

OPTION NOTES

Volume 4, Issue 2

June 26, 2004

\$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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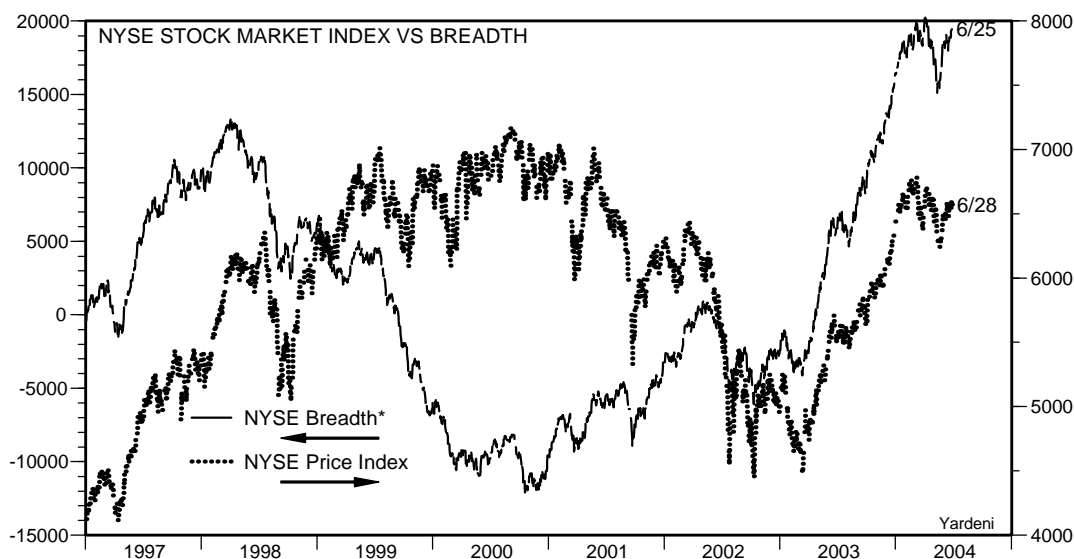
Regular Publication Schedule

The decision has been made to publish Option Notes on the following Saturday after the regular options expiration Friday. Options traders who like to sell premium in the current month, are just at the point when time decay begins to accelerate. We will do the selections on Saturday, using the previous Friday closing information. Of course, prices will change on the next Monday, so make sure the quotes you receive are still close to those recommended. With respect to risk management and trade size, we will recommend trades as “one lots”. That is, 100 shares of stock and one option for each suggested leg. If your risk tolerance is greater, simply increase the size of the recommended trade. Remember, most options exchanges have automated execution systems for option trades up to 10. Try hitting the bids and offers of the quoted prices. This gives market makers’ incentive to keep their quotes current and may be an opportunity, if you can get an automatic execution on a stale quote. No guarantee, of course but it is worth trying.

Market Comment

While we do not plan to offer regular opinions on market conditions, we do want to share specific observations from time-to-time. It’s been awhile since we did a complete market review and we were pleasantly surprised to see the significant improvement in the breadth statistics. We use the cumulative breadth numbers and they are truly outstanding. NYSE breadth is far above the market top in 2000 (no surprise), but is even above the 97-98 top. This market is expanding in the sense that many more stocks are participating, indicating market strength. Take a look at the chart.

On the other-hand, the Dow Theory crowd is skeptical and will remain in doubt until the DJ Industrials confirm the higher level of the DJ Transports. Since there is sector rotation going on, we encourage you to do your own research on the market internals.



* Breadth is measured by subtracting the number of declines from the number of advances, and adding the result to that of the previous day.

Action Now!

No candidate this issue.

Subscription Rates

We are local and available in the San Diego area. We can be found at the monthly Trader SIG group meetings and are always available to discuss markets, trading, and options strategies.

All for the low price of:

Annual Rate: \$139/year

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We reserve the right to terminate publication at any time. In this event, unused proportion of subscriptions will be cheerfully refunded.

Results from Last Issue

We recommended a fairly complicated option combination for Cyberonics (CYBX) in the previous issue. When the stock began trading on Monday June 14, 2004 it was a \$1 or so higher and the options prices had changed somewhat. The numbers we got were as follows: Bought 100 shares CYBX @ 19.55, Sold one Jun 17.5 put @ 2.55, Sold one Jun 22.5 call @ 2.45 and bought one Jun 12.5 put @ .40. Trading in the shares were halted on Tuesday, June 15 awaiting the announcement. On the 16th, the news was an-

nounced that the FDA panel recommended the product.

The stock gapped up 12 points on the opening. We closed out the position shortly after the opening and booked the following:

Sold shares CYBX @ 31.96,

Bought one Jun 17.5 put @ .05,

Bought one Jun 22.5 call @ 9.20 and

Sold one 12.5 put @.05.

When we booked the final numbers we got these results: \$773 gain in two days with a \$1,170 margin requirement. That's a 66% return, even higher annualized.

Existing Portfolio

Long one BLDP Jan 7.5 call, symbol XOTAU at 2.75, current market indication 2.55.

Value

Value is a new category focused on fundamental value opportunities using option strategies. Our first recommendation is Frontline Ltd., (FRO) \$32.84, a Bermuda-based ship management company that owns controlling interest of Ship Finance International (SFI). Ship Finance owns VLCC and other tanker ships that operate in the spot market. This means they benefit directly as shipping rates increase. The market implied volatilities (MIV) are high, due to the fact that FRO has been paying substantial dividends from its operations. The trade here is to buy 100 shares of FRO and sell the July 40 call. With the stock at 32.84 and the July 40 call at 2.75 this seems too good to be true.

They will not declare a dividend between now and the July expiration.

If the stock rallies to 40 or above, we would make \$990 in three weeks on a \$1643 margin requirement. A stock chart follows. Don't be concerned by the gaps in the charts, as they represent the dividends that they have been paying. The last one was \$5.00 in cash and about \$3.00 worth of Ship Finance Limited stock. The previous gap in the spring time was a \$3.75 dividend. The shipping market is tight as there are not enough ships to handle the demand for more crude oil.

Buy 100 FRO @ \$32.84
Sell 1 July 40 Call FBJGH @ 2.75



Special Situations

Special Situations is another new category and represents specific opportunities, generally of a longer term nature.

Real Estate Market Hedge. For any or you who may have accumulated big equity in your houses and are wondering what to do in a rising interest rate environment, we suggest that you hedge your home equity. They way to do this is to buy puts on companies that will go down in value with a housing sector decline. Our pick is Lennar Corp (LEN) \$45.90. New home starts announced Wednesday set a record. The industry is in the middle of a boom! However, look at the chart of LEN above.

In March they traded above \$55 but now are at a \$46 resistance after the record housing numbers. What's wrong with this picture?

Wall Street does not buy the story and is selling the stock, along will all others in the sector. Watch the \$46 resistance, if the stock trades higher then be careful and wait for a better entry.

If the stock shows any weakness on Monday June 28, 2004, then make your move. Buy one Jan 05 45 LEN put, symbol LENMI. On Friday they were \$4.20 with a market implied volatility of 34. These are not expensive puts and the volatility will most likely expand when the market accepts the fact that this cycle is over. Remember the objective here is to be offsetting an impending decline in home equity, so choose your size accordingly and be patient as this will take several months and will not happen overnight.

Buy 1 Jan 05 45 Put LENMI @ 4.20

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All prices are based upon the close as of June 25, 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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