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Some Trades for '01

And a new accounting rule takes effect

By ERIN E. ARVEDLUND

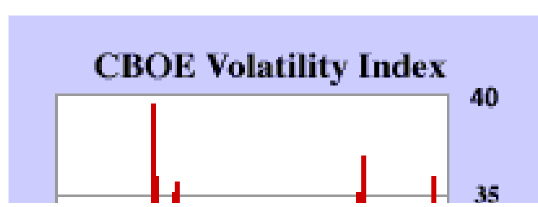
Option traders don't care where the market goes, as long as it's volatile. So we'll leap right in to 2001 and ask strategists what their trades are for the New Year.

Larry McMillan of McMillan Analysis has two main points. The first concerns the misunderstood January Effect. That's a start-of-the-year rally usually due to a reversal of tax-loss selling.

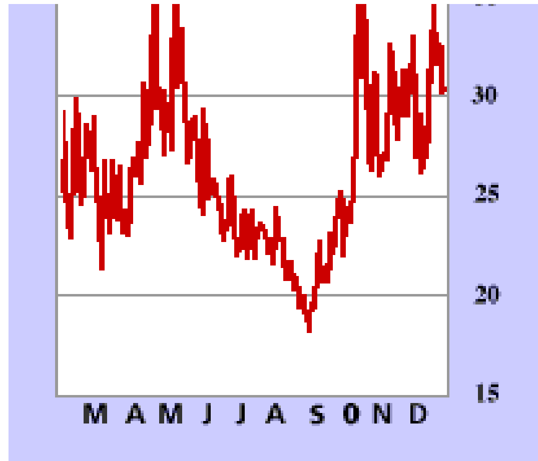
At the end of a normal year, small-capitalization stocks are sold to generate losses and offset gains taken on big-cap stocks. Last year, however, the market turned upside down. Big-cap stocks were devastated -- Microsoft, IBM, Cisco, Lucent and AT&T. So these big-cap stocks were sold for tax purposes. By McMillan's logic, then, these same big-cap stocks should have the better rebound in the New Year once tax selling ends.

Second, McMillan likes a few stocks as ideas for straddles, a trading position that involves both a put and call option on a stock with the same strike price and expiration. The bet is on a stock with good statistical history of exploding either to the upside or downside, so that either leg of the trade makes money; he likes Owens-Illinois, PepsiCo, Peoplesoft and Xilinx.

Bear Stearns option strategists Wing Chow and Gary Semeraro point to volatility and premiums in the drug sector as still fairly cheap, although not as cheap as late last year. Their bet is to sell options dated out to the April-May time frame, in particular collars on the large-cap drug stocks. A collar is normally used as a protective strategy if you are long a stock; you then sell an out-of-the-money call and buy an in-the-money put option on that stock.



A tax-related idea comes from John Cassoll, option strategist with UBS Warburg in Stamford, Connecticut. Are you holding 2001 January-dated puts and riding a big profit? If you want to take some money off the table, but not take a whopping tax hit, you can sell a new January-dated option at a different strike price, or sell a later-dated option at the same strike price.



Watch out for FAS 133 in the New Year. In June 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard No. 133, "Accounting for Derivative Instruments and Hedging Activities." All companies on January 1, 2001, had to adopt FAS 133, which requires them to "mark to market" their derivative positions, or recognize them at fair value. Changes in fair value are to be recorded each quarter in current earnings; until now, the cost of an option was generally applied over the holding period.

This could have an odd effect on stock prices, since the true value of a derivative strategy or hedge isn't known until a future date. Starting in January, all companies must report their exposure to such strategies -- which could lead to some bottom-line volatility and investor unease.

Look for FAS 133 reports out of companies that are involved in major financing activity or commodities trading. Microsoft gave one of the first signs of the impact the new rule may have on corporate earnings. The software giant took a $350 million after-tax charge in its fiscal first quarter, ended September 30, to comply with FAS 133. But it also said fluctuations in the fair market value of its derivatives could be both positive and negative, depending on market conditions.

Be prepared for a higher level of income volatility than before from other heavy users of derivatives, such as banks, brokerage firms and multinational operations with large foreign-exchange risk, says Ira Kawaller, president of a Brooklyn-based derivatives consulting firm that bears his name.

"The SEC realizes this isn't an easy standard to implement, but because it's so significant, they'll likely make an example out of at least one company," says Joseph Neu of FAS133.com (www.FAS133.com), a Website on compliance with the new standard.

Feel as if the wounds in your portfolio require some options iodine? To learn more about option strategies, visit the Options Industry Council's Website (www.888options.com), a great place for free educational materials and a new 2001 schedule of free seminars around the country. Or call the free hotline, 1-888-OPTIONS.

Also, online broker Mr. Stock offers an excellent "Option Investing Guide" to investors who open an account online (www.mrstock.com). A basic options reading list includes McMillan's *Options as a Strategic Investment*, James

Bittman's *Trading Index Options*, or a recent addition, Max Ansbacher's *The New Options Market*.

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