



Increasing Profits Without Increasing Your Risk

Options Trading for The Conservative Investor

THE SUMMARY IN BRIEF

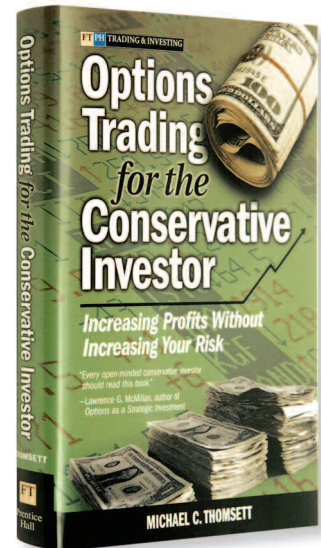
If you're an investor concerned with preserving capital, maximizing predictability and maintaining consistently strong returns, your best solution just might surprise you: Options. In *Options Trading for the Conservative Investor*, Michael C. Thomsett reveals a narrow band of options strategies that can help you improve results as you systematically reduce unnecessary risk throughout your portfolio.

To some conservative investors, options are too exotic and too risky. But we proceed on the premise that a conservative investor is not necessarily someone who does not want to expand beyond a well-understood and short list of investment possibilities. Being a conservative investor does not necessarily mean that you are unwilling to examine new ideas, expand your portfolio, or take acceptable risks. It means that you are not interested in speculation or in exposing yourself to the possibilities of high risk.

Investors tend to be aware of the potential for high returns without also acknowledging that such strategies are usually accompanied by unavoidable high risks. Conservative investors naturally seek methods for using their capital that achieve some specific goals, including: preserving spending power after both inflation and taxes; avoiding unacceptable market, liquidity and diversification risks; and protecting profits without selling securities and giving up the potential for future gain.

IN THIS SUMMARY, YOU WILL LEARN:

- The fundamental ground rules for conservative investors.
- How options can protect and enhance your conservative portfolio.
- Deciding what stocks to buy or sell options on and what to avoid.
- How to determine which options strategies are appropriate for you.
- How to recover your investments when market values have fallen.
- How to take profits without selling stock.



by Michael C. Thomsett

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THE COMPLETE SUMMARY: OPTIONS TRADING FOR THE CONSERVATIVE INVESTOR

By Michael C. Thomsett

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Copyright © 2005 by Pearson Education, Inc. Summarized by the permission of the publisher, Financial Times-Prentice Hall, Upper Saddle River, N.J. 255 pages. \$34.95. ISBN 0-13-149785-5.

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The Ground Rules

Options are probably the most flexible investment products available. They can be used alone, in combination with other options, or as hedge devices to protect other positions.

Options are contracts that grant specific rights to the buyer and impose specific obligations on the seller. Think of options as intangible contractual rights rather than as tangible items such as shares of stock.

A put option provides the buyer with the right, but not the obligation, to sell 100 shares of a specified stock, at a specified strike price and by an expiration date, and obligates a seller to purchase 100 shares at a fixed strike price, if and when the contract is exercised by the buyer.

A call option provides the buyer with the right to purchase 100 shares of a specified stock, at a specified strike price and by an expiration date, and obligates a seller to deliver 100 shares at a fixed strike price, if and when the contract is exercised by the buyer.

The arguments in favor of options are based on a series of underlying assumptions. These ground rules should always be kept in mind:

1. Limit options activities to stocks you have prequalified as strong, long-term hold stocks, to be a permanent part of your portfolio.
2. Believe that your stocks will rise in value and you will change a hold to a sell when the fundamentals change.
3. Accept the premise that fundamental analysis of stocks is an essential first step in the process of examining options opportunities. Many first-time options traders

make the mistake of selecting options (and stocks) based on the immediate return potential, but ignore the very real market risks of the underlying stocks.

4. In a temporary downward movement in a stock's price, be happy to buy more shares.

5. Believe that there are an adequate number of available stocks that meet your criteria. ●

PART I: OPTION BASICS

The Workings of Option Contracts

The biggest hurdle in the options market is terminology and understanding the meaning of key concepts.

The attributes of the option contract determine its value. This value relates not only to how high or low the premium is, but also to how the option has value as a strategic tool in your stock portfolio.

Option contracts refer to 100 shares, so each contract allows the buyer to control 100 shares of the underlying stock (the company on which the option is bought). Every option relates specifically to that one stock and cannot be transferred.

The *premium* is the cost to the buyer or value to the seller of the option contract. This cost/value is expressed as the value per 100 shares, usually without dollar signs. For example, if an option's current premium is 6, it is worth \$600.



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Published by Soundview Executive Book Summaries (ISSN 0747-2196), P.O. Box 1053, Concordville, PA 19331 USA, a division of Concentrated Knowledge Corp. Published monthly. Subscriptions: \$209 per year in the United States, Canada and Mexico, and \$295 to all other countries. Periodicals postage paid at Concordville, Pa., and additional offices.

Postmaster: Send address changes to Soundview, P.O. Box 1053, Concordville, PA 19331. Copyright © 2008 by Soundview Executive Book Summaries.

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The *expiration date* is a fixed date specifying when the option expires. After the expiration date, the option will no longer exist. As a buyer, you know that the time value premium will evaporate if your option is not exercised or sold before expiration dates.

The option position can be closed in one of three ways. It may expire worthless, in which case all the premium received by the seller is profit. It may be closed by buying it back at any time, with the difference between the initial sales price and final purchase price representing profit or loss. It may be exercised by the buyer, and the seller is then obligated to complete the transaction.

If you buy a call, you want your stocks to rise in value. If you buy a put, you're betting prices will fall.

In addition, the decision to go long refers to buying options; going short refers to selling them.

Intrinsic and Time Value Premium

Option premium is based on two components: intrinsic value and time value. The *intrinsic value* is equal to the number of points that an option is *in the money*. The strike price is the price at which an option can be exercised and it remains unchanged until the option expires.

If a call option has a strike price of 45, it means that it provides the buyer the right (but not the requirement) to buy 100 shares at \$45 per share. The money rules for this example are as follows:

1. If a 45 call is held on stock currently valued at \$47 per share, the option is 2 points *in the money*.
2. If the stock is valued at \$45 per share, there is no intrinsic value, also known as *at the money*.
3. If the stock is valued below the strike price, there is no intrinsic value. If the stock is selling at \$44 per share, the condition is *out of the money*.

The opposite direction applies to puts. In-the-money intrinsic value refers to the number of points the stock is below the strike price of the option. For example, if the strike price of a put is 40 and the stock is currently selling at \$37 per share, the put option contains 3 points of intrinsic value. If the stock is lower than the call's strike price or higher than the put's strike price, there is no intrinsic value.

Time value is the portion of the option premium above and beyond intrinsic value. The longer the time to expiration, the higher the time value. So time value is the key to identifying option strategy opportunities.

Long-Term Options and Their Advantages

The LEAPS (Long-term Equity Anticipation Security) option is a long-term contract that may exist for up to

36 months as compared to the 9-month maximum for a standard listed option. That longer expiration makes a lot of difference to both long and short strategies.

The expiration, and more specifically the time between opening an option position and the expiration date, determines the premium value and affects the decisions made by speculators on the long side and investors on the short side. ●

Long And Short

The decision to go long (buy options) or short (sell options) involves analyzing opposite sides of the risk spectrum. The interesting feature of options is that strategies cover the entire range of risk, often with only a subtle change.

There are circumstances in which conservative investors will want to go long in options. For example, following a large price decline in the market in a short time span, prices of strong stocks may rebound; but not being sure where the market bottom is, investors tend to be the most fearful when the greatest opportunities are present. In these cases, buying calls allows you to control shares of stock, limit potential losses and expose yourself to impressive gains — as long as prices rebound in a timely manner.

The same argument applies when stock prices rise quickly. The dilemma is that you do not want to sell shares and take profits because you want to hold the stock as a long-term investment. At the same time, you expect a price correction. In this situation, you can use long puts to offset price decline. First, if and when the price decline occurs, you can sell puts for profit. The short-term profit from puts offsets the price decline in stock. The second choice is to exercise the puts and dispose of the stock at the strike price, which would be higher than current market value.

Buying calls, the right to buy shares at a set price, is the best known and most popular option strategy, but it is usually a purely speculative move. There are exceptions. For example, if you are convinced that a stock's market value is sure to rise before the expiration of an option, you can buy calls as an alternative to outright purchase of shares when:

1. You are concerned with short-term price volatility and you do not want to commit funds to buy shares, but you still want to fix the price at the strike price value.
2. You want to buy shares, but you do not have funds available at the moment so buying a relatively cheap call is a sensible alternative given the chance that you could lose the money.

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3. You are aware of the risk of loss and you want to proceed with buying a call anyhow. ●

The Nature of Risk and Reward

Market risk, the tendency for stock prices to rise and fall and the volatility those price levels demonstrate, is manageable in a number of ways involving options. The most obvious is writing covered calls to reduce your basis in stock to create downside protection and take paper profits. Timing covered calls for price peaks is the most advantageous. If you expect overbuying short-term trends to correct in the near future, writing a call can produce fast option profits. This form of profit taking does not require you to sell shares.

Another way to manage market risk is to time option strategies for a stock's pricing trends. When prices rise much more quickly than you expect, you may buy puts in anticipation of a reversal in that trend. Buying puts is normally considered speculative, but when you buy relatively cheap puts to protect stock profits, it is a form of insurance.

As another alternative, you do not have to take any action. You could listen to your conservative voice and decide to simply wait out the short-term trends, reminding yourself that the fundamentals of the company continue to indicate a hold policy.

Lost Opportunity Risk and Options

The risk that the stock's price will decline exists whether you write calls or not. But there is also the lost *opportunity risk* to consider. If the stock's price soars far above the strike price of the covered call, you may lose shares through exercise. Your stock may have to be sold at the fixed strike price when that strike price is below the current market value.

Is writing covered calls worth the lost opportunity risk? When you remember that your stocks tend to be conservative in the first place, how many of your issues are likely to soar in price? When you compare the certainty of short-term returns from writing covered calls to the risk of losing appreciated price in the stock, you realize that the consistency in writing covered calls produces higher overall profits. ●

Short Positions, Naked or Covered

Some strategies involving short calls and puts may conform to your conservative risk profile based on prevailing market conditions and your portfolio positions. The basic

covered calls strategy is the most obvious example.

However, uncovered calls have to be viewed as one of the highest risk strategies possible, and not a good fit in your conservative portfolio without modification. ●

PART II: MANAGING PROFITS AND LOSSES

The Conservative Investor's Dilemma

The conservative risk profile discourages short-term decisions, but does not preclude protecting profits when price levels become volatile.

Options can be employed to protect profits and even take those profits without selling stock and without taking market risks. Options can also be used to eliminate loss positions through rescue strategies.

The ongoing conflict between short-term market trends and your long-term mindset is efficiently managed with options as long as they are used for managing price volatility and not as a primary and speculative change in policy.

But in the long-term context, short-term price changes and the reasons for price volatility really have nothing to do with long-term value. Conservative investing emphasizes fundamental corporate strength — competitive position, excellence of management, diversification, healthy capitalization, consistent dividend record — all based on faith in long-term fundamental indicators. ●

Managing Profits With Options

The very real problem of “managing” profits is often ignored by investors. It may seem odd to refer to the “management” of profits because the usual thinking is, you either sell to take profits or leave them intact. But in fact, management is precisely what you want to do, even when your primary emphasis is on long-term growth.

The traditional advice to buy long-term stocks and ignore short-term volatility is generally good advice. But ironically, it may also be irresponsible to simply leave it at that. Your on-going portfolio management involves monitoring fundamental indicators. If and when corporate strength, competitive position, dividend payments, earnings trends, capitalization and other fundamentals change, you may decide to sell shares and redirect a portion of your capital elsewhere.

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The two methods of protecting profits with options are buying puts and selling covered calls. ●

Overcoming The Profit-Taking Problem

While you may not want to take profits just because the current price of stock is higher than your basis, it would certainly be desirable to take those profits without selling stock, using the following guidelines:

1. Use long puts as insurance to ensure that current profitable prices are protected.
2. Use long calls only as a form of contingent purchase, when long-term options are available and when the purpose is to reserve the possibility of exercising those calls to purchase shares of stock.
3. Use long calls if and when prices of stocks you currently own have fallen rapidly due to marketwide price declines.
4. Use short puts as a form of contingent purchase (you have shares put to you at the strike price if and when exercised) only when you would be pleased to purchase shares at the net price.
5. Use short puts in place of long calls when prices of stock you own have declined and you expect near-term prices to rise.

When is the decision to employ options speculative and when is it a valid conservative strategy? One consideration is whether or not you already have a position in the stock. As long as your purpose in using options is to protect profits, exploit price spikes, or average down your cost of stock, your conservative standards are compatible with using options. ●

Managing The Inertia Problem

For some conservative investors, the problem may not be in mastering the complexities of option trading. It may be inertia — becoming overcautious and failing to act when the timing is right. Inertia is another word for lost opportunity. Some suggestions for dealing with it include:

1. **Set goals in advance.** The emotional block to taking decisive action is a common flaw you can overcome by operating from the base of your own rules.
2. **Follow your own rules without exception.** Once your rules are set and analyzed critically, follow them without fail, even if your instinct tells you to wait and see or to take a different action.
3. **Develop two-part strategies.** What if prices

rise? What if they fall? Plan your actions based on worst-case scenarios.

4. **Consider closing positions when risk attributes change.** Volatility is often more than cyclical market change; it may also be a symptom of a change in the stock's fundamental profile, indicating a need for further investigation. ●

PART III: OPTIONS AS CASH GENERATORS

The Covered Call Concept

The covered call is among the most attractive of conservative option strategies. It provides an impressive rate of return when properly structured and it does not increase the most common forms of risk. The key is in exploiting the time value premium. For the strategy to make sense, your basis in stock must justify the short position (selling options), the option premium must be adequate to justify the risk of exercise, and you must know the tax ramifications before you open short positions.

A covered call strategy has two elements. First is the ownership of 100 shares of stock for each option to be covered. Second is the short position in the call option. If you own 100 shares, you sell one call to achieve the one-to-one “covered” status. The call grants the right to the buyer on the other side of the transaction to buy your 100 shares (to call them away) at the set strike price at any time from the date of sale until expiration. As long as the current price of stock is below the strike price, the call is not likely to be exercised.

When you enter a covered call position, you are selling the call against stock you own. This means you give the right to exercise to the buyer and that decision is entirely in the buyer's hands. You are allowed to keep the cash you receive upon selling the short call, whether the call is exercised or simply expires. You also continue to receive dividends during the period you are short on the call.

The advantage to selling covered calls is that it produces instant cash. You are paid for selling the call. The disadvantage is that you tie up 100 shares for each call sold, and you cannot escape from the covered position without closing out the short call. ●

Working Within Pre-Established Standards

The covered call strategy is conservative, assuming that you understand the transaction's specific attributes

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and you are sure the numbers work in your favor. Observe the following rules to ensure a truly conservative application:

1. Your original purchase price has to justify the strategy.
2. The premium value you will receive has to provide enough yield to justify the covered call exposure.
3. You are willing to accept exercise as one of the possible outcomes.
4. You are aware of the tax consequences in the event of exercise.
5. You are aware of the possible loss of future market gains if and when stock prices exceed the call's strike price.
6. The covered call strategy commits the capital invested in stock for as long as the short call remains open.
7. Your primary portfolio strategy has to remain the same, seeking long-term investment in the stock of properly selected companies, not in selecting stocks based only on potential covered call returns. ●

Rolling Forward And Up

While covered call writers have to accept the possibility of exercise, it is often preferable to keep well-selected stocks in the portfolio and to take steps to a) avoid having it called away, b) be able to continue writing subsequent calls, and c) in the event of exercise, maximize income from the transaction. All of this requires employing the *rolling* technique.

In a roll, you close out a current open position and at the same time open a subsequent position that has one of the following attributes:

1. **A roll forward.** The new covered call expires later than the old covered call but at the same strike price.
2. **A roll up.** The new covered call expires at the same time but at a higher strike price.
3. **A roll forward and up.** The new covered call expires later than the old covered call and at a higher strike price. ●

The Exercise Acceptance

A final strategy worth mentioning is the exercise acceptance strategy. Most conservative investors are content to keep their long-term stocks and to use well-selected out-of-the-money calls to create additional profits along with downside protection. However, what if you would be happy to see your call exercised?

For example, if you bought shares of Federal Express at \$72 per share two years ago and that stock has a current market value of \$87.78 per share, you would be happy to

sell today and take a 15.78-point long-term capital gain. However, you could sell a covered call expiring in 27 months and gain even more. Today, the 27-month 90 calls sell for \$1,230. If exercised, you could keep the \$1,230 and earn capital gains.

Selling covered calls is a profitable alternative to simply owning stock. You can also force exercise by intentionally writing in-the-money calls. However, because this ensures the loss of long-term status of capital gains when exercise occurs, the strategy has to be studied on an after-tax basis. ●

PART IV: ALTERNATIVES TO STOCK PURCHASE

Leverage And Options

With options, there are many safe ways to enter the market. Contingent purchase using either long calls or short puts is a powerful weapon in your strategic arsenal.

Contingent sale — represented by the covered call strategy — is the most conservative use of options. However, you can also use options to leverage capital in several forms of contingent purchase. As an alternative to buying shares of stock, you can either buy calls or sell puts with the intention of acquiring stock before expiration. This strategy is appropriate when the market is volatile or when market-wide prices fall significantly. You recognize the buying opportunity, yet you do not want to risk capital on stock that might continue to fall even more.

The ability to leave positions open for as long as three years makes LEAPS well suited for this range of strategies, whereas traditional listed options do not survive long enough for contingency to mature. The risks are simply too great that the option's life will end before stock prices move adequately. This is especially true when you employ contingent strategies with long calls.

Applications of Contingent Purchase

Contingent purchase is a way to fix the price of stock if and when you buy shares (in the case of calls) or if stock is put to you. In either case, the basic rules remain:

1. You would be pleased to acquire stock at the indicated strike price.
2. You can afford to buy the stock.
3. You have performed fundamental analysis and found the company suitable.
4. The contingent-purchase strategy is appropriate and you are comfortable with it as an alternative to simply buying shares at the current price.

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Just as any options strategy is wrong when based solely on option premium levels, using contingent purchase without intending to buy stock is wrong as well.

Contingent purchase is appropriate only if you intend to buy shares, and your purpose in employing the strategy should be to limit current risk and not to incur more. ●

The Long-Call Contingent Purchase Strategy

The first contingent strategy involves buying calls instead of stock. This would be a speculative move if the only purpose was to create profits in call premium. However, as long as your intention is to buy shares, this strategy fixes your future purchase price at the strike price. If you buy calls in several stocks and only some increase in value, you should exercise those calls only on profitable positions.

The strategy should involve several different stocks. This diversifies your exposure in a long-option position. ●

The Covered Long Call

The major risk involved with long-call contingent purchase is if expiration occurs before an adequate price increase occurs in the underlying stock, it is extremely difficult to make a profit. Even if the stock's market value rises, you still need to overcome the time value problem.

There is a way to achieve this. Assuming that some or all of the stocks increase in value before expiration, you can employ a secondary strategy designed to recapture the premium cost of the long call. The basic strategy is to sell a call with a higher strike price and earlier expiration than the long positions. ●

Short Puts And Contingent Purchase

You are not limited to long LEAPS calls to enter a contingent purchase strategy. You can also use short puts. When you sell puts, you are required by your brokerage firm to have adequate funds on deposit to satisfy exercise of the put, if and when that occurs.

The benefit of the put strategy is that money flows to you rather than away from you. Time value is also an advantage. You receive a premium for selling the put, and that premium value declines over time, even when the stock's value falls to in-the-money price levels. Time value may offset intrinsic value to a degree.

The value of shorter exposure terms is:

1. Less time is required for leaving funds on deposit.
 2. Turnover profits are higher.
 3. Time value premium declines more rapidly. ●
-

Additional Conservative Strategies

Investors often describe themselves as conservative, but they act irrationally when sudden and unexpected trends emerge. Fear and greed often have more to do with decision making than does prudent or analytical, strategic thinking. How can you avoid making the common mistakes?

Some options moves qualify as conservative strategies — as long as the purpose is to manage the portfolio rather than to simply speculate. You can use long puts or calls to manage price change, and short puts — with their limited risk — present great opportunities as long as they are used solely when you would be happy to acquire more shares of the underlying stock. ●

The Long Put: The Overlooked Option

The temptation is to sell shares at the market top and take profits. This is a dilemma. You want to keep shares for the long term, but you also want to protect paper profits. If you don't want to sell shares, buying long puts is a sensible alternative.

The strategy of buying puts to ensure paper profits (or even to provide a safe floor for your purchase price of shares) is a system for managing short-term volatility while continuing to execute the long-term conservative policies you have established in your portfolio. This is not mere speculation; it is a method for protecting current value at a relatively small cost.

When a stock's price falls, long puts are used. In this situation, you may recognize a buying opportunity on an intellectual level, but you also fear further declines. So you use long puts to provide an immediate floor for stocks in your portfolio. In cases of extreme short-term volatility, you can combine long puts with long calls. Long puts protect your capital value in case of a further decline. At the same time, a price rebound would make the long calls profitable. ●

Short Puts: A Variety of Strategies

In a down market, you face the dilemma of wanting to take advantage of buying opportunities, but you're not sure

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where the market is going. The conservative point of view recognizes down markets as the chance to pick up more shares of your favorite stocks. When you buy cheap shares, you lower your overall basis in a stock, and that improves long-term as well as current income potential.

Given the fear factor in down markets, you may hesitate to put a lot of capital into shares. What if the market continues to fall? What if it takes months instead of days to recover? This is where short puts are especially valuable. There is always the possibility that stock prices will fall and not recover. The value of using options is that strategies may exploit temporary price declines. When prices fall and remain down, options reduce the losses (if you use short options) or provide the opportunity for recovery with limited additional cost (if you use long options). ●

PART V: OPTION STRATEGIES IN DOWN MARKETS

Using Calls In Down Markets

Using puts to average down your basis and acquire more shares — or to increase income when those short puts are not exercised — is one way to manage your portfolio in a down market.

An essential element of using calls in down markets is the reduction of losses caused by further downside movement. Premium earned for writing short calls reduces net basis in stock, which also helps close the gap between basis and current market value.

Long puts or long calls provide profitable outcomes as long as stock prices move enough in the desired direction. The problem with long-option positions is twofold. First, time works against you when you buy options. Second, time value declines as expiration approaches, requiring far more price movement in the stock to justify the decision to go long in the option. ●

PART VI: COMBINATION CONSERVATIVE TECHNIQUES

Spread And Straddle Techniques

The most impressive returns available using options involve combination strategies: spreads and straddles. However, in utilizing these more advanced strategies, there are two important points to remember. First, the complex tax rules for such positions could jeopardize your long-term capital gains status. Second, the risks involved are

conservative only if and when the basic assumptions continue to apply. These include your willingness to acquire more shares of stock and to accept exercise if and when it occurs, and your continued belief that the fundamental value of the companies remains strong.

A *spread*, the opening of two or more option positions on the same stock, involves different expiration dates or different strike prices. A more complex spread involves both different expiration and strike features.

A *vertical spread* has different strike prices but the same expiration date. A *horizontal spread* is the opposite: It contains the same strike price but different expiration dates. A *diagonal spread* has different strike prices and different expirations.

The spread is distinguished in other ways as well. For example, a *bull spread* is one designed to work out profitably if and when the value of the underlying stock rises. In comparison, a *bear spread* is maximized when the underlying stock's value declines. A *box spread* is the simultaneous opening of a bull spread and a bear spread.

The terminology is even more complex than these basic definitions. For example, a *ratio calendar spread* is any spread in which the long and short positions are not identical numbers. One final advanced spread is called the *butterfly spread*. This strategy has three parts: open options within a strike-price range, offset by other options at both higher and lower strike price ranges.

While the spread involves variation of strike price, expiration date or both, *the straddle*, by definition, requires that strike price and expiration are the same. To open a straddle, you buy an equal number of calls and puts (a long straddle) or sell an equal number of calls and puts (a short straddle); in either case, the option positions would have the same strike price and expiration date. The long straddle is highly speculative.

Simplicity as a Worthy Goal

The complexity of combination strategies is only one of the problems you have to sort through. As a conservative investor, you may prefer simplicity, if only because basic conservative strategies involve fewer likely risks. The possible tax consequences may also discourage you from complex strategies.

One conservative principle worth adopting is: Keep it simple. The fall-back position for any option strategy is to return to the basic conservative theme: Select high-quality growth stocks and hold for the long term selling only if and when the fundamentals change. If any options strategy is overly complex or difficult to understand, it should be avoided without exception. ●