

A LEAPS Primer

James E. McWhinney

Overview

Long-Term Equity Anticipation Securities (LEAPS) are long-term options contracts. Unlike traditional options, which expire within nine months, LEAPS have expiration dates up to 36 months in the future. LEAPS are available in a variety of formats and can be used to implement a variety of investment strategies. Understanding how they work and learning about the risks and benefits associated with LEAPS, will help you determine whether or not they should play a role in your investment strategy.

Like other options, LEAPS are available as “puts” (the right to sell) and “calls” (the right to buy) and give investors the right, but not the obligation, to purchase (call) or sell (put) a specific number of shares in the underlying security at a predetermined price within a predetermined timeframe. LEAPS are available in three subcategories: Equity LEAPS, Index LEAPS, and Interest Rate LEAPS.

Equity Leaps

Equity LEAPS are available on hundreds on individual securities, but they are not available for every publicly traded stock due to the difficulty in determining a fair market price on a contract that may last for several years. Equity LEAPS for a specific stock will not be made available unless investors exhibit enough interest to suggest a viable long-term market for the contracts.

Equity LEAPS are American-style options, so they can be exercised anytime between their issue date and their expiration date. When exercised, they can be settled either in cash or with shares of the underlying securities. Equity LEAPS may be appealing to investors that:

- Do not have the time or interest to track securities prices on a daily basis
- Have a longer-term investment time horizon and do not wish to spend the amount of money that would be required to purchase the underlying securities
- Wish to hedge against the decline of a large stock position
- Seek to profit from the rise or decline in the price of specific stock

Index LEAPS

Index LEAPS are available on a variety of major equity indexes. They can be purchased as either American-style options or European-style options (which may only be exercised during a specific time period). When exercised, Index LEAPS are cash settled on the difference between the value of the underlying index and the exercise price. Index LEAPS may be appealing to investors that:

- Wish to hedge the market or specific industry sectors over a period of years
- Wish to take a bullish or bearish position on the market
- Are seeking to protect a portfolio against market moves

Interest Rate LEAPS

Interest rate LEAPS are options on the yield of U.S. Treasury securities. They are cash settled European-style options. Interest rate LEAPS may appeal to investors seeking to:

- Profit from rising interest rates
- Profit from falling interest rates
- Protect a fixed-income portfolio against rising interest rates

Trading

Standardization is a hallmark of options trading and, like other options, 1 LEAPS option represents 100 shares of the underlying security in all but the most unusual of circumstances. Orders are executed on national stock exchanges and are regulated by the SEC. The “strike” price, which is agreed upon when the contract is created, is the price at which the underlying shares can be bought or sold prior to the expiration of the LEAPS contract.

The LEAPS contract itself trades at what is called the “premium,” which is a fraction of the underlying strike price. Premiums are quoted on a per share basis, thus a \$0.40 per share premium on a single LEAPS contract represents \$40.00. The

premium fluctuates daily. LEAPS investors pay the premium even if the contract expires unexercised, so investors who wish to profit need to factor the premium into their calculations prior to exercising a contract. If unexercised, all LEAPS expire on the Saturday after the third Friday of their expiration month. Equity LEAPS expire in January, Index LEAPS expire in December or January, and Interest Rate LEAPS expire in December.

Investment Strategies

When investors anticipate that a particular stock will rise in price, they can purchase LEAPS calls to participate in the rally without purchasing the actual securities. LEAPS puts are purchased when a market decline is anticipated. Puts are often used as a sort of insurance by investors who hold existing positions and fear a market decline. While the money spent on the put is an expense that detracts from a portfolio's return, owning the put places a "floor" under the portfolio by limiting downside potential. More sophisticated strategies, such as selling a call and buying a call with a higher strike price but the same expiration date may also be employed when a rally is anticipated.

Risks

Unlike Index LEAPS and Interest Rate LEAPS, where investors risk only the premium, Equity LEAPS may present a different situation. While many buyers and sellers of Equity LEAPS contracts are described as "covered," because they own the underlying shares against which the contracts are written, some sellers of LEAPS calls don't own the shares. These investors are described as "uncovered," and their risk is much greater because they may be obligated to deliver shares that they do not own. Equity LEAPS, like all options, are sophisticated investments. Prior to purchasing any LEAPS contract, investors should carefully review the investment vehicle and strategy prior to making a financial commitment.

About the Author

James E. McWhinney is a professional writer with more than a dozen years of experience. He has worked for major financial services organizations including The Bank of America, Lockwood Financial Services, The Vanguard Group, and Federated Investors. James is a successful freelance writer specializing in financial services and travel.

Although information and opinions expressed reflect responsible points of view, they do not necessarily represent the opinions of the IMCA Board of Directors, the IMCA staff, or IMCA members.