Despite the similarity between the leverage characteristics of stub stocks and options, the two types of securities differ in one important way. Options have a limited life; they only have value until their expiration date. Stub stocks are common stocks so in some sense, they are really like calls without an expiration date (although the stub stock may become worthless as a result of a bankruptcy proceeding). It is this unlimited life that makes stub stocks so attractive. That's why buying LEAPS, which are merely long-term options, can be an attractive way to emulate a stub stock investment.

While LEAPS don't have an unlimited life like stub stocks, they can usually be purchased up to two and a half years before they expire. This often gives ample opportunity for the stock market to recognize the results from an extraordinary corporate change (like a spinoff or restructuring) or a turnaround in fundamentals (like an earnings gain or the resolution of an isolated or one-time problem). Additionally, two and a half years is often enough time for many just plain cheap stocks either to be discovered or to regain popularity. Since current tax law favors holding investments for more than one year, buying LEAPS is also a way to receive long-term capital gains treatment while receiving the leverage benefits of an option investment.

In some ways, though, LEAPS can't duplicate the dynamics of a well-planned recap. In a recap, management and employees can be incentivized using the new stub stock. Given the tremendous upside of stub stocks, this can be a powerful way to unleash the forces of management and employee stock ownership in an organization. Also, a recapitalized company has the immediate benefit from the tax advantages of a leveraged balance sheet. Obviously, buying LEAPS doesn't affect the tax status of a corporation. (However, because there is an implied interest cost factored into the price of the LEAPS, interest expense does get included in the LEAPS holder's tax basis.)

On the other hand, there is one huge advantage that LEAPS have over stub stocks. You can trade LEAPS on hundreds of companies, while the list of available stub stocks is limited to the number of companies that choose to recapitalize. Even in the 1980s, this list covered only a select few companies at any one time. The fact that there are so many LEAPS to choose from—and that *you*, rather than a company's management, get to choose which stocks would make the best leveraged (or "stub-like") investments—should make LEAPS a very useful investment alternative.

While stub stock opportunities are generally easy to spot, as there is usually an announced recapitalization transaction, in-

Often, however, option traders who use these formulas do not take into account extraordinary corporate transactions. The stocks of companies undergoing an imminent spinoff, corporate restructuring, or stock merger may move significantly as a result of these special transactions—not because historically their stocks have fluctuated in a certain way. Therefore, the options of companies undergoing extraordinary change may well be mispriced. It should be no surprise, then, that this is where your opportunity lies.

Depending upon how large or how important a spinoff is relative to the parent company, the stocks of spinoffs and parent companies can move dramatically after a spinoff is completed. Since the date of distribution of spinoff shares is announced in advance, knowing this information along with some fundamental information about the underlying companies involved can give you a large edge over option traders who invest "by the numbers." One strategy would be to buy options that expire several weeks to several months after a spinoff is consummated. In the period after the spinoff, the parent company's stock may make a dramatic move because investors had previously been holding back on purchasing the parent's stock until the divestiture of the unwanted business was completed. So, too, the spinoff stock's price could be a source of surprise during this initial trading period simply because it is a new stock with no trading history and no underwriter to set an expected price range. The bottom line is that the options markets can be a profitable place to exploit your research efforts in the spinoff area. Specifically, you can apply both your knowledge of when a spinoff is scheduled to take place and your fundamental understanding of the underlying companies involved.

Restructuring transactions and stock mergers can provide similar advantages to knowledgeable option investors. In restructuring situations, knowing the timing of crucial events in an ongoing program can help you choose the appropriate option expiration date for a call or put position. In many cases, the date of a significant distribution of cash or securities or the target date for the sale of assets can correspond to a significant price move in the underlying stock.

In merger situations, where a portion of the acquisition price is paid with common stock, it is the closing date of the merger that can be the catalyst for extraordinary stock price moves. Shares of the acquiring company (into which your options on the target company become convertible once the merger is completed) are under all sorts of pressure before and immediately after the merger is finalized. First, in most cases, risk arbitrageurs start buying shares of the target company and simultaneously begin shorting shares of the acquirer almost immediately after a merger is announced. Only once the merger is completed is this source of selling pressure on the acquirer's stock usually relieved. Also, in the weeks immediately after the closing of a merger, those shareholders who had not already sold their shares when the merger was announced tend to sell the shares they received in the acquirer's company. This is usually because the original investment in the target company's shares was made for reasons specific to that company—reasons not applicable to the acquirer's shares. After this selling pressure subsides, the acquirer's stock can sometimes move up dramatically. This is most apt to take place when a large amount of new stock is issued in the merger relative to the amount of predeal shares the acquirer had outstanding.

But enough theory. Now, let's see a real-world example of how extraordinary corporate events can throw a wrench into the workings of the most sophisticated computer models.

CASE STUDY

MARRIOTT CORPORATION OPTIONS

The Marriott spinoff situation (discussed in chapter 3) provides a good example of this phenomenon. As we saw, Marriott Corporation was splitting into two separate companies—a "good" Marriott (Marriott International) and a "bad" Marriott (Host Marriott). Marriott International was ex[illegible] to have all of the valuable hotel-management con-
[illegible] hold all of the un-

with an exercise price of $25 per share for a cost of $3.125. Since the third Friday in October fell on October 15th (and the spinoff was to be completed by September 30), the stocks of both Marriott International and Host Marriott would be trading independently for at least two weeks before my calls expired. Usually, if a spinoff takes place before an option expires, upon exercise the option holder is entitled to receive shares in both the parent company and the spinoff as if he had owned stock on the spinoff date. In this particular case, this meant that if I exercised my calls when they expired in the middle of October, I would receive one share of Marriott International and one share of Host Marriott in exchange for the exercise price of $25.

The trick was that the price I paid for my options didn't take into account the fact that a spinoff was being consummated several weeks before their expiration. Both stocks, the parent and the spinoff, would be trading independently before my options expired. Investors who had been waiting to purchase the "good" Marriott (Marriott International) without taking on the risks of all that debt and unsalable real estate would finally be able to buy the stock in the first two weeks of October. This could mean a significant

A Quick Summary and a Free Offer

1. **Stub Stocks.** There is almost no other area of the stock market where research and careful analysis can be rewarded as quickly and as generously.

2. **LEAPS.** There is almost no other area of the stock market (with the possible exception of stub stocks) where research and careful analysis can be rewarded as quickly and as generously.

3. **Warrants and Special Situation Option Investing.** There is almost no other area of the stock market (with the possible exception of stub stocks and LEAPS) where research and careful analysis can be rewarded as quickly and as generously.

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