Buying call options as protection for future purchases

SITUATION
Many times, investment decisions may be hindered by cash flow considerations. That is, funds to acquire stock may not be available at the time that prices appear most favourable.

OBJECTIVE
Buying call options to determine a future purchase price on a stock.

STRATEGY
An investor finds the shares of ABC Inc. at a price of $21.00 to be an excellent portfolio investment for the long term. But the investor's funds are committed to term deposits expiring in October and he does not want to pay the penalty of early withdrawal in order to acquire ABC shares. On the other hand, the investor is concerned that the share price may rise considerably over the next few months such that the planned purchase of ABC stock might cost considerably more than $21.00 per share.

The investor could purchase ABC OCT 20 call options at a premium of $2.00, assuring him of an effective ceiling price of $22.00 (strike price plus premium) for ABC stock at any time until the third Friday of October.

RESULTS
A call option on ABC stock can protect the investor against a rise in the price of the stock before his planned purchase. The buyer of a call option sets the maximum effective price he will have to pay for an underlying security during the life of the option, i.e. no greater than the strike price of the option plus the premium paid. The option can therefore be considered as "insurance" against a market price increase of the security he wishes to acquire at a later date. By purchasing options now, he can set the maximum price he is willing to pay and insure himself against a rising market. If, at the option's expiry, the price of ABC Inc. is below $20.00, the investor will lose the premium paid to acquire this insurance.