

## Buy & Hold Options

### Requirements

- Access to an Options Brokerage account
- Knowledge, understanding and practice in buying/selling Options
- Medium to Long-term market outlook

### Benefits

- Using the same principles for decision-making for investment with stocks
- Purchasing long-term options requires a smaller investment to hold value of the same underlying stock position. Example; \$10,000 of stock might be approximately \$1,000 of option value.
- Risking smaller amount of investment capital to gain a larger percentage of profit.
- Can Buy an option that benefits from the markets increasing, or decreasing.
- Can also adopt defensive strategies if the markets change conditions.

### Risks

- Lack of understanding can cause investors to pay too high a price for options or to purchase wrong options to suit expected goals.
- Education and practice are required to gain a thorough understanding of options. This takes time and patience.
- 100% of position could be lost if position is not managed correctly
- Different strategies could be adopted depending on the investors outlook for the stock and time-frame for investment

### How to ...

- Decision on direction and long-term expectations for company must be established
- Choose the type of Call option you wish to purchase. This includes what strike price and expiration (for more information on option terminology, see Option Basics section)
- Establish exit criteria before entering into position. How long will you hold the position if it is shifting against you? At what point will you close the position for a profit? (See Trading Plan section)
- Purchase selected Call option (or Put option if directional outlook is down/Bearish).

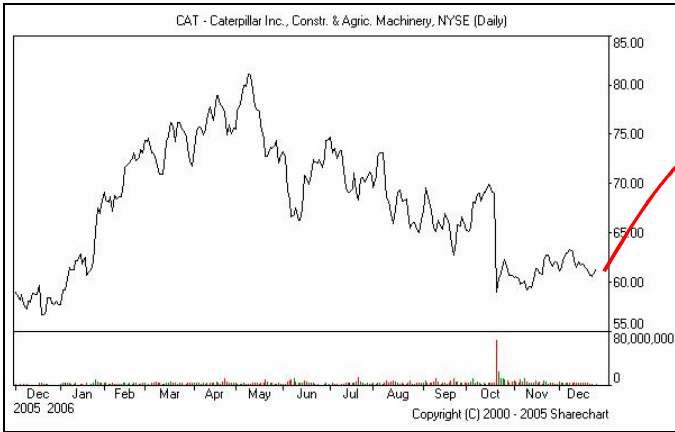
### Tips & Hints

- Only purchase options if you fully understand how they work, and have practiced with choosing positions
- Long-term (long expiration date) options can be purchased, and strike prices on different levels. Different options will suit different outlooks for time.
- As with any investment strategy, only invest capital that you can afford to invest with.
- An understanding of Volatility, the Greeks and Theoretical values will help establish which option contract to trade.
- Establish a clear and precise plan for entry and exit.
- Although you use less capital on the one position, do not increase the amount of money you use. Example, you may buy \$10,000 of stock, but do not buy \$10,000 of options. Purchase \$1,000 of options or 10% of the value you would use on stocks (this is an example)

# FMR Analysts

INDEPENDENT STRATEGY ANALYSIS

**Example**



Expecting share price to rise over time

- CAT (Caterpillar Inc) has retraced through most of 2006.
- Investor believes that CAT is a fundamentally strong company
- For last 2 months, stock price has held above \$60 per share
- Investor believes that CAT will be worth more then \$60 over the coming year, potentially trading back to last long term high around \$80

Decision has been made to enter into a long-term Call option - The Jan2008 60.00 Call. Based on the quote below, it would cost \$8.20 per share.

Symbol	Last	Change	Bid	Ask	High	Low	Volume
CATERPILLAR INC	61.47	▲0.57	61.11	62.38	61.58	60.90	2,773,800

Strike	Symbol	Last	Chg	Bid	Ask	Day High	Day Low	Vol	Open Int
55.00	WKTAJ	10.60	0	10.90	11.10	0	0	0	3,048
60.00	WKTAL	8.00	+0.30	8.00	8.20	8.20	7.80	51	8,611
65.00	WKTAM	5.60	+0.20	5.60	5.80	5.70	5.60	41	4,136
70.00	WKTAN	4.00	+0.40	3.80	4.00	4.00	4.00	23	7,068

(387 days to expiration)

Yellow options are in-the-money

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INDEPENDENT  
STRATEGY ANALYSIS

- The current stock price for CAT, according to the quote above is \$61.47 per share.
- If we were investing \$2,000, we would be able to purchase 32 shares in CAT.
- Using the Jan2008 60.00 call option which is quoted at \$8.20 per share, we could purchase 2 call options with our \$2,000.
- Because 1 option contract = 100 shares, this is the equivalent of purchasing 2,000 shares, the value of which = \$12,000
- The worse case scenario is that the share price falls significantly. We could lose the value of our options, decreasing from \$8.20 per share to \$0. Which would mean a 100% loss.
- If the share price rises back to its last long-term high around \$80, the share position would have gained \$20 per share, or 33.33%
- It is difficult to clearly explain how the option price would react, however, it is estimated that there would be an approximate 150% gain (using a Delta of 0.63 - see advanced options education) for the same \$20 stock price movement.

## Order Placing

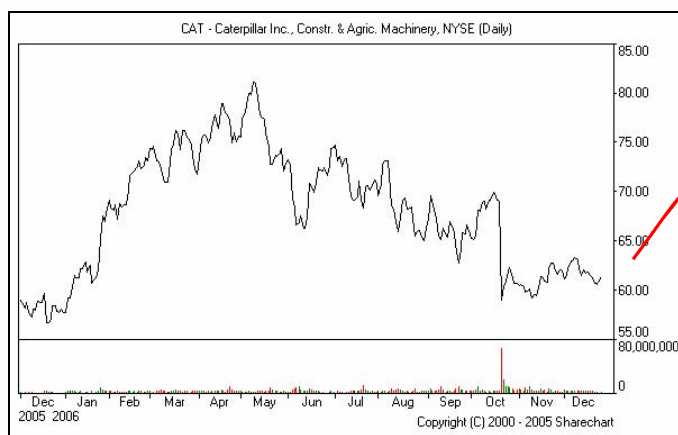
Buy to Open (BTO), January 2008 60.00 call options. Code: .WKTAL

- When entering into option positions, the investor must be specific with their terminology.
- The first section of the order denotes what the action is - Buy to Open the trade.
- The next section of the order denotes what option - the January 2008 60.00 calls.
- Finally, the trader will need to specify how to transact the order; 1) at market value (the current price), 2) at a limit (a maximum price paid), or 3) some sort of advanced order (beyond the scope of this explanation).

*Special Note: For investors who have a negative outlook for a company, the same type of long-term position can be entered where gains are made on the stock price decreasing. This is done using a Put option contract.*

## What to do if ...

If the stock price rises:



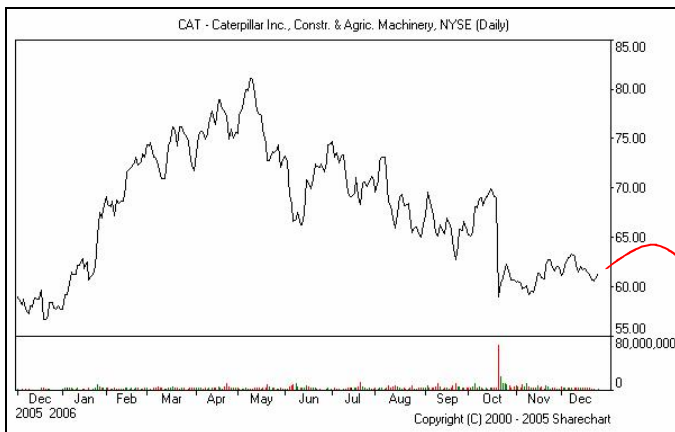
- This price movement will benefit the Call Option, but negatively affect the Put Option.
- Use profit strategy for Call options, but adopt exit strategies for Put Option contracts - Keep losses short.
- Hold Call position as long as you believe there is reason for the stock to continue rising. Example; company remains fundamentally strong, stock price maintains an upwards trend, and/or positive sentiment remains with company

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INDEPENDENT  
STRATEGY ANALYSIS

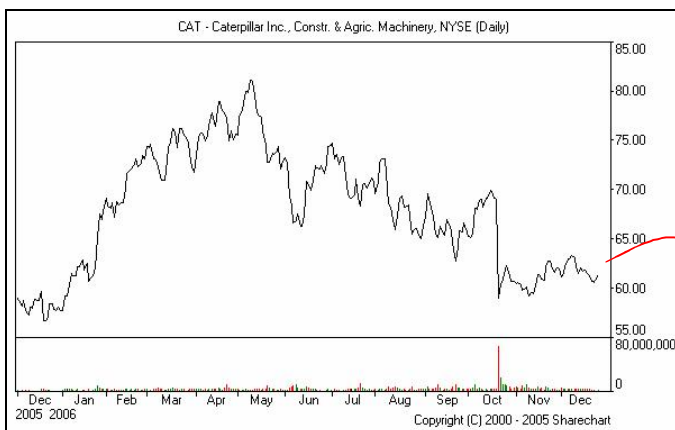
- Be aware, that there may be short-term counter-trend retracements, where the stock price falls slightly before resuming upwards trend
- Time decay (see Option Basics) will affect the option value. Therefore, the position must be exited at some point before the due (expiration) date of the option. As a basic rule of thumb, exit the position no later than 1 or 2 months before the expiration date.
- Establish pre-determined points to exit, either at a monetary/percentage value or based on time

If the stock price remains steady:



- Establish a “time frame” for exiting the position. Option contracts are inhibited by time. Within the last month or two of the contract, a decay in Time Value will affect the value of the option. Therefore, depending on the strategy of your trading/investing, exit the position before Time decay takes a heavy toll on the value of your position.
- Is there a reason for the stock price failing to find direction? Could the stock find the bullish/upwards activity you were expecting, or could it eventually find sellers?
- Rule of thumb ... the longer the stock price holds the support level, the stronger the sentiment becomes that buyers could prevail. But once that support level is broken, it is clear there are no interested buyers in the market - exit the option position.

If the stock price falls:



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INDEPENDENT  
STRATEGY ANALYSIS

- This will benefit bought Put Options, but cause a loss in Call Options
- Adopt profit strategy for Put options, but look for an Exit strategy for Call options - Keep losses short ....
- In the above example, the position was entered because support around \$60 had been identified, suggesting that buyers found the stock as a “good buy” at that level. If the stock price were to break the support level, then the reason for entering a Call position is no longer valid. The position should be closed
- Establish a value at which you are willing to exit the Call options. This could be determined by a percentage fall in stock price, or maybe a dollar loss.
- Maintain discipline. When the option price reaches your exit point, close the trade - no matter what your expectations are. If the stock price recovers, you can re-enter later. However, if the stock price continues to fall, you will realize a loss.

## Defensive action ...

For either call or put options, if the stock price is moving against your expected directional outlook, then the position will lose value. Defensive action can be taken to limit the risk of the position. These are Advanced Option strategies.

### Bought Call options

- Sell to Open call options at different strike price - This is known as a debit spread. You receive money for Selling the call option, off-setting the cost of purchasing the original Call option (see Advanced Option strategies)
- Buy to Open put options at same/different strike price - this is known as either a Straddle or a Credit spread. It will cost to purchase the options, however, should the stock price significantly shift against you, the bought put options will gain in value, offsetting your original bought call option.

### Bought Put options

- Sell to Open put options at a different strike - this is known as a debit spread. You receive money for Selling the put option, off-setting the cost of purchasing the original Put option (see Advanced Option strategies)
- Buy to Open call options at same/different strike prices - this is known as either a Straddle or a Credit spread. It will cost to purchase the options, however, should the stock price significantly shift against you, the bought call options will gain in value, offsetting your original bought put option.

*Special Note: Advanced option strategies can initially be entered, rather than as a reactionary action. They are designed to limit risk of the position, in turn, limiting the profit potential of the trade.*

## Disclaimer

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