

While options can provide a great way to leverage a position, SSFs may in some cases offer some unique benefits over them.

In 1973, standardized exchange-listed options began trading at the Chicago Board Options Exchange and revolutionized the trading arena. Soon single stock futures trading will begin in the U.S. and will have the potential to be equally as groundbreaking. While the full impact of single stock futures (SSFs) may not be known for a number of years, there are some elements of SSF contracts that may make them more appealing than options for market speculation.

Options are very popular with market speculators because there are hundreds of ways to capitalize on market movement, combined with the tremendous leverage of capital. Unfortunately, due to the complexity of option pricing, they can be difficult to trade successfully, even for the seasoned professional. Factors such as days until expiration, market volatility and hedge ratio (or delta), all affect the price of an option. In short, a trader can be on target on market direction and still lose money on the options.

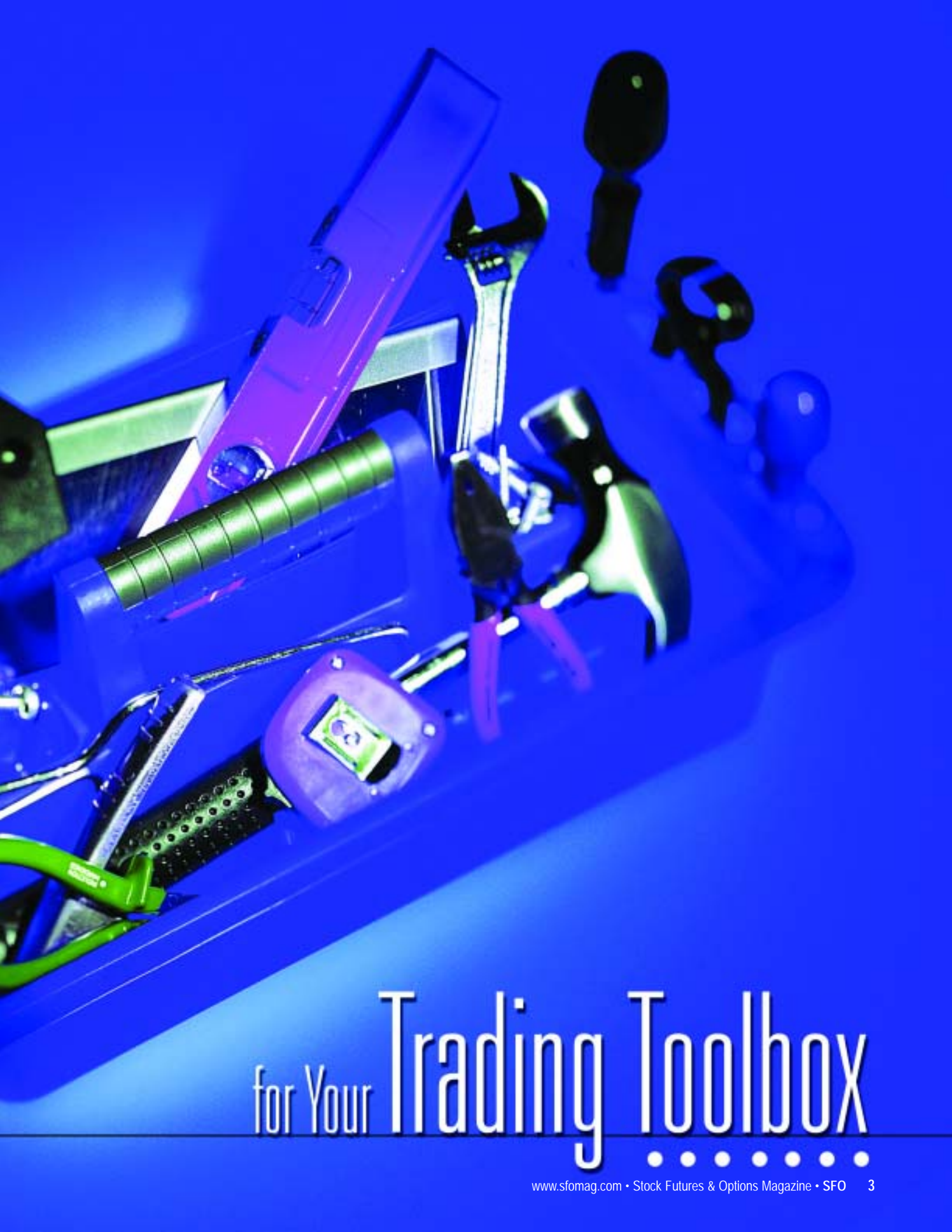
On the other hand, single stock futures, once they actually appear on market screens, will be more simply priced and will offer advantages of leverage without the disadvantage of complex pricing models that could adversely affect profitability. The equity options trader who employs single stock futures in his trading arsenal will have some substantial advantages over other traders.

While buying an option gives traders a limited-risk position, they lose a number of other advantages. As a result, those traders who

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buy (or "go long") put and call options to speculate in a particular stock using a large degree of leverage may wish to explore the possibility of using single stock futures instead.

When a trader purchases an out-of-the-money option or an option that has a strike price away from the current market price, the only value of the option is time premium, or extrinsic value. There is no intrinsic value. The closer an option gets to expiration, the less this time premium is worth. This is the effect of time decay, or theta, on the price of the option.

Because a single stock futures contract is bought or sold at a value representing the price of the stock plus the cost of carry, there is no adverse effect of time decay (cost of carry consists of the value of current interest rates less any dividends paid).

For example, a trader wishes to speculate on Johnson & Johnson (JNJ). His analysis says that JNJ, currently trading at 55, "should" be trading at 65 by the end of 2002. He would like to gain as much leverage as possible, so he will consider using either the January 60 calls or the December 2002 JNJ SSFs.

Calculating the cost of the option is not difficult. Options trade in contracts of 100 shares, so if the options are trading at \$2.00, the cost per option would be \$200. We know this is all time premium because the stock is trading below the price of the call option.

The basis, or fair value, of the December SSFs six months prior to expiration would be expected to reflect the current share price plus interest, less any dividends. In this example, we will use the current price of JNJ at \$55 per share, a short-term interest rate of 1.75 percent, and the JNJ dividend yield of 1.49 percent. We would expect then that the futures should be trading at around \$55.0715 (\$55 plus six months short-term interest of 0.875 percent less dividends of 0.75 percent). Full contract value would be \$55.0715 x 100 shares or \$5507.15. SSF margins will be about 20 percent of the full contract value so the margin to hold this contract would be about \$1100.

While this calculation may seem a little complex and may be somewhat confusing, it merely gives some background on the fair value of single stock futures. Since hedge funds and large institutions will most likely be taking advantage of price discrepancies between the actual stock and the SSFs through arbitrage, the SSFs will most often trade at or around fair value. It is more important that traders be aware of fair value, not necessarily how to calculate it. [It is likely that the concepts of fair value in SSFs will be similar to those of stock index futures. For an in-depth look at fair value as it relates to stock index futures and concepts of arbitrage, see *Exchange Traded Funds and E-mini Stock Index Futures* by David Lerman.]

The advantage of trading the option in this example is that the

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total risk on the trade is limited to \$200. This is the better trade for those who may be adverse to greater risk, but the benefits of trading SSFs outweigh this advantage. First, the only value of the option is time value, so if the market does not move ahead quickly, the value of the option will decrease as time goes on. Time decay will accelerate as expiration approaches. In fact, the profit target needs to be very precise.

In order for the option trade to be profitable at expiration, the stock must be trading higher than \$62. How can that be? If the option strike price was 60, wouldn't the option be profitable above \$60 per share? Not exactly. The original outlay to purchase the option was \$200. To turn a profit, the option has to be more than \$200 in-the-money at expiration. So at \$62, we get the initial investment back, but anything less yields a loss. Only above \$62 per share will the option turn a profit.

The SSFs, on the other hand, yield a profit if they are trading at a price higher than they were originally purchased. If they were purchased for \$55.07, as in this example, any price above that yields a profit. It is that simple. If the stock is at \$60 at expiration, where the option would have expired worthless, the SSFs show a profit of \$4.93 per share, or \$493 for each 100-share contract (the standard contract unit).

Granted, a trader needs to accept more risk in order to gain this advantage. However, in the case of buying the SSFs, the risk is not unlimited. The risk is limited to the stock going to zero. Of course, while recent market events have shown that this can be a real possibility, it is not the "text book" unlimited risk of loss.

Another advantage to using SSFs is contract expiration. In the case of the option, if the market has not moved into profitable territory, the option merely expires worthless. The trader holding a single stock futures contract at expiration, how-

ever, can take delivery of the physical stock and, thus, hold onto the position for an indefinite period of time.

In the case of put options, the reasons to consider using single stock futures become even clearer. Put options are frequently used by the speculator to take a bearish position in the market. Additionally, puts are often used to hedge an existing stock position. Single stock futures may be a better alternative vehicle in both scenarios.

In the case of taking a bearish position in the market, the put option has been popular mainly because it is an easier position to enter than shorting the stock. In order to short stock, a number of events must all come into alignment. First, the brokerage firm must have the stock to loan the trader. Once the stock can be obtained, it can only be sold short when the last trade in the market is an uptick. Margin must be posted and interest is charged on the margin. If any dividends are to be paid, the trader is responsible for those costs as well. By purchasing a put option, the trader is able to speculate on the stock going down without these hindrances.

The same disadvantages arise for the put option trader as were apparent in the call option example. The time decay is working against the position, and the trader must be fairly precise in both market direction and time in order to make a profit. An additional disadvantage in options trading that we can explore in this example is an overpricing of the option due to an increase in volatility.

If the market is moving down already, the price of the put option is going to reflect that market sentiment in the volatility. The actual calculation of these numbers involves complex mathematics. Suffice to say that the option premium is going to be high in this trade due to an increase in volatility. [For more information on this and other factors of option pricing, see *Option Volatility & Pricing* by Sheldon Natenberg.] In higher volatile markets, the opportunity for profit decreases because the cost of the option becomes too high relative to the potential gain.

Using single stock futures will provide the trader with an easier and more efficient way to capitalize on downward price movement in stocks. As we examined in the call option example, the price of the futures is not affected by the various factors that affect the premium cost of the options. Furthermore, there is no restriction on selling the futures short. The required margin is the same and there is no borrowing cost associated with the posted margin. Because the dividends already are calculated into the cost basis of the futures, the trader does not need to worry about paying dividends either.



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Continuing on with the JNJ example, we will assume that a trader has decided that JNJ will be trading lower in six months. With the stock at \$55 per share, the trader considers the put option versus the single stock futures. He considers the January 2003 50 put which is trading at \$3. The risk on trading the put is then \$300, so the stock must be trading lower than \$47 for the trader to be profitable at expiration.

Using the single stock futures, however, the trader will be profitable if the SSFs are trading at a price lower than what they were sold. The ease with which a trader can speculate on bearish stock price movement using single stock futures makes this product a powerful tool for the speculator.

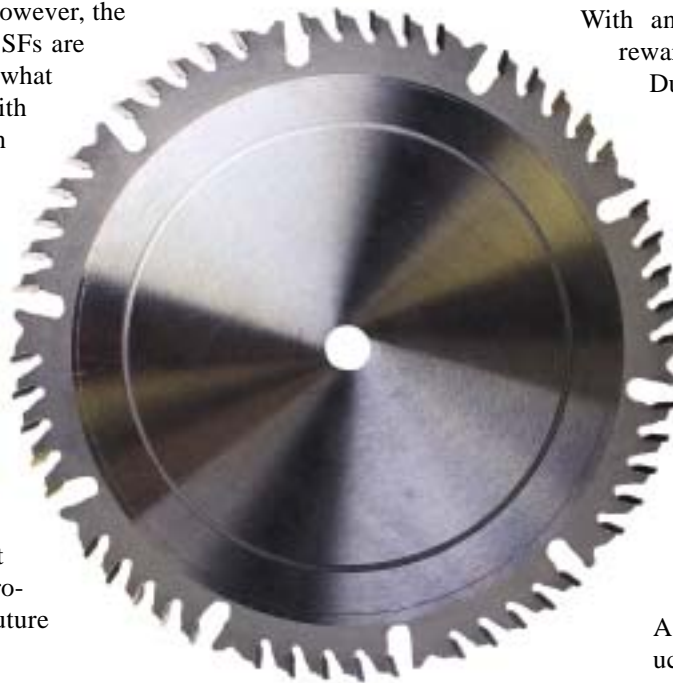
Another popular use of the put option is not necessarily to speculate on bearish market moves, but rather to protect a current position by hedging. Single stock futures will definitely be the better product to use in contrast to put options. A hedge is used to protect and lock in profits for a future transaction at today's prices.

If the trader owns JNJ at \$55 and is concerned about price declines in the future, he could hedge either by buying a put or selling the JNJ SSFs. Using the put option does not provide a perfect hedge for the trader. For example, let's say the trader purchases the January 2003 50 put for a total of \$300 per contract. The position is only profitable at expiration if the stock is lower than \$47 due to the \$3 per share option premium that was paid.

Let us assume that at expiration, JNJ stock is trading at \$50 per share. Using the put option did not protect the trader. The stock is sold for a \$5 per share loss, and the \$3 per share that was paid for his hedge is sold, resulting in a total loss of \$8 per share. The trader hedged his position in the stock to protect from losses, yet he managed to lose \$800 for every 100 shares.

Compare that with the use of single stock futures for this hedge. Using the estimated fair value as previously discussed, the trader is able to sell the December 2002 SSFs for \$55.0715 per share. As time continues to expiration, the cost


of carry in the fair value decreases until, at expiration, the cash price and the futures price converge. At expiration, if the stock is trading at \$50 per share, the \$5 loss has been fully covered by the hedge. The stock lost \$5 per share while the hedge gained slightly more than \$5. This makes single stock futures a clear winner in terms of choosing an effective hedging tool.



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With any trading plan, the risk versus reward needs to be fully evaluated. Due to certain limited risk features, purchasing options may be a better choice for the risk-averse trader. However, for the trader willing to take on a greater degree of risk, the potential for profit with SSFs can be greater. The trader himself is the only one who can determine exactly how much risk he is willing to take. Risk management and money management are important keys to any successful trading program. Do not leave them out of yours.

As with any new investment product, there are nuances and issues that will need to be discovered, studied and tested over time before a clear trading plan can be developed. By initial investigation, however, it appears that there will be clear advantages in the single stock futures camp.

Since SSFs have yet to commence trading in U.S. markets, there is a great deal of speculation on the possible success of this new product. As is often the case with a new product, there are a number of vocal rivals that are actually calling for the demise of single stock futures. While the use of options trading should not be disregarded for the market speculator seeking to leverage a position, single stock futures may, in some cases, be a better alternative to trading options. 

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