

>: 6 Ways to Make Money Just as Easily - Synthetic Positions

Thursday, February 8, 2007 | Chris Rowe

Today, I will talk about options in a way that might benefit anyone, from folks who don't know anything about options, to the sophisticated options traders.

THE TOPIC: "Synthetic Positions"

Synthetic positions are two positions which, together, act like a third position. I will give you a common example, and then I'll show you the six basic "synthetics".

For Example: You are probably familiar with, or you have probably heard of "Covered Calls" or "Covered Writes."

Simply stated: A covered call position is when you own or buy a stock (quite simple,) and you then sell someone the right to buy your stock from you at a specified price.

Since this article is about synthetic positions, I won't get into the *reasons* that people sell covered calls today.

(For a quick review of the "covered call" strategy, read my article titled "[Become the Casino](#)" with this simple options strategy.)

Well, did you know that selling "naked puts" is basically the same thing as selling covered calls? The two strategies are considered "synthetic positions". The only major difference is that you have to commit less cash to the trade when you sell a naked put. In other words, you can utilize more leverage without paying any interest as you would do when utilizing margin.

Obviously, you take on a certain amount of risk with certain potential reward when you sell covered calls. What I'm telling you is that you are taking the same risk with the same possible reward when you sell naked puts.

The benefit in understanding synthetic positions is that you may have one reason or another for putting the same risk/reward ratio on a particular stock, but in a different way. Since you commit less capital to selling naked puts than you would when selling a covered call, for instance, you may decide that you like naked puts better because using that alternative frees up capital, and gives you the ability to have more diversification into other positions.

Now, if you have, maybe, a level 2 understanding of options, then you may say that selling "*naked* options" is very dangerous. But it isn't any more dangerous than selling covered calls (which is considered by some - not me - to be the most conservative options strategy.)

When you own a stock already, and you sell a call option to open, it's a covered call. When you buy the stock and simultaneously sell (write) a call, it's considered a "buy write." I will use the second scenario as an example for simplicity.

Buy Write Example:

You buy 100 shares of Exxon Mobil Corp (Symbol: XOM, which is trading at \$75.00) and sell someone a March 75 call option for \$180.00 which would give that other person (the buyer of the call option) the right to buy 100 shares of XOM from you at \$75.00 any time before March expiration.

The cost of this trade is \$7,320.00. (100 shares at \$75.00 = \$7,500.00, less \$180.00 that you received for selling the call.)

Here, you are risking \$7,320.00, the amount invested (assuming that the stock trades to zero.)

Your maximum potential gain is the \$180.00

which you've collected by selling that call option. You are profitable as long as the stock is anywhere above \$73.20 on March's expiration day.

Naked Put Example: You sell one March 75 put for \$180.00 which gives that person (the buyer of the put) the right to sell you 100 shares of Exxon Mobil at \$75.00 if he or she decides to do so by the time option expires.

The cost of the trade is technically zero

. You would have \$180.00 deposited into your account. But you will have to abide by your brokerage firm's capital requirements. Each firm has different requirements or formulas, but you probably will have to have a certain minimum equity with your firm. The point, however, is that the requirement is usually less than you would have to commit to a buy write.

Here you are risking \$7,320.00

can bet your butt that Joe Shmoe who paid you \$180.00 for that put will be putting the stock to you (selling you XOM) at \$75.00. 100 shares of XOM at \$75.00 = \$7,500.00, and you received \$180.00 for the put, hence your risk: \$7,320.00.

Your maximum potential gain is \$180.00. You are profitable as long as the stock is anywhere above \$73.20 on March's expiration day.

Conclusion: This is a "synthetic position" because we have the same risk, and the same reward. The difference (and not necessarily the reason for using naked puts as an alternative to a "buy write" or "covered calls") is that you have more free cash.

Remember: I don't care if you love or hate the covered call or naked put strategy, and I'm not telling you to do one or the other. The point is to show you that there are many ways to "skin a cat". I use "covered calls" as an example, since many people already understand that strategy.

Have you ever bought a stock and a "protective put" as insurance in order to protect you from a decline in the stock's price? Well, you have the same risk and reward when you just buy a call option. You just have to commit much less trading capital to a call option than you do to a stock position as well as a put option.

Not only that, but you incur *less trading expense* for two reasons:

- 1) You pay less commission by purchasing a call option than you do when you buy a stock position and a put option.
- 2) You lose less money due to the bid/ask spread. (The best way that I can explain this is to imagine if an option trades at \$2.00-\$2.30. If you bought it at the market you would pay \$2.30, but if you sold it right away, you would sell it for \$2.00 and lose 30 cents. When you buy a stock and a protective put, you have two positions, so just as you incur twice the commission, you also incur a bid/ask spread difference twice.)

Again, there are any number of reasons that people choose one alternative over another. These are just a few examples off the top of my head.

Another very popular scenario is when you want to sell a stock short (in an attempt to profit from a downside move,) sometimes your broker will tell you that it is not possible to borrow the stock from anyone, and that it is, therefore, impossible to short the stock. If you understand synthetics, you know that you can go to the options market and just "short" a call (sell a call option to open,) and "go long" a put (buy a put option to open.) You have the same risk and reward here, as well.

This works well for folks who don't want to simply buy a put option instead of shorting a stock. This may be due to the fact that they don't want the risk of losing the extrinsic value portion (time value) when they are long a (put) option. But since the trader also sells a call option to open, the money received from the sale of that call option makes up for the risk of the time decay on the put. The trader may lose money from time decay if that trader is long a put, but that trader would profit from time decay at the same time because of the call option that was also *sold (or written.)*

I don't want to confuse anyone with the specific strategies. But by explaining the concept of synthetics (different approaches to achieving the same risk reward ratio by constructing the position differently,) I'm giving you....Options.

Here are the six basic and most popular options synthetics:

Synthetic Single Position	Synthetic Combination Position
Long Call	Long Stock and Long Put
Short Call	Short Stock and Short Put
Long Put	Short Stock and Long Call
Short Put	Long Stock and Short Call
Long Stock	Long Call and Short Put
Short Stock	Short Call and Long Put

I hope this helps. And remember, we are going to mold TheTycoonReport.com based on what we hear from you, so don't be shy. I have a gazillion requests from you already, and the other four super-human geniuses who write for *The Tycoon Report*(LOL) and I will be focusing on giving you our perspective and/or knowledge based on what you ask us. (Sometimes we'll just talk about

funny, astonishing, and, most of all, beneficial to your bank account.)

Thanks for the feedback. More to come...

?Profit from the Trend?

A handwritten signature in black ink that reads "Chris Rowe". The signature is written in a cursive, slightly slanted style.

Chris Rowe

Chief Investment Officer

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