

# Leverage **(Cheap Options)** for the Value Investor

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**Core Principle:**

How good is your estimate of  
Intrinsic Value?

## **Questions:**

1. What is Leverage?
2. Why use Leverage?

**Answer 1:**

Leverage is **NOT** borrowing money to get higher returns.

**Answer 2:**

Leverage



Efficiency



Alpha (Value Added)

**For the Value Investor:**

**Leverage is buying mispriced  
in-the-money long dated calls.**

## Example :

## Coca-Cola (KO)

- In the money call
- January 2009 Expiration
- Stock Price = \$49.64
- Strike Price = \$30
- Option Price = \$20
- Premium = (Strike Price + Option Price) / Stock Price
  - $(\$30 + \$20) / \$49.64 = 100.7\%$
- Intrinsic Value of Coke = \$58
- P/V for Stock = Stock Price / Intrinsic Value
  - $\$49.64 / 58 = 85.6\%$
- P/V for Option = Option Price / (Intrinsic Value – Strike Price)
  - $\$20 / (\$58 - \$30) = 71.4\%$

**Example:**

**Coca-Cola**

Return from Stock = 16.8%

Return from Option = 40%

## **Conclusion:**

- Value Added is a Function of Portfolio Efficiency
- Options (Leverage) Should be Used by the Value Investor