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Wenning Investments, LLC

Wenning Advice

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The "Options" Option

Most investment managers pay little attention to options. They advise clients to buy stocks and bonds, or mutual funds and rationalize that if you're diversified enough, you can weather a bear market.

So how is that strategy working out?

At Wenning Investments, we believe it is important to consider every investment option - including "options." Investment managers that do otherwise are doing their clients a disservice.

An option is a contract that gives the buyer the right to buy or sell a set amount of stock (or other securities) at a predetermined price, called the "strike price." A "call" option allows the holder to buy a set amount of stock and a "put" option allows the holder to sell a set amount of stock.

The potential risk to the buyer is known up front. If the option is not exercised and is allowed to expire, it becomes worthless.

Typical uses for options include:

Reducing risk by hedging. By buying puts in a stock, you can secure the right to sell your stock in a company at a particular price, regardless of what the market is doing. The down side, of course, is if the stock doesn't drop, you've wasted the money you invested in puts.

Be sure to consider the tax impact, as the purchase of a put terminates the stock's holding period for tax purposes.

Using leverage. Those with a high tolerance for risk who are seeking the potential for high returns often use options to create leverage. Prices for options are often a fraction of the price of the underlying stock, so you can buy many more call options with the same money than if you were buying shares of the underlying stock.

If the stock appreciates in value significantly, the investor will be able to buy more shares at the strike price and take advantage of the appreciation in value. If the stock value sinks, though, the options may become worthless.

These are the two most basic uses for options. There are many other uses, such as a "covered call" strategy, which requires the purchase of both call options and the underlying stock to cover your risk.

It's Time to Start Rebuilding Your Portfolio

If you've lost money during the current bear market, it's time to start rebuilding your portfolio.

If you've followed an "active" investment approach, your losses likely have been much lower and you're probably anxious to get your portfolio back on track.

But is it possible to make money in today's market?

Given that this is the worst bear market in decades, it's a challenge - but even today money can be made if you have the right strategy. No one can predict what will happen tomorrow, of course, but we may be stuck in these market doldrums for some time yet.

Thinking Sideways

The market has fallen significantly, but during January and much of February, it was moving sideways within a narrow trading range.

So how do you make money in a sideways market? One way is to use an options strategy. Using the strategy described here, some Wenning Investments clients have enjoyed returns in the 10% to 15% range in a month on a single security - in spite of the current financial crisis!

Past performance is, of course, no guarantee of future returns. There is risk involved with this strategy, but there is always risk when there is the potential for significant returns.

Here's how our strategy works. When the market is oversold and prices are low, we've bought call options in large cap stocks for companies like Merck, AT&T and Goggle. As the stocks have appreciated in value, we've sold the calls against the stocks. In the process, we've locked in both the premium (the price of the option) and the appreciation on the stock.

Merck				
Merck & Co. (1000 shares)		**Cost**	**Option Proceeds**	**Total Cost**
Purchased 12/3/08	$25.76	$25,762.95	$1,374.99	$24,387.96
January 30 stock price	$28.55	$28,550.00		$28,550.00
Strike of call sold	Jan 30			
Option Bid on 1/5/09	$1.40			
Expiration Value (10 contracts)	$1,374.99	$1,374.99		
			Appreciation	$4,162.04
			Return	**17.07%**
Google				**Total Cost**
Purchased 1/15/09 (100 shares)	$295.75	$29,587.95		$58,100.90
Purchased 1/20/09 (100 shares)	$285.00	$28,512.95		
January 30 stock price	$338.53	$67,706.00		$67,706.00
			Appreciation	$9,605.10
			Option	-$330.01
			Return	**17.10%**

No investment strategy is foolproof, but the options strategy we've used has provided significant returns. This strategy, unfortunately, won't work in a down market, but should be considered if the market goes sideways again.

Q&A

What's the difference between options and futures?
Both options and futures are derivatives - that is, their value derives from another underlying investment. While an options contract gives the holder the ability (not the obligation) to buy or sell securities at a predetermined price at a future date, a futures contract requires the holder to buy a commodity or a security at a specific date at a price agreed upon today.

Learning From Your Investing Mistakes

It's commonly recognized that there is a strong relationship between risk and reward, but investors often fail to recognize it. They may expect big returns with little risk or forget that the consequences of risk can be severe.

Mistake #3: Imbalance between Risks and Expected Returns. Many investors have unrealistic expectations. They want safety, so they avoid stocks and invest conservatively in Treasury bonds or even certificates of deposit. The risks are low, but so are the returns.

Other investors seek out risk in the hope of gaining high returns. They may invest in volatile small-cap growth stocks or emerging market stocks or BBB-rated bonds - yet they're shocked when the value of their investments plummets.

Diversifying between a mix of risky investments and more conservative investments, based on your tolerance for risk, can provide a reasonable return for those willing to take reasonable risks.

Determine what level of risk you feel comfortable taking and whether the returns generated at that level are sufficient to achieve your financial goals. If not, you may need to adjust your goals or your tolerance for risk.

Keep in Touch

Have an idea for a future issue of *Wenning Advice*? Are you interested in active investing or would you like to refer a friend who may be interested?

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