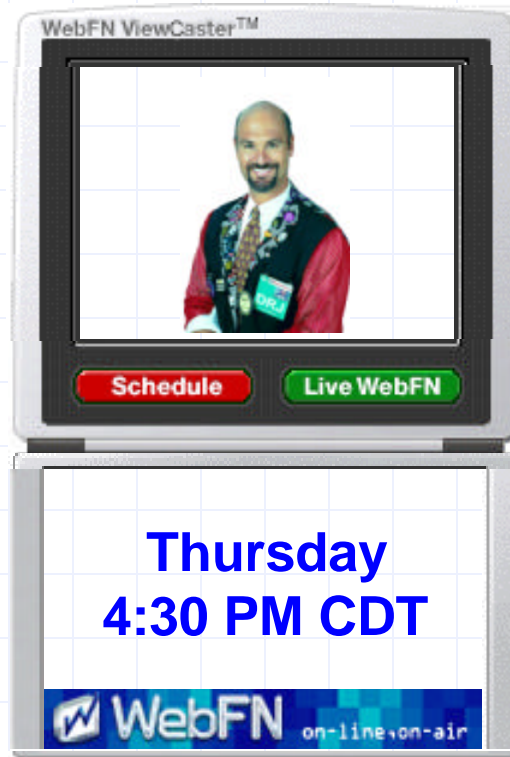
### LEAPS®

- Can be useful in all markets
- Can be a strategic tool for risk management
- Help combat one of the greatest enemies of options buyers:

***TIME EROSION***



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## “Doctor J and the Traders”