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Contrarian Call

How options traders are girding for the bear

BY ERIN E. ARVEDLUND

So many people are banking on a yearend rally that it might be a sign a rally isn't in the cards.

That's the contrarian approach to market calls, and it's one that many options traders favor. "I don't think a rally will happen," says Jordan Kahn, president of Kahn Asset Management, a hedge fund in Santa Monica, California. "Too many people need it, and that's when the market inflicts the most pain."

If the rally proves a phantom, then, how are options professionals strategizing to avoid a looming bear trap?

Kahn, for one, isn't writing covered calls on the stocks in his portfolio at this time. Selling or "writing" call options was an immensely popular strategy when the bull market raged. Under current conditions, however, the strategy has lost a lot of appeal. "If the market wasn't going anywhere, I'd take in premium," Kahn says. "But when the market is more volatile, with huge swings up and down, we don't want to be sellers of options. We want to be buyers -- that is, to get long options."

Remember, buying either put or call options means your long options. That's different from the opinion you take with these options. Owners of puts are betting against the underlying stock or market index, while call buyers believe the stock or index is heading higher.

"Covered calls are a horrible strategy right now," Kahn says. If you write call options on your portfolio and the stocks fall precipitously, he explains, you're only partially protected. If the stocks rocket higher, you've sold away your upside. In a volatile market, Kahn adds, it's best to be long stocks and puts. If your stock gets a lift, you can sell some puts; if it fluctuates, you remain hedged.

Kahn recently bought January 300 puts on the MNX, or Mini-NDX index options. The MNX, dubbed the "Minx," is one-tenth the size of the NDX, or the Nasdaq 100. When buying options, he tends to stick with those that expire three to five months out.

Other than "regular folk" just trying to protect their investments, there are some more sophisticated strategies.

Kyle Rosen, manager of Rosen Capital Management, is trading Nasdaq and other index-option volatility in a sort of index-option arbitrage. It's a more risky strategy that takes advantage of divergent levels of option volatility. He takes in premium by selling Nasdaq index options, which currently are very volatile and hence, expensive. And he buys Standard & Poor's index options with what he bets is cheap volatility.

When the Nasdaq was in a recent swoon, Rosen sold some NDX December -- and January -- dated puts. He has also created his own baskets of stocks, against which he sells single-stock options and buys index options.

"The vulnerability of the Nasdaq is mostly gone in light of all the money already taken out," he declares. "Until the December expiration this is the trade to be in."