COMMON SENSE

A Lesson From the Options Game: Being Greedy Doesn't Pay Off

By JAMES B. STEWART
January 25, 2006; Page D3

Pride goeth before a fall, as Common Sense was reminded last week.

On Tuesday, Jan. 17, I was feeling smug. My Yahoo and eBay options were set to expire Friday, and I was looking at a handsome gain and a profitable resolution to an experiment I embarked on last summer.

Back in July, after Yahoo reported disappointing earnings and eBay surprisingly strong ones, I sold "covered" eBay call options -- which means I owned the stock, but sold the right to buy those shares at a fixed price at some point in the future. I used the proceeds to buy Yahoo calls, which gave me the right to buy shares in the future. Both options were trading at $2.50 a contract.

My hoped-for outcome was that Yahoo calls would gain and that eBay calls would decline, eventually expiring worthless. I would keep my existing eBay positions and exercise the Yahoo calls at what I hoped would be a bargain at the strike price of $35 a share.

Some professional options traders began sending me mocking emails as soon as I unveiled the strategy. Their mirth was triggered by my supposed naïveté, since the experiment was premised on fundamentals rather than the technical factors that drive the options market.

To many professional traders, options pricing follows a strictly mathematical model based on volatility, and they use sophisticated computer programs to ferret out pricing

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Dow Jones, Reuters

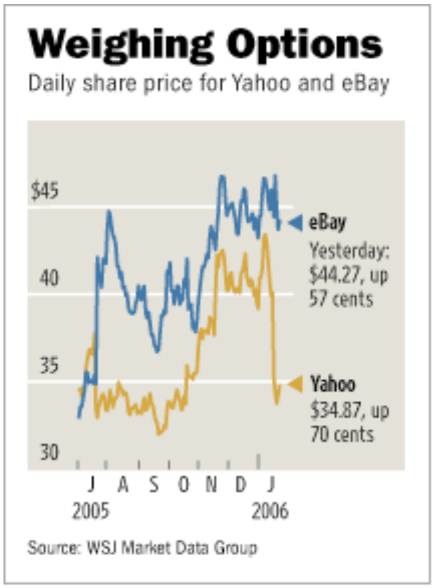
Yahoo! Inc. (YHOO)

PRICE	35.17
CHANGE	0.68
	4:01p.m.

eBay Inc. (EBAY)

PRICE	44.05
CHANGE	0.60
	4:00p.m.

anomalies. I am neither a math whiz nor a full-time trader, but I happen to believe there is a place in the options market for a fundamental investor like myself -- and that it may actually be an advantage when everyone else is a technician.



My notion was that the euphoric reaction to eBay's earnings and the punishment meted out to Yahoo last summer were predicated on short-term issues that wouldn't persist, and, thus, Yahoo shares would outperform eBay on a relative basis.

And so the experiment began. Almost from the beginning, it went according to plan. EBay's next set of earnings were mildly disappointing, so much so that I recommended buying the stock. I could have bought back my options for a pittance. But this was an experiment, and I was determined to stay the course. The Yahoo calls bobbed around in price, but by late November had more than tripled. The question seemed to be not whether the experiment would pay off, but by how much.

Last Tuesday, my Yahoo calls were above $8, having nearly quadrupled. My eBay calls, with a strike price of $45, were just above $1. It looked possible that I would have to deliver the shares, but I would still come out ahead, since I had sold the calls for more than $2.

Then the unthinkable happened: Both eBay and Yahoo announced their latest earnings. Both reports, on the face of it, were strong. But both warned about softer market conditions ahead. Yahoo's shares plunged in after-hours trading Tuesday, with eBay's stock following suit after-hours Wednesday. But when regular trading resumed Thursday, the day before the options were set to expire, Yahoo shares continued their decline, while eBay shares inexplicably rallied.

My options were whipsawed. By late Thursday afternoon, my Yahoo calls had shed nearly all their value, plunging from $8 to a nominal 15 cents. My eBay calls had jumped to $2.50. I was suddenly underwater on my experiment.

The next day the options finally expired. In a cliffhanger, both Yahoo and eBay were hovering around their respective strike prices of $35 and $45. Yahoo closed at $33.74 and eBay at $44.97. Both options expired worthless.

Naturally I was kicking myself over the vanished Yahoo gains. Still, I hadn't really "lost" anything, since the eBay calls had paid for the Yahoo position. The experiment was inconclusive, a wash. So what did I learn?

The simplest lesson was an old one: Don't be greedy. With a huge gain on the Yahoo calls, I should simply have taken some profit rather than wait another day or two for the possibility of an upside surprise on the Yahoo earnings. But on reflection, I also decided that this earnings- and expiration-related volatility marred my experiment and obscured the larger issue. Call me crazy, but I decided to place the bet all over again. This time I sold the July 50 eBay calls for $3.50 and used the money to buy the July 35 Yahoo calls, trading at just above $3.

I'm bracing myself for another wave of mocking emails. But time will tell. Victory may have been snatched from my grasp at the last minute, but to me that is no reason to give up.

James B. Stewart is an editor at large at SmartMoney magazine and a contributing editor at SmartMoney.com. He may have positions in the stocks he writes about. To read past Common Sense columns, visit www.smartmoney.com/wsj_common.