

OPTION NOTES

MAKING MONEY WITH LIMITED RISK

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\$139 / year

Categories:

Action Now!

Option trades that are likely to produce results in the immediate future.

Strategic Wealth Builder

Longer-term opportunities that have macro-economic justification that may not be fully recognized in the market.

Value

Trades with a medium length time frame from the perspective of fundamental value using options strategies with edge.

Special Situations

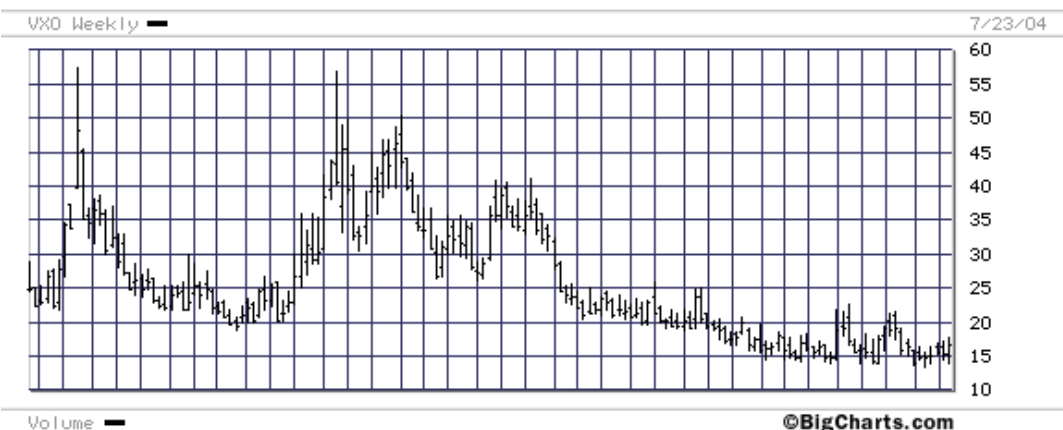
Opportunities that are the result of specific market conditions.

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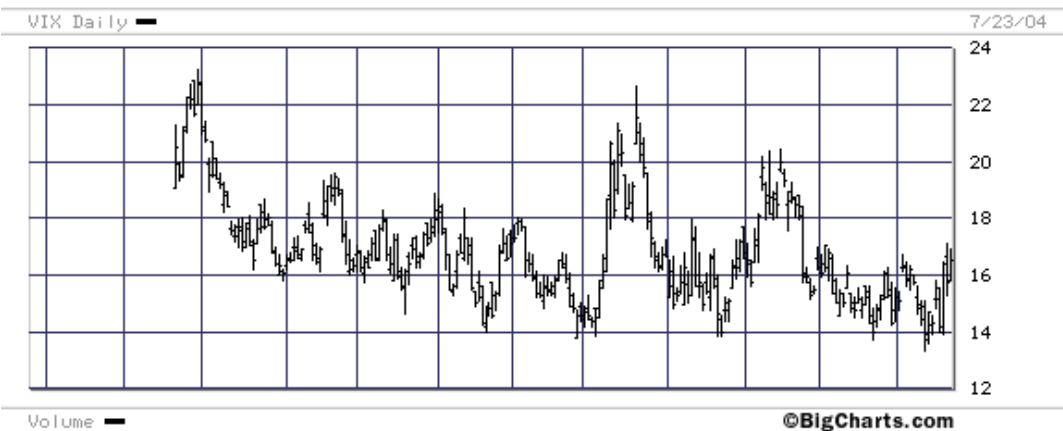
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VIX and VXO

You may be aware that the Chicago Board Options Exchange has revised its method of calculating the VIX, volatility index. The old calculation was based upon the at-the-money strike prices of the S&P 100. The new is based upon a wide range of strike prices, not just the at-the-money, and it is based upon the S&P 500. The old method is still available with the symbol VXO. For some perspective of the current volatility, look at the chart below. Currently at 16.63 on the VXO (old VIX) with a 52 week low of 13.37 on June 23, 2004.



The difference between the VXO and VIX are not significant, and the new VIX is now 16.50 with a 52 week low of 13.34 made on July 14, 2004. We see a noticeable increase in volatility, as one would expect in this now declining market.

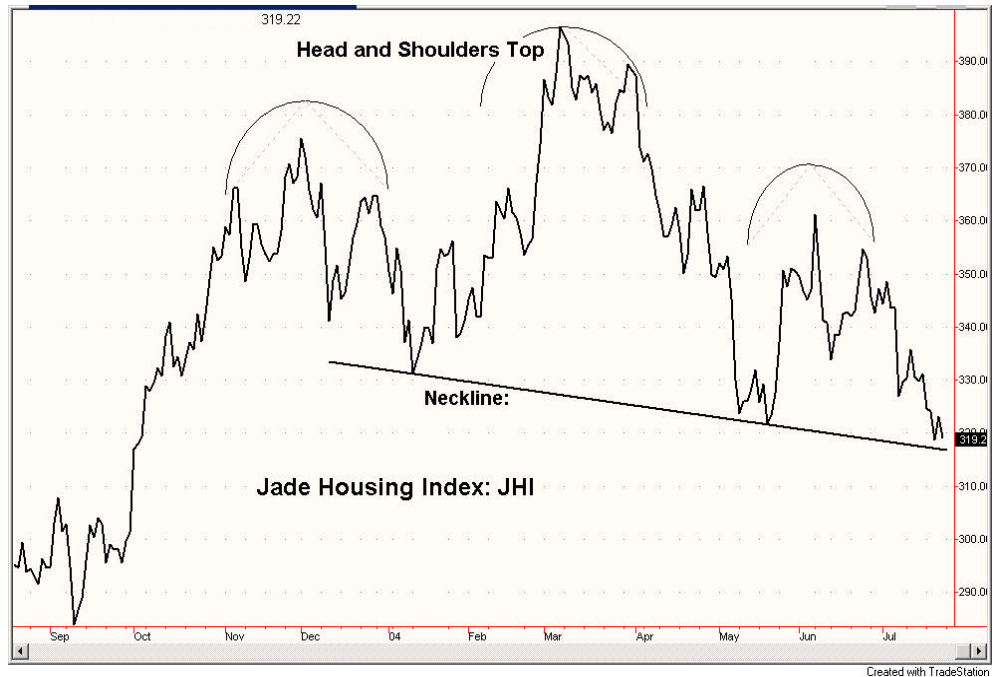


In a rising volatility environment, one should be long more options than short options; as their value increases with the increase in volatility. Look for long puts in weak sectors that have more downside to go.

Action Now!

Last month's pick from the Special Selection is being featured again as an Action Now! Last month we recommended the purchase of a January 45 Put LENMV @ \$4.20. The housing stocks are having problems despite the company's recent record earnings. Take a look at the Jade Capital Housing Index:

Note the H&S Top formation and the current price in relation to the neckline. We would expect to see a significant move to the downside when they cross the neckline. In the case of **Lennar (LEN)** the number is 41.33. The close today was 41.87, just ½ point away. In this environment of increasing volatility, the odds are high that this stock and many in the group will set off the H&S Top patterns. This, of course, would mean lower prices. Use the January 42.50 Put LENMV 4.20-4.40 or the alternative (split adjusted) XFFMV 3.90-4.10. We plan to use the XFFMV, as we think this will be resolved soon, so we expect Action Now!



Buy January 42.50 Put LENMV 4.20-4.40 or XFFMV 3.90-4.10

Value

In the value category, we remain long **Frontline (FRO)** stock as our call option that we sold last month expired worthless and we kept the stock. Our basis in the stock is 33.60 and it closed today at 36.95. Last month we collected 3.00 premium as we sold the FBJ July 40 call. When Frontline spun off **Ship Finance International Ltd (SFL)** last month, they created a new option series for the stock that includes the portion of SFL that was spun off, plus the cash distribution. So, the new options series FBJ now comprises 100 Shares of Frontline, 25 shares of Ship Finance and \$475. Therefore in order to maintain a perfect hedge we need to buy 25 shares of SFL and keep \$475 available in the event our option is called. So this is the trade: Buy 25 SFL, which closed Friday at 16.81, after the open on Monday and sell one August FBJHH 6.10-6.60. The premium we collect will provide the cash reserve in the event it is called and will partially pay for the purchase of the 25 shares of Ship Finance. Our basis in the 25 SFL shares would then be 11.41 per share. If our position was called Frontline would need to be trading at 40 or above and SFL would be trading at 18 or above. We would make 6.40 on Frontline (our basis is 33.60) and 6.50 on SFL. The alternative is for the option to expire and we would keep the 6.10. In that event, we would do it again next month.

Buy 25 SFL
Sell one August FBJHH 6.10-6.60

Special Situations

Crude Oil Hedge

Crude Oil prices seem to be holding at the 41 level basis the October futures contract. There is a potential double top from the 41 level set in late May. While we have expected the double top to turn crude lower, we now think we need to establish a position in the event it breaks out above 41.



This a good opportunity to use a bull call spread. If it breaks out to the upside we will buy back the short call leg of the position and retain the long call. In the meanwhile we have a defined risk. While many companies can be used for this strategy we like **Unocal (UCL) 37.56**. They have just announced the appointment of a new President and are accelerating their exploration plans. Buy the September 37 1/2 call UCLIU and sell the September 40 call UCLIH. Based upon today's closing prices it will be a net debit of 1.10. So we are risking 1.10 to make a maximum of 2.50 (the difference between the two strike prices). If crude oil prices do turn down close the position and buy a September 37 1/2 put. The stop loss trigger is the October crude oil futures contract with a close below 39. While volatility is not high, it will expand if the price of the stock declines. This is the most likely scenario and our debit call spread can be viewed more as a hedge against a further rise in crude oil prices. If crude breaks out above 41, then there will most likely be further damage to the broader market, especially in the consumer cyclicals. Consider it an insurance policy with a small premium that will be profitable if the breakout event occurs.

Buy September 37 1/2 call UCLIU
Sell September 40 call UCLIH

Results from Last Issue

Bad news for **Ballard Power (BLDP) 6.12** resulted in the close of our long January 7 1/2 call. We sold it on July 9th for 1 when the company announced that they were having difficulty selling complete power systems to the automotive industry. It seems the major automotive manufacturers have decided to develop their own systems. It's also likely that Ballard could not raise additional capital and decided to turn over the automotive development operations to Ford and Daimler-Chrysler at a loss. We booked a 1.77 loss on this position.

In Frontline we were able to keep the premium on the July 40 call that we sold for 3.00, so this is a booked gain of 2.99.

Existing Portfolio

	Cost	Current Market	Mark to Market
Long 100 Frontline shares	33.60	36.95	3.35
Long Lennar Jan 45 Put	4.40	5.60	1.20

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All prices are based upon the close as of July 23, 2004. Nothing contained in this letter constitutes a recommendation to buy or sell any security. Before entering a position check to see how the prices compare to those used in the recommendation as the prices are likely to change on the next trading day. Make sure to do your fundamental and technical analysis before making a commitment.

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