

The Stock Repair Strategy



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Hippo Financial Trading Ltd Trading as Share Navigator
Company Number 547242

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1. The Repair Strategy

In the dynamic world of investing, it's crucial to acknowledge that stocks don't always follow the anticipated upward trajectory. Even seasoned investors, like Warren Buffett, encounter unexpected downturns—it's an inherent aspect of the investment landscape. However, understanding that options provide a means to address and recover from losses is pivotal. Rather than avoiding the reality, effective management strategies exist.

Whether it's adopting a patient approach, allowing the stock to rebound, or utilizing a combination of call options, options play a vital role in reducing break-even points and managing risk. While options aren't a one-size-fits-all solution, they serve as a powerful tool when aligned with a well-informed forecast for the stock. In this course, we emphasize the necessity of having a clear target price for the stock—a fundamental prerequisite for devising effective repair strategies. Our format will guide you through real-world scenarios, diverse forecasts, and fitting strategies, ensuring you're well-equipped to navigate the complexities of options trading. Remember, practice is key on your journey to mastering these invaluable techniques. Download our course now to elevate your understanding and refine your skills in repairing and optimizing stock positions.

1.1. Short Explainer Video

[CLICK HERE](#) to view.

1.2. Establish a Target Price to Sell

[CLICK HERE](#) to View.

1.3. Stock down 5% to 10%

[CLICK HERE](#) to watch a video presentation.

Scenario: An investor purchased 500 shares of GXG a few months ago at \$51. The stock has since retreated to \$47, a fall of 7.8%.

1.3.1. Possible forecasts:

1. Things are not looking good. None of the expected developments have materialized and it now looks as though GXG is heading south.

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2. Nothing has changed fundamentally. Sales and profits are as forecasted and the original target price on the stock remains unchanged.
3. Stock has retreated on some negative developments, although the investor now believes that all of the bad news "is priced into the stock". Nevertheless, the outlook is not as positive as it was when shares were first purchased, and the original target price looks overly optimistic. A revised target price of \$50 appears much more realistic.

1.3.2. Possible follow-up action:

1. **Sell the stock.** If the outlook for GXG is now negative and the odds are that this is the beginning of a bear market, there is no reason to hold on. Yes, selling at a loss is never a pleasant experience (both the pocketbook and the ego have to take a hit), but better to sell now at \$47 than in a few months at \$37. Cutting one's losses is part of a disciplined investment approach.
2. **Do nothing.** If the stock is down close to 8% on no news and if the outlook remains unchanged, there is probably no reason to panic. Very rarely does a stock go up in a straight line immediately after having been purchased. Investors in the stock market know that they sometimes have to live with adversity and must learn to be patient.
3. **Write covered calls.** If a realistic target price on GXG is now \$50, one possible avenue would be simply to wait for the stock to bounce back to this level and then sell the shares. But with the stock at \$47 our investor finds the following call options listed for trading:

	36 day-calls	64 day-calls	80 day-calls
Strike price: \$50	\$0.10	\$0.85	\$1.45
Strike price: \$55	\$0.00	\$0.10	\$0.40

Looking at the options' prices, our investor quickly realizes that writing the 55 calls makes little sense: with 500 shares, writing the 64-day 55 calls would only generate \$50 before transaction costs. By writing 5 of the 50 calls, either the two-month options at \$0.85 (total premium of \$420 before commissions) or the three-month options at \$1.45 (\$725 before fees) our investor can look to break-even (or very close!) on a bounce

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back to the \$50 area. The choice between the two and the three-month option should be made in light of how quickly GXG is expected to go back to \$50 and the investor's risk tolerance. He may be more comfortable pocketing \$1.45 immediately and living with his position for the next three months, or he may prefer to write the two-month options at \$0.85 with the thought that if GXG has not reached \$50 in 36 days he might have the opportunity to write a different series of calls and pocket additional option premium.

Some investors hesitate to write covered calls in a situation such as the one described here because they feel they are getting "locked into" their stock position until the options' expiration date – don't forget that you can always buy yourself out of the contract.

Finally it must be noted that writing covered calls against a stock that is down 5 to 10% from its purchase price will only help the investor break-even if the stock cooperates and rallies to or beyond the short calls' strike price. If, as in our example, an investor writes the two-month calls at \$0.85 and GXG continues to decline the \$0.85 premium received may appear as a small consolation if another \$5 or \$10 in losses accrue on the long stock position.

1.4. Stock Down 10% to 25%

[CLICK HERE](#) to watch a powerpoint presentation.

Scenario: An investor purchased 400 shares of LXL at \$75 sometime ago. The stock is now trading at \$65, 13% below the investor's cost. This investor would now be more than happy to simply break-even on this equity position.

1.4.1. Possible forecasts:

1. Things are going from bad to worse. LXL has broken through some technical resistance and the next move could see it drop to \$55.
2. This correction is overdone, the fundamental outlook still is excellent and the original target price on the stock is unchanged.
3. The move to the downside is over, but the odds of seeing \$75 in the short-term appear very low. A bounce can be expected, but not back to the purchase price of \$75.

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1.4.2. Possible follow-up action:

1. **Sell the stock.** A 13% loss is no fun, but let's not let it turn into twice this amount.
2. **Do nothing.** If the bullish picture is intact and the upside still present.
3. **Repair.** The goal here is to break-even on a bounce that will not take the stock back to its purchase price. How is this possible? One stock oriented strategy is to "double up", i.e., purchase an additional 400 shares at \$65 (not advisable). The advantage of doubling-up is that the average cost of the stock is brought down to \$70 (\$75 plus \$65 divided by 2). The disadvantages are the significant additional capital required (\$26,000 to purchase 400 shares) and the fact that the downside risk is doubled: every \$1 drop in the price of LXL will now accrue \$800 in losses, versus \$400 if the current stock holding is simply maintained. A second possibility is to look at writing covered calls. With LXL at \$65 the following call options are listed:

	28 day-calls	56 day-calls
Strike price: \$65	\$2.95	\$4.20
Strike price: \$70	\$1.15	\$2.30

The problem is that by writing the 56-day 70 calls at \$2.30, for example, the investor will not break-even if the stock rallies to the calls' strike price of \$70 since his cost is \$75 and his effective selling price would be \$72.30 (the 70 options' strike price plus the \$2.30 premium). An alternative to doubling up or writing covered calls is to use options to reduce the investor's break-even point.

1.5. The Repair Strategy

The repair strategy consists of the following:

1. Purchasing 4 of the 56-day 65 calls at \$4.20 (effectively giving us control of another 400 shares at \$65). Now our total share control is 800 (400 stocks position plus another 400 via the right to buy another 400 at \$65).
2. Simultaneously writing 8 of the 56-day 70 calls at \$2.30 (Covered Call....we can write 8 contracts because we now have effective control over 800 shares).

Let us look at the cost and benefits of this strategy.

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1.5.1. Costs:

The cost of initiating the above strategy is the \$4.20 paid to purchase 4 of the 65 calls (\$4.20 times 400 = \$1,680) less the premium received from the sale of 8 of the 70 calls at \$2.30 (\$2.30 times 800 = \$1,840). This turns out to be a credit of \$160, some of which can be used to pay for the transaction costs. To keep things simple in the following discussion, we will assume the options' position was initiated for even money.

1.5.2. Rights and obligations:

By purchasing 4 of the 65 calls, he now has the right to buy an additional 400 shares at \$65. Instead of "doubling up", our investor has obtained the right to double his stock position for the next 56 days. Obviously, he will only do so, (i.e., double up by exercising his long calls) if it is to his advantage. By writing 8 of the 70 calls, this investor has obligated himself to sell 800 shares at \$70. But this investor does not own 800 shares, only 400. Is he writing uncovered options? No. He may only own 400 shares, but he has just acquired the right to purchase 400 additional shares. In fact, he has obligated himself to deliver the 400 shares he owns, plus the 400 shares that he has the right to purchase, all at \$70. Where does this leave him on a profit and loss basis?

1.5.3. Profit and Loss

What if, as forecasted, the stock rallies part way back to its purchase price? The following table dissects the profits and losses for LXL prices from \$65 to \$70.

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Price of LXL	Accrued Loss on LXL Stock position	Value of Long 65 Call	Value of Short 70 Call	Value of Short 70 Call
\$65	(\$10)	\$0	\$0	\$0
\$66	(\$9)	\$1	\$0	\$0
\$67	(\$8)	\$2	\$0	\$0
\$68	(\$7)	\$3	\$0	\$0
\$69	(\$6)	\$4	\$0	\$0
\$70	(\$5)	\$5	\$0	\$0

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The accrued losses on LXL are based on a \$75 cost basis. There are two columns showing the value of the short 70 calls since 2 of these were written for every 100 shares held (8 calls sold, 400 shares held). Also, we have not taken into account the cost of entering into the options position since this was done for even money. Where does this leave our investor?

1. At \$65 the repair strategy's contribution is nil: all of the options are worthless, but then there was no cost in entering into this position.
2. At \$66 the 65 call is worth \$1, the \$70 calls worthless. If this is the situation at expiration our investor will probably sell the 65 call, pocket \$1 and reassess to determine if he should re-enter into the same strategy with options expiring at a later date.
3. The same applies if the stock price ends anywhere from \$67 up through \$70. But notice the overall profitability of the position if LXL ends up at \$70 at option expiration: the investor will then have a \$5 accrued loss on his 400-share position. But the long 65 calls will then be worth \$5. Our investor can then sell his shares, liquidate his options, and break-even on the total position. It is as if he now doubled up at \$65 (reducing his average cost to \$70) and liquidated his total position at \$70 to break-even.

The good news is that the option strategy has reduced the investor's break-even point from \$75 to \$70. What if LXL, at option expiration, has risen past \$70? The following table will help answer this question.

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Price of LXL	Accrued Loss on LXL Stock position	Value of Long 65 Call	Value of Short 70 Call	Value of Short 70 Call
\$70	(\$5)	\$5	\$0	\$0
\$71	(\$4)	\$6	-\$1	-\$1
\$72	(\$3)	\$7	-\$2	-\$2
\$73	(\$2)	\$8	-\$3	-\$3
\$74	(\$1)	\$9	-\$4	-\$4
\$75	(\$0)	\$10	-\$5	-\$5

As discussed above, at \$70, the \$5 loss on the stock is offset by the value of the 65 call and the investor breaks-even. At \$71, the accrued loss on the stock is now only \$4 and the net value of the 3 options is \$4, once again fully offsetting the stock's accrued loss. For any of the ending stock prices in our table, the accrued losses on the stock are fully offset by the value of the option position. Another way to look at this, is that if LXL rallies above \$70 our investor can do no better than breaking even. Not surprising since when he initiated the options position he obtained the right to "double up" at \$65 but also assumed the obligation of selling a total of 800 shares at \$70, effectively eliminating his position if LXL rallied to this \$70 level.

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To summarize, the repair strategy can often be initiated for even money, so at no initial cost, does not add any downside risk, although the risk of the existing stock position is not diminished or eliminated; it also reduces the break-even, but an investor can do no better than breaking even.

Entering into the repair strategy is relatively straightforward and can be done with one contingent order. But there is more than one way to existing at or close to expiration and investors need to decide which tack to take.

1.6. Practical considerations in exiting the repair strategy.

Assume for example that an investor was long 400 of LXL, bought 4 of the 65 calls and wrote 8 of the 70 calls. The stock price has rebounded to the \$71-72 range and option expiration is just around the corner. Our investor has achieved her goal of lowering her break-even point and simply wants to exit the entire stock and option position. What are her choices?

1.6.1. Exercise and assignment:

Wait until expiry Friday, if shares still above \$70, Interactive Brokers will automatically assign another 400 shares at \$65 and then sell 800 shares at \$70. There are no commission costs for this.

1.6.2. Liquidate:

You can liquidate the call long options and half her short options, and wait for assignment on the second half of your short options. This would consist of selling 4 65 calls and buying 4 of the 70 calls, a spread that theoretically should be worth \$5. But in real life you will probably not be able to obtain the full \$5 on a spread order, maybe having to settle for \$4.80 or \$4.90. This would leave you short the remaining 4 * 70 calls which will be assigned and against which you will deliver the 400 shares of LXL. You would have to pay commissions on exiting the 4 by 4 option spread and upon assignment of the last 4 call options.

So which is the best way to exit? We look at "best" as that which will yield the most cash after transaction costs and bid-ask differentials. The first exit route has the advantage that stock will be purchased at exactly \$65 and sold at exactly \$70 yielding the full \$5 spread.

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Important Note: If the stock continues its downtrend, the options position will neither protect him against further losses nor increase his downside risk. The investor will see losses continuing to accrue on the 400 shares he still owns, but the options position will become worthless as both series of call options will be out-of-the-money and will expire worthless. The options will neither have helped or hindered as the total initial cost was nil, and their final value also zero.

1.7. How to Construct a Repair Strategy

[CLICK HERE](#) to view.

1.8. Pre Repair planning

[CLICK HERE](#) to view.

1.9. Post Repair Trade Mgt

[CLICK HERE](#) to view.

1.10. Summary

[CLICK HERE](#) to view.

1.11. Test Your Knowledge 1

[CLICK HERE](#) to take the quiz.

1.12. Test your knowledge 2

At this stage it is best if you start practicing for real so this is what we want you to do:

1. Pick any optionable stock
2. Imagine that you bought the shares 15% higher than what they are trading at today.
3. Pick a new target price below the purchase price
4. Prepare a repair strategy expiring 3 months from now (roughly)
5. Create Profit and Loss tables
6. Identify your breakeven
7. Identify your Max Profit
8. Compare what your profit would be with the repair strategy if new target price is reached vs not doing the repair strategy
9. Share your insights on our daily members web meetings

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2. Real Life Example - QCOM

2.1. The QCOM Scenario

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2.2. Repairing QCOM

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2.3. Rights and Obligations with QCOM Repair

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2.4. Please leave a Review on Google

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