Index Options Touted as Providing Peace of Mind

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The proliferation of indexes doesn't derive just from a desire to measure things. As with most things on Wall Street, indexes are, by and large, about cash.

For exchanges trading index options, increased volume means more commission dollars for their members. For investors, index options can provide profit insurance and peace of mind in the highflying sector. Through certain hedging techniques, analysts suggest investors use index or equity options to protect their profits without selling their hot technology stocks or mutual funds and incurring what might be a lofty capital gains tax payment.

"Keep in mind that the SOX index (the Philadelphia Stock Exchange semiconductor index), made up of 16 stocks of companies in the semiconductor industry, has risen almost 100% since the beginning of the year," says Marshall Kearney, options analyst at PTI Securities L.P. in Chicago. And interest in the SOX index is intense, with more than 325,000 options contracts traded since the beginning of the year.

Shareholders seeking broader protection than just semiconductor stocks should look at the recently created Chicago Board Options Exchange Technology Index, traded under the symbol TXX, or the American Stock Exchange Computer Technology index, traded under the symbol XCI.

Technology Insurance

Nervous tech investors can use puts to lessen their downside risk. Here's a chart showing how the purchase of puts on the TXX technology index (now at about 159.5) can affect an investor's portfolio:

INDEX AT EXPIRATION	PROFIT/(LOSS) STOCKS	STOCK ONLY RETURN	PROFIT/LOSS 150 PUT ONLY	COMBINED PROFIT/LOSS STOCK & PUTS	COMBINED RETURN STOCK & PUTS
130	($9,248)	−18%	$4,425	($4,823)	−9%
150	($2,978)	− 6%	($1,575)	($4,553)	−9
160	157	0%	($1,575)	($1,418)	−3

Investors who expect stocks in the high-tech area to decline in the near term can buy put options, while those who expect them to rise can purchase call options. Put options entitle their owners to receive a cash payment based on the amount, if any, the index value is below the exercise, or "strike," price of the option. Call options entitle their owners to receive a cash payment that depends on the amount the index is above the option's strike price.

Mr. Kearney, who is bullish on technology stocks for the long term, says investors could protect their profits from a near-term decline by purchasing put options, or bets on a market decline, on an appropriate index.

For instance, an investor nervous about the profits in a $50,000 technology portfolio could buy some TXX index puts with expirations of Oct. 20. Right now, the TXX is at about 159.5, and investors could buy October puts with a strike price of 150. At expiration, the put will be worth $100 for each point below the strike price—if it falls that far. If the price is above 150 at expiration, the puts are kaput and the money lost.

Investors can make a rough determination of how many put options they need to hedge their risk by multiplying the strike price of the option by 100, and dividing that number by the value of the portfolio. For instance, for our investor with $50,000 and interested in the 150 puts, that formula would indicate a need for three options (50,000/15,000=3.3).

With such puts costing about $525, insurance would cost about $1,575 plus commissions of between 2% and 5% of the value of the options.

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