Chapter Eighteen Exercises

1. Investors who had been following a stock options strategy touted by brokers as a sure thing lost hundreds of millions of dollars when the Dow dropped 508 points on October 19, 1987. Were they buying calls, selling calls, buying puts, or selling puts? Explain your reasoning.

2. E.G. Capital Management, an investment management company, buys high-dividend stocks and writes call options against these stocks. *The New York Times* says that this fund has done very well in sluggish markets, but "in surging markets . . . will almost always underperform market indexes." Explain why this is so.

3. In 1989 the vice president of options and futures at Alex. Brown & Sons Inc. recommended that investors consider protecting their portfolios by purchasing put options, arguing that, "The worst thing that can happen is the value of your portfolio goes up." How do put options protect a portfolio? Why does something bad happen when your portfolio goes up? Is this really the worst possible outcome?

4. One investment advisor recommends this spread strategy:

   > You first determine the level of the index—either the S&P 100 Index (OEX) or Major Market Index (XMI)—and then buy the nearest in-the money options and sell the nearest out-of-the-money option with the same expiration month. If you are bullish, you use call options—and, if you are bearish, you use put options.

   He gives an example in September 1986, with the S&P 100 at 237.32, of buying an October 235 call at $7 and selling an October 240 call at $4.50. Graph the profits from this strategy as a function of the value of the index in October 1986. Do the same for buying an October 240 put at 7 1/8 and selling an October 235 put at 4 5/8.

5. An investment advisor recommended the following "absurdly easy" way to make money. On July 29, 1988, with the S&P 500 index at 272.02, a December put option on the S&P 500 with a striking price of 260 sold for $8 while a December call option with a 290 striking price sold for $1. Show the dollar gains and losses from selling the put and the call simultaneously, as a function of the value of the S&P 500 index when the options expire in December.