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Buy Write Strategy

A strategy of buying stock and forward selling is called covered writing or a “Buy and Write” strategy. A call is a contract that entitles the buyer to purchase from the seller a fixed number of shares at a fixed price up until the expiry date. A covered call writer therefore only sells a number of calls equal to the number of shares already owned. The underlying share price of a stock would have to rise substantially to outperform the covered writer.

A few basic points on the Buy and Write:

1. The major risk in a Buy and Write strategy is the price paid for the stock. Investors should only buy stock at a price that represents fundamental value.
2. Equally the investor must be prepared to sell stock at the strike price of the option should the share price rise.
3. The Buy and Write strategy is used primarily by investors who are interested in generating income. Private investors often have unrealistic expectations for share price growth and underestimate the inherent risk and cost of buying and holding physical shares. A growth stock that does not have a high dividend may trade in a tight range for a period of time. This would mean that the investor would not receive sufficient return to compensate for the holding costs. A strategy of combining a physical stock purchase with writing calls can provide the investors with a minimum return for a given period at an acceptable level.

Once a share price moves up, there are several different actions the investor can take.

1. Liquidate the position by selling the underlying shares and repurchasing the call option sold. This is usually only considered where the delta on an option is close to one.
2. Roll up to a higher strike price. This is done by repurchasing the option sold and recording a loss, but then selling a higher strike price to record a greater net gain should the share price continue to gain.
3. Create a spread by purchasing a higher strike price than the strike price already sold. This would create a bear call spread. The underlying stock could then be sold out.
4. Do nothing and allow the estimated returns from the buy and write to stand.

Here is an example of a buy write strategy showing the difference in **capital only** and also **Margin Lending**:



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NSX
THE NATIONAL STOCK
EXCHANGE OF AUSTRALIA



Lihir Gold – LGL – 12th December 2008 – 76 days until February expiry				
Capital only				
Buy/Sell	Stock	Units	Price	Total
Buy	LGL	4000	\$2.46	(\$9,840.00)
Sell	LGL Feb 250	4	\$0.30	\$1,200.00
Calls				
				(\$8,640.00)
Downside protected to \$2.16				
Standstill return – 12.19%		Annualised – 58.56%		
Exercise at expiry return – 13.82%		Annualised – 66.37%		
Using Margin Lending with an borrowing interest rate of 9% p.a. and a Loan to Value Ratio (LVR) of 60%				
Buy/Sell	Stock	Units	Price	Total
Buy	LGL	4000	\$2.46	(\$9,840.00)
Sell	LGL Feb 250	4	\$0.03	\$1,200.00
Calls				
				(\$8,640.00)
Initial capital required per share - \$0.984 Total initial capital - \$3,936				
\$0.984				
Total Interest cost for 76 days @ 9% - \$110.64				
Downside protected to \$2.16				
Standstill return – 27.67%		Annualised – 132.92%		
Exercise at expiry return – 31.74%		Annualised – 152.44%		



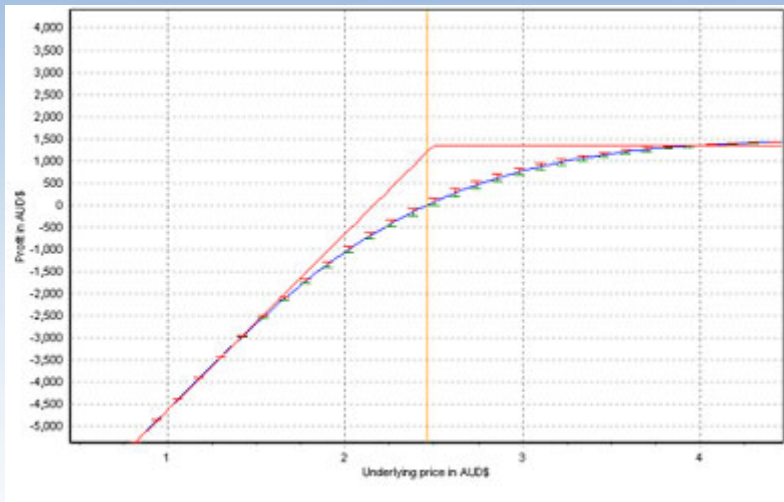
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If you are interested in these strategies you should contact an experienced broker. MDS Financial maintains offices in Sydney, Melbourne and the Gold Coast and NISER can assist local businesses or individuals contact them. Sean Rothsey is Executive Chairman of the ASX listed diversified financial services company MDS Financial Group Ltd. (MWS: ASX). He works in Cooroy and lives in Sunshine Beach.

If you would like to discuss these issues further please contact Sean Rothsey at niser@niser.org.au or 5442 5050 or your own financial advisor or visit www.mdsfinancial.com.au

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