I want to begin by going through the primary attributes of the LEAPS option, and explain how these are distinguished from better-known listed options.

If you read the introduction, then you’re already familiar with the rules of the game: calls and puts. Now we need to cover the basics of all options. These concepts and definitions are mandatory before we proceed, so let’s get started.

LEAPS is an acronym for Long-term Equity Anticipated Securities.
IMPORTANT TERMS

Before proceeding to a discussion of LEAPS strategies, there are a few terms that are important to master.

- Strike price
- Exercise/Assignment
- Premium
- Expiration

Strike Price

The first and most distinguishing feature of LEAPS options is the strike price. Every option is an intangible contract granting rights to buyers and placing obligations on sellers. All of the valuation of those terms, and ultimately of the LEAPS option itself, are based on the strike price, the level at which the contract takes effect.

Every LEAPS has a fixed strike price—the price at which the call or put can be exercised.

Every option is specifically related to an underlying security, usually a stock, ETF, or index. For example, if you buy Wal-Mart calls, they cannot be transferred to JCPenney or Sears. They are, and will always be, Wal-Mart calls. Strike price is the price per share at which that option can be exercised. As an example, let’s say that you purchase an XYZ January 40 call at $2.25. If XYZ goes to $60 per share, the 40 strike call is $20 in-the-money (ITM). When an
option is *in-the-money*, the current price of the underlying stock is higher than a call’s strike price, or lower than a put’s strike price. If XYZ fell to $30 per share, the 40 strike call would be considered $10 out-of-the-money (OTM). An option is *out-of-the-money* when the current price of the underlying stock is lower than a call’s strike price, or higher than a put’s strike price.

**Exercise/Assignment**

When an owner exercises a call, he or she is able to buy 100 shares at the strike price, even if current market value is much higher. When an owner exercises a put, he or she is able to sell 100 shares at the strike price, even if the current market value is far lower.

ITM LEAPS options can also be exercised (by owners of the options) or assigned (to investors who have sold the option) before expiration. This happens rarely, as long-term options usually have time premium embedded in the options price. When options are exercised, the Options Clearing Corporation assigns the exercised option to one of those sellers, either on a first-in, first-out basis or, usually, on a random basis.

**Premium**

The price of an option is called the premium. It is made up of two components, *intrinsic value* (how much the option is in-the-money) and *time premium* (the difference between the option price and its intrinsic value). If XYZ is trading at $60, and the 40 strike call
is trading at $24 (the premium), $20 of that is intrinsic value and
the other $4 is time premium. The further ITM the option goes,
the greater the value of the option should be. Premium is the value
per share, and because every option refers to 100 shares of stock,
you have to read the quote properly. When you see that an option is
worth 2, that means $200; if a LEAPS option is quoted at 4.35, its
dollar value is $435.

The premium is the market value of the LEAPS, which rises and falls as the
underlying security’s value rises and falls, and as expiration nears.

Expiration
Another attribute of the LEAPS option is expiration. Every op-
tion expires at some point in the future. As expiration gets nearer,
the likelihood of exercise increases as well, especially when the un-
derlying security’s market price is higher than the strike for calls,
and when the underlying security’s market value is lower than the
strike for puts. Once the expiration date passes, all of the options
pegged to that expiration cease to exist.

Distinctions also have to be made between LEAPS options and
the more traditional, shorter-term listed options. First, LEAPS
options exist up to 30 months, which is an incredibly long time
when compared with the lifetime of eight months or so for non-
LEAPS options. Because LEAPS options last beyond the current
12 months, the ticker symbols for LEAPS options are more com-
plex than for traditional options. As dates get closer, specific strike
prices and expiration times become more important. Overall, because of their longer-term option contracts, LEAPS offer a range of practical strategies.

So, let’s sum up what we’ve learned about LEAPS so far:

- LEAPS are Long-term Equity AnticiPation Securities
- Can have a lifetime of up to 30 months (2 ½ years)
- Because of their length, they require different ticker symbols
- Many practical strategies can be applied to trading LEAPS

All LEAPS are going to expire in the future. Unlike shares of stock, which never expire, LEAPS have a limited life. This fact directly affects premium value.

DIFFERENCES: SECURITIES VERSUS OPTIONS

Although LEAPS share the same trading rules and attributes as traditional options, they are actually more like stocks. This is because they have lifetimes up to 30 months. The duration of a LEAPS contract is important because it is treated as a security (thus, the name Long-term Equity AnticiPation Security). But they are also conversion securities. This means that the closer the time gets to expiration (the third Friday of the expiration month/year), the more a LEAPS starts to act like a traditional option. In their last nine months, LEAPS options behave more and more like traditional, shorter-dated options. This distinction is important only in an esoteric sense. As you will see later, strategies for trading LEAPS are really identical to those you would use for three, six,
and nine month options, but the time frame is far longer. This provides you with more flexibility and often presents you with better pricing bargains and returns. Keep in mind, however, that LEAPS options—whether you think of them as securities or options—act like the old-style options and are used in the same ways to speculate, hedge, insure, or take profits on long positions.

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See that word “security”? LEAPS are not options, they are securities. To see this explained, log on to www.traderslibrary.com/TLEcorner.

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**A BRIEF HISTORY OF OPTIONS**

The trading of standardized, listed options began in 1973 with the founding of the CBOE, the first U.S. options exchange¹. In the beginning, these options used to be simple to track because their expiration month never exceeded a year. (Expiration month is the specific month when options expire.) So September options always expired the third Friday in September, and December options always expired the third Friday in December. Technically, it’s the Saturday following the third Friday of the month, but “expiration friday” is the common usage.

As options gained popularity, it soon became apparent that both the floor traders and individual investors preferred to trade or hedge for shorter terms. So, the original rules were modified and

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the CBOE decided that every stock would always have the current month plus the following month available to trade.

Every option you can think of now has options in the next two months as well as in their expiration cycle of three, six, and nine months. Every traditional option trades on one of three cycles: JAJO (January, April, July, October expirations); FMAN (February, May, August, November expirations); and MJSD (March, June, September, December expirations). So for listed options, you’ll find contracts that expire in the next two months as well as those expiring in the coming months of their expiration cycles.

Expiration cycles and months used to be quite limited; today, option traders have more variety and flexibility, not only in the duration of options, but also in the frequency of expirations.

Then, traders asked: “Well, it’s nice to be able to trade in the immediate one or two months, but if we can go out nine months, why can’t we have a product that goes out further?” So LEAPS evolved to address that. On October 5, 1990, the CBOE introduced LEAPS to supply investors’ demand for options with longer-term expirations. Because LEAPS appealed to both options and stock traders, they proved successful from the start.

Currently, on the U.S. exchanges that trade options, there are about 2,800 stocks on which you can trade options. Unfortunately, only

\[ Source: \text{http://www.cboe.com/LearnCenter/Advanced.aspx#leaps.} \]
about 900 of those stocks also offer LEAPS, so not every stock has long-term options. “What?” you might be asking. “Only one-third of the stocks have LEAPS? Which ones?” Well, the stocks that are in the news—the stocks that trade, such as IBM, Microsoft, QQQQ, and Intel, for example.

Today, LEAPS extend as far as approximately two and a half years. They can technically go out 39 months, but at this point, 30 months is the longest duration you will find.

**OPTIONS SYMBOLS**³

U.S. options trading symbols tell us four important things about the option: what the underlying stock is, whether the option is a call or a put, the option’s expiration month and its strike price, all in just a few letters. To help you understand, let’s break down an option ticker symbol into three parts.

- The first two to three letters of an option ticker make up the option symbol, which tells you what the underlying stock is for that particular option. Normally, this is the same as the stock symbol and is common to all options for that company, but there are exceptions. For example, Microsoft’s stock symbol is MSFT, but MSQ and MFQ are both used as option symbols for the company.

- The single letter immediately following the option symbol tells you the option’s expiration date and whether it is a call or a put. Since there are 12 possible expiration periods for

³ Source: http://www.investopedia.com/ask/answers/05/052505.asp
options (one per month), letters A through L are used for calls, and letters M through X are used to represent puts.

- Finally, the last letter of an option ticker symbol corresponds with the specific strike price of that option.

**STOCK SYMBOLS**

The New York Stock Exchange is the oldest stock exchange in America. Since that is where modern trading began, many of the companies listed on the NYSE have ticker symbols that consist of only one or two letters. Today, if a company’s symbol consists of three letters, it is traded on either the NYSE or the AMEX. NASDAQ stocks generally have symbols consisting of four to five letters. However, in July 2007, the U.S. Securities and Exchange Commission began allowing companies that transfer listings from other exchanges to the NASDAQ to keep their ticker symbols, regardless of the number of letters.

Originally, with traditional options, there was only one September contract and one December contract. A two-digit designation was added to the end of the option quote—one for the month and another for the strike. There are only 12 months, so the alphabet worked well for that. If you use five-point increments, there are only 20 possible strike prices in a 100-point range, so the alphabet worked for that as well. Thus, before LEAPS came along, you could look at a ticker symbol such as WMT FJ and say, “This is a Wal-Mart June

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When options first started, the stocks being traded made it fairly simple. IBM’s symbol was IBM and so on, with 3-letter symbols. But then Microsoft, MSFT, came along and its symbol was made MSQ and things began to get confusing. To hear Marty clarify “options symbology,” watch at www.traderslibrary.com/TLEcorner.

(F is the sixth letter, representing the sixth month call) 50 (J is the tenth letter, times $5 increments, equals the 50 strike) call.” Puts would use one of the 12 letters at the end of the alphabet. To this day, I bump into investors that say “I have a question about the WMT FJs,” and they don’t see my hand behind my back counting out the month and strike prices!

When LEAPS entered the market, the possibilities broadened to two or three contracts on a stock with the same strike price and the same month of expiration (a January 35 put for 2009, 2010 and 2011, for example). But the system could only accommodate expirations for one year. So, thanks in part to LEAPS, the system of trading symbols had to be expanded.

<table>
<thead>
<tr>
<th>Table 1.1- LEAPS - Ticker Symbols</th>
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<tbody>
<tr>
<td><strong>Wal-Mart</strong></td>
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<tr>
<td>Stock symbol: WMT</td>
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<tr>
<td>Regular Option symbol: WMT</td>
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<tr>
<td>LEAPS Symbols: LWT('04) ZWT('05)</td>
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<tr>
<td><strong>Microsoft</strong></td>
</tr>
<tr>
<td>Stock symbol: MSFT</td>
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<tr>
<td>Regular Option symbol: MSQ</td>
</tr>
<tr>
<td>LEAPS Symbols: LMF('04) ZMF('05)</td>
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</table>
Today, every stock offering LEAPS uses a two-tier symbol. One is used for regular options, and the other for LEAPS. While other options have fixed symbols, LEAPS symbols change to reflect the expiration year. This is supposed to make it easier to distinguish a longer-term option from a shorter-term option in data listings. The letters L and Z were chosen to represent these “miscellaneous situations.” For example, Wal-Mart is designated as WMT for its short-term options listings, and LWT or ZWT for LEAPS (see Table 1.1). This is confusing and complicated, but it is the system we have to live with—but not for long. Just as computer design in the 1950s failed to anticipate future complications by using only a two-digit year field, the designers of exchange symbols for option trading never anticipated the needs growing from expansion into LEAPS. But the need for an improved system of symbols is now apparent.

Unfortunately, the two-digit system for identifying options is not well-suited to today’s expanded terms for LEAPS. A new and better system is on the way!

To make it even worse, we have also run out of symbols that start with the letter L and the letter Z. Now you’ll see some option symbols on the ticker for LEAPS that start with O or K as well, just to help confuse you.

The need for an expanded system includes not only multiple year/month expirations, but also the possibility of prices spanning more than 100 points (or, at the very least, making LEAPS available in
those different price ranges). In today’s volatile market, the likelihood of a stock moving 100 points or more is the new reality. Anyone who has followed Google for the past few years knows that this can and does occur. So a GOOG 250 strike, 350, 450, 550, and 650 strikes would each need unique option symbols.

**Symbology: What to Expect**

We have discussed option symbology, how it was designed, and how unforeseen events critically compromised its effectiveness. Well, as the talented songwriter Bob Dylan once said, “The times, they are a-changin’.”

Are you reading this before or after late February 2010? The reason I ask is the much-anticipated solution scheduled for the first quarter of 2010.

The final symbol project may change before the publication of this book, but some things that you can expect to see include:

- Four digit option symbols. QCOM will not be abbreviated to QAQ and permutations of that. They’re leaving room for a six digit symbol.
- Strike prices in decimals, not fractions. Strike prices over 1,000, with three decimal places, allow for unusual stock splits.
- The day, month, and year of expiration. Expect to see something like the following in 2010: GOOG 1/20/2012 330 call 2.25
• Room to grow for interest rate options, flexible options (FLEX), currencies, volatility options, and others to follow. Good-bye WMT FJs!

MEANINGFUL STRIKES AND EXPIRATION STYLE

The range of possible strike prices for calls or puts over two to three years is substantial. A meaningful strike price can mean different things to people employing various strategies, but here’s one important aspect to remember: the longer out the expiration goes, the more remote the final outcome. As a buyer, I have the right to exercise a LEAPS call or put any time I want. The potential is there, and this gives me great freedom. It means that for a relatively small cost, I can control 100 shares of stock for a long time. In the stock market, 30 months can define the difference between bull and bear markets. The entire situation for any one company is likely to be vastly different that far away. If I sell options, it is true that they could be exercised at any time, but what are the chances? The odds are quite remote, but it could happen; and this is one of the uncertainties sellers have to accept when they short a LEAPS position.

Investors know that they can move into and out of LEAPS options as they can with shorter-dated options. Whether they have a position in a stock (called an “equity” by professionals), an ETF (exchange traded fund) or an index, a contract can be closed at any time before expiration. Since LEAPS are longer-dated by definition, they may not be the best investment vehicle for a short-term outlook.
All stock and ETF options (and a few index options) are “American Style” options, which can be exercised or assigned at any time before expiration. Most index options are “European Style”, meaning that one cannot exercise or be assigned before Expiration Friday. Most users of index options like this; the position stays on until they decide to exit it. Another important characteristic of index options is that they all settle in cash. IBM options settle in shares of IBM, while index options (DIA, for example) settle in cash.

The term “meaningful strike prices” was probably coined by a marketer years ago. With shorter-term IBM options for example, you might find July options with 110, 115, 120, 125, 130, and 135 strike prices. With LEAPS options, there might be IBM strike prices going out 20 to 30 months, but only with 110, 120, and 130 strike prices. Some of this has to do with the amount of strike prices (hundreds of thousands) and the capability of disseminating all of the bids, offers, and last trades of each option. So to some of us, the term “meaningful strike prices” could also be called “slightly fewer but certainly significant strike prices to choose from.” I guess “meaningful strike prices” does indeed sound better.
OPTIONS/LEAPS PRICING

When we talk about options or LEAPS pricing, we are still dealing with the basic components of these instruments:

- Stock price
- Strike price
- Time to expiration
- Interest rate / dividends
- Volatility

We need to ask: What’s the stock price? What strike price are we looking at? How much time until expiration? What are the interest rates and dividends? Granted, dividends and interest rates with options having less than six months of life are considered the least important components if you are only trading the options, and not also owning shares of stock. But if you use long-term options (LEAPS), interest rates and dividends can have a more dramatic effect. For example, for LEAPS going out 25 or 30 months, the interest rate can be very significant.

We also have to judge trades based on the volatility of the underlying security. No two stocks will trade at the same volatility. They’ll change like the waves in the ocean, varying with traders’ and investors’ expectations, as well as adjustments in supply and demand.
Using Options Requires More Decisions

Let’s face it, using options requires more decisions. If you’re going to buy IBM stock, you buy the stock; if you’d like to consider some IBM options, there are 250 different choices in any permutation of those buying and selling, as well as any particular spreading or combination of these options. At the very least, you need to be aware of (a) the range of possibilities, (b) the risk/reward scenario of each, and (c) how risk/reward is affected by proximity between market value and strike.

In the next chapter, I will address some of these questions by explaining why LEAPS are attractive alternatives to traditional option trading and the old “buy and hold” approach of just buying stocks and holding on to them, hoping they will grow in value over the years. The questions are more complex when LEAPS come into play, and of course, so are the answers.
1. The strike price of a LEAPS option is:
   a. the current price of the underlying security, so-called because it is the level where a LEAPS trade “strikes.”
   b. a value level of stock where it becomes possible to exercise a LEAPS, also called parity.
   c. the fixed price at which options may be exercised.
   d. the crossover point between traditional short-term listed options and extended expiration cycles of LEAPS.

2. Exercise is:
   a. the opposite term of assignment
   b. the act of taking delivery of stock at the fixed strike price by exercising a call
   c. the act of delivering stock at the fixed strike price by exercising a put
   d. all of the above

3. The premium is defined as:
   a. the current market value of a LEAPS.
   b. extra payment made to buy LEAPS with greater than average potential to rise in value.
   c. profits earned through the exercise of a LEAPS option, apart from capital gains and dividend income.
   d. the combination of LEAPS profits and dividends, excluding capital gains on the underlying security.
4. The abbreviation FMAN stands for:
   a. Future Merger & Acquisition Numerator (a contingent valuation model for options in companies that are takeover candidates).
   b. February, May, August, November, an expiration cycle.
   c. Feb-Mar-Apr Numerator (part of a valuation model for short-term options).
   d. Fiscal Marketing Assessment & Numeration (the procedure employed by U.S. exchanges for setting option premium values).

5. LEAPS are available on:
   a. about one-third of U.S. listed companies.
   b. all listed companies.
   c. all listed companies offering traditional options.
   d. only the 30 industrials in the Dow.

For answers, go to www.traderslibrary.com/TLEcorner.