

Module 6: Strategy #4: The “Stock Repair” Strategy: Ratio spreads



Module overview

- When a stock unexpectedly crashes, an option strategy can be used to help repair the damage to your portfolio
- This is an alternative to "hold and hope" or "double up" strategies
 - The "hold and hope" strategy involves hoping a stock recovers its loss all the way back to the investor's purchase price, an event that may be a long time in the making.
 - The "double up" strategy involves purchasing additional shares at a now lower price, lowering the investor's break-even point

Strategy overview

- The repair strategy can be used with a stock that is trading at a lower price than the investor's original cost
 - For every 100 shares held, you will buy 1 call option and sell 2 call options with a higher strike price
 - All options having the same expiration month
 - Your cash outlay will be minimal and it's possible selling the options will result in a credit to your account
- That ratio is constant: buy 1 and sell 2 for each 100 shares

Example

- Assume you bought AAPL at \$125, watched it fall to \$92 (a 26% decline) and are now concerned about more losses
- For each 100 shares you own, a repair strategy could buy 1 \$110 call expiring in two months for \$1.05 and sell 2 \$115 calls expiring in two months for \$0.60 for a credit balance of \$0.15 ($-\$1.05 + (2 * 0.60) = \$0.15$)
- This is equivalent to two covered call positions

Example: Possible outcomes (slide 1 of 3)

- If AAPL falls to \$85, the calls all expire worthless but the cost basis has been lowered by \$0.15 (0.1%) which isn't much but helps
- If AAPL is unchanged, the options all expire worthless and the cost basis is reduced by 0.1%
- If AAPL rises to \$115, the calls you sold expire worthless but the call you bought is worth \$5 and the basis is reduced by \$5.15 including the credit from calls sold to \$119.85. You can now open a new repair trade

Example: Possible outcomes (slide 2 of 3)

- If AAPL rises to \$120, the call you bought is worth \$10 and the two you sold are worth \$10 ($2 * \$5$)
 - The options cancel out and you still hold the shares of AAPL which have now almost fully recovered
 - You can do another repair trade, implement another option strategy or simply hold the shares

Example: Possible outcomes (slide 3 of 3)

- If AAPL rises to \$150, you suffer a small loss
 - The call you bought with a \$110 strike price is worth \$40 and the two you sold with a \$115 strike price are worth \$70 ($2 \times \$35$)
 - If you close the options with a “buy to close” order you suffer a \$30 loss but have a \$25 profit on the shares you bought so your loss is \$5 (\$500 for 100 shares)
 - If you allow the options to be exercised, you receive \$23,000 for the two calls that are exercised and deliver 200 shares at a total cost of \$23,500 for a loss of \$500

Bottom line

- The goal of the strategy is to reduce the investor's break-even price, without having to assume any additional downside risk
 - If the stock declines more, you will still lose money on the stock but the losses can be offset with small credits from the strategy
- If the stock increases significantly, you have limited upside unless you unwind the trades
 - You can always close an option trade before expiration

To implement Strategy #4

- This strategy works best with stocks that are down 20% to 30% (or less)
 - It does not work well with stocks that are down 40% or more because the premiums on options that far out of the money do not allow for significant repair
- Calls with 60 to 90 days to expiration work best because they tend to have significant premium
- Look for options with strike prices that are about halfway between the market price and your cost basis

What's next?

- Strategy #5: Buying puts for protection