

# OPTION NOTES

## MAKING MONEY WITH LIMITED RISK

Volume 4, Issue 5  
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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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## Action Now!

### Cheniere Energy (LNG) \$19.81

Everybody knows there is something going on in the energy sector. Crude oil prices are at new highs and so far show no sign that they will move lower anytime soon. With respect to natural gas, prices moderated somewhat from the spring, and have now resumed the up move typical for this time of year. Wall Street analysts remain sanguine in their forecasts for lower energy prices just around the corner. We do not share that view. We believe there is a fundamental imbalance between supply and demand. Only much higher prices will bring forth the necessary exploration and production to eventually moderate prices at a new higher equilibrium level. Some energy experts

have been expressing the view that importing Liquefied Natural Gas, LNG is the short term solution and have started to look for companies that are in this business. While the selection is limited we have found one. Cheniere Energy is a Houston based developer of liquefied natural gas receiving terminals. It is developing Gulf Coast LNG receiving terminals near Sabine Pass in LA and near Corpus Christie in Texas. While we believe it will take a long time for such facilities to have a meaningful impact upon the natural gas shortage we are encouraged that at least one company is starting. In the meanwhile we are wondering why the major companies are not yet involved. On recent terminal development and ship charter news the stock price gapped above \$20. See the chart that follows.

Date = 09/24/04 o/h/l/c = 19.65 20.00 19.45 19.81 +0.16 vol = 291200



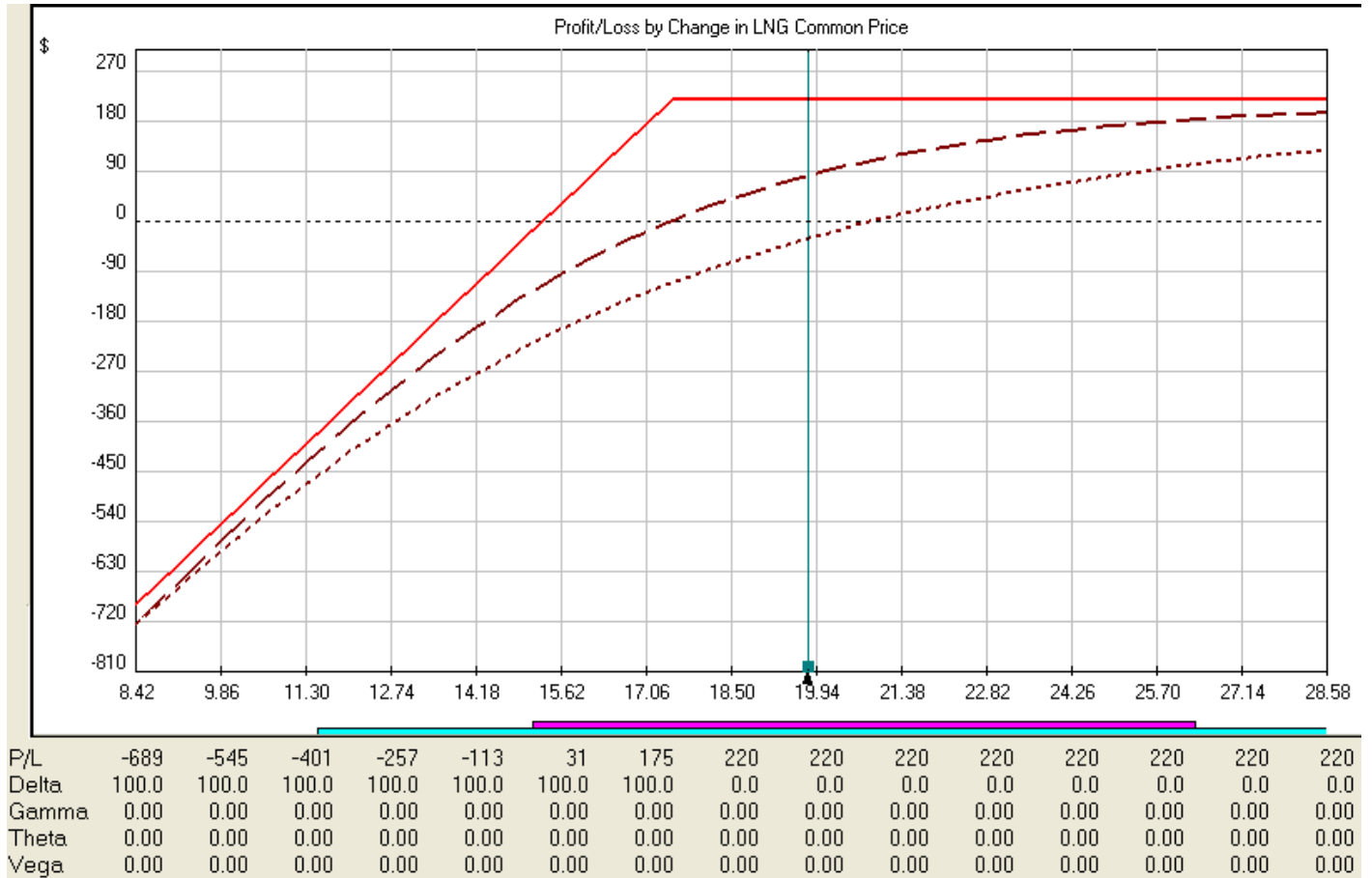
This activity caused the options, which recently just began trading, to be priced at very high levels. This means that we want to be selling options to capture that edge. We can buy the stock and sell call options or we can simply sell put options as an alternative strat-

egy to get long. We have selected to sell March 17.5 puts which were bid on Friday at 2.20. At the bid the Market Implied Volatility is 64.4 while the Statistical Volatility of the underlying is 33 and both are declining.

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While we like the fundamental story of the underlying this proposed trade is actually a volatility trade. We are expecting the volatility to decline. When it does we will plan to exit the position and we would not expect to hold the short option for the 175 days to expiration. The trade profile follows.



We collect \$219 for each put option sold and using Interactive Brokers we would have a margin requirement of \$979. While the forecasted return does not seem to be a lot if we keep it for 175 days we fully expect to capture a substantial portion well before March expiration. We have a break even price of \$15.31 with a probability of profit at 83%. Along the bottom of the chart the solid back line represents a one standard deviation move. Before the P/L becomes negative we would have to exceed a one standard deviation move. This is shown as the -113 number. However, within the one standard deviation range the downside is +31 dollars while the upside

is + 220. This seems like a reasonable trade. The P/L position chart shows the change in expected profit and loss at three time intervals. The dotted line assumes the trade was done on Friday at 2.20. The dashed line is one-half way to expiration and the solid line is the numbers at expiration. It does not show the expected gain from the change in volatility. We would plan to hold the position as long as the volatility is declining. The put option has a Vega of 4.78. Vega is a measurement for the sensitivity of volatility changes. It means that because we are short the put option, we make money as the volatility declines.

## Current Portfolio

At this point we don't have any open positions, but we would encourage you to get some positions in the energy sector as either a hedge for your other holdings or as an outright long position.

## Results from Last Issue

### PSFT

On the September options expiration we closed out our open positions. The PeopleSoft trade worked out and finished pretty much as we described it in our September 10, 2004 update. We sold the two remaining October 12.5

puts on options expiration for .10 each resulting in a loss of 34 for these options. So the final recap is a gain of \$251 on an investment of \$1,598 in 18 days. This is 16% or 319% if annualized.

### UCL

Our low cost energy hedge using the Unocal bull spread worked out just as one would have expected. These are low risk trades and if the underlying moves in the forecasted direction, they are very profitable based upon the

required investment. We invested a net of \$97 and closed the position for a gain of \$238 in 53 days. This is 245% or 1,690% if annualized.

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