



The Keller Fund's Option Investment Strategies

The Keller All-Star Growth Fund (the “Keller Fund”) was a medium-sized closed-end investment company with approximately \$300 million invested primarily in publicly-traded common stocks. Shares in the fund were owned by a large number of individual investors and were themselves listed and traded on a public stock exchange

The Keller Fund's investment objective was to provide long-term capital appreciation. While some of its investments did yield dividends, income was not an important consideration in its selection of stocks. Since its inception in 1985, the fund sought to achieve this objective by investing in a diversified portfolio of common stocks with above average potential for growth in revenues and earnings. High technology stocks tended to dominate its portfolio. In most years, the fund's return performance equalled or exceeded that of the Standard & Poor's composite index of 500 common stocks, though its net asset value experienced greater volatility than that of the market as a whole.

A Proposal to Initiate Option Trading Strategies

At a recent board meeting, one of the fund's directors proposed that the board consider using put and call options as a means of enhancing the fund's performance. The fund's charter permitted it to engage in options trading, though so far it had not made use of this privilege. The director suggested that intelligent trading in options on a regular basis might be able to improve the fund's returns while possibly lowering their volatility. If the board did approve the initiation of an options trading policy, the fund's charter would permit the following investment strategies:

1. Buying the stock of a listed company;
2. Buying a call option on a listed stock;
3. Writing (i.e., selling) a call option on a listed stock;
4. Buying a put option on a listed stock;
5. Selling a put option on a listed stock; and
6. Various combinations of the above strategies.

Professor W. Carl Kester prepared this case as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

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Without committing the fund to pursue option trading, the board agreed that studying the concept would be in order. To prepare for their discussion at the next meeting, the directors requested that a pilot study of the profits or losses resulting from selected option trading be conducted. As a first step, the fund officer assigned to oversee the pilot-study decided to collect some information about option contracts on the common stock of AT&T Corp. and Lotus Development Corporation. These stocks were both being considered by the fund for possible purchase in the near future.

Option Prices

On Tuesday, January 18, 1994, the stock of both AT&T and Lotus closed at exactly \$55.00 per share. Various put and call options for each of these stocks traded on the Chicago Board Options Exchange. As shown in **Exhibit 1**, the maturity of these options ranged from a few days to two years in the case of AT&T options (options with maturities longer than a year were called "LEAPS"). All these contracts were so-called "American" options in that they could be exercised by the holder any time on or before maturity.¹

The quoted option prices shown in **Exhibit 1** were in dollars per share. Each option, however, represented a contract to buy or sell 100 shares. Thus, a call option contract quoted at, say, 5 (see the Lotus April 55 call option) would actually cost \$500 per contract and would give the buyer the right to purchase 100 shares of Lotus's common stock.

Background information about AT&T and Lotus is provided in **Exhibits 2** and **3**, respectively.

¹An alternative type of option contract is a "European" option, which can be exercised only at the point of expiration.

Exhibit 1 Selected Closing Option Prices, January 18, 1994**A. Options on AT&T Corp.'s Stock^a**

Stock's Closing Price	Exercise Price	Month of Maturity						Exercise Price	Month of Maturity																		
		1994			1995				1994			1995															
		Jan.	Feb.	April	July	Jan.	Jan.		Jan.	Jan.	Feb.	April	July	Jan.	Jan.												
Calls														Puts													
55	30	25.0	--	--	--	--	--	--	30	--	--	--	--	--	--	--	--										
55	50	5.0	--	--	--	6.375	7.875	10.25	50	--	--	--	--	2.0	3.25	3.25	3.25										
55	55	0.5	1.375	2.3125	3.5	5.25	8.0	55	55	0.5	1.125	2.0625	2.75	4.375	5.5	5.5	5.5										
55	60	0.0625	--	--	--	--	--	60	60	4.75	--	--	--	--	--	--	--										
55	65	--	--	--	--	1.5	--	65	65	--	--	--	--	--	--	--	--										

B. Options on Lotus Development Corporation's Stock^a

Stock's Closing Price	Exercise Price	Month of Maturity			Exercise Price	Month of Maturity		
		1994				1994		
		Jan.	Feb.	April		Jan.	Feb.	April
Calls								
55	55	1.375	2.875	5.0	55	0.75	2.625	--
55	60	0.0625	1.75		60	4.0	5.5	--
Puts								

^aExpiration dates are as follows: January 22, 1994; February 19, 1994; April 16, 1994; July 16, 1994; January 21, 1995; and January 20, 1996.

Exhibit 2 Background Information on AT&T Corp. (millions of dollars, except per share amounts)

AT&T Corp. is the largest U.S. provider of long-distance and cellular telephone services. It is also a major supplier of telecommunications equipment, computers, information management services, and leasing and financial services. In 1993, telecommunications provided 59% of its total revenues. AT&T's stock is listed on the New York stock exchange.

Year	Revenue s	Oper. Inc.	Net Inc.	Per Share		Stock Price		P/E Ratio
				Earnings	Dividends	High	Low	
1993	67,156	9,864	3,974	2.94	1.32	65	50 1/8	22-17
1992	64,089	9,941	3,807	2.86	1.32	53 1/8	36 5/8	19-13
1991	63,089	9,451	522	0.40	1.32	40 3/8	29	NM
1990	51,321	7,821	2,735	2.51	1.32	46 5/8	29	19-12
1989	50,976	7,634	2,697	2.50	1.20	47 3/8	28 1/8	19-11

AT&T Corp.'s Daily Stock Price Returns, 1993

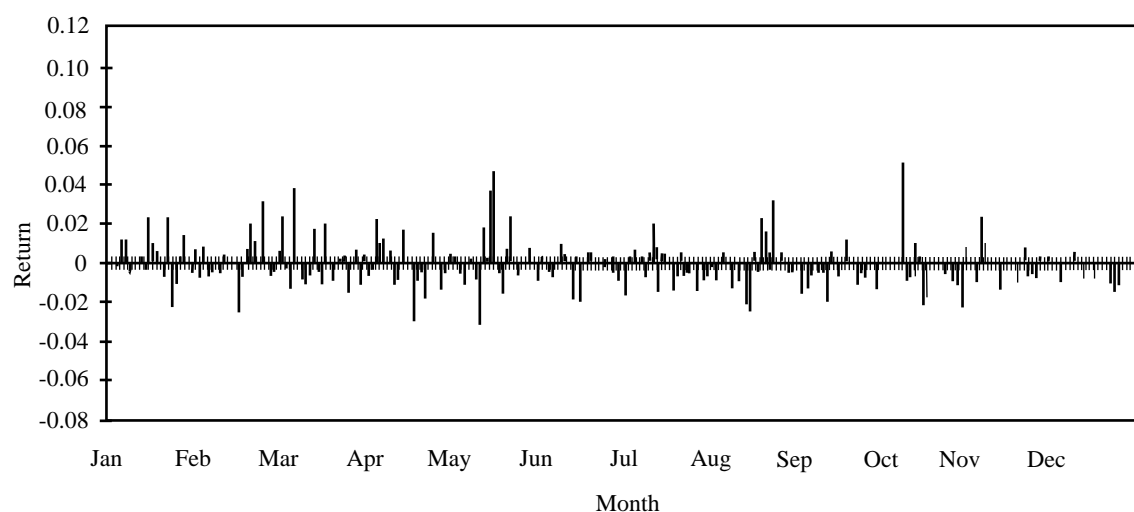


Exhibit 3 Background Information on Lotus Development Corporation (millions of dollars, except per share amounts)

Lotus Development Corporation is a leading developer, producer, and vendor of applications software and information services. Its major desktop applications include spreadsheet and word-processing programs, and communications products and services, including groupware and electronic mail offerings. Lotus's stock is traded over the counter on the National Association of Securities Dealers Automated Quotation (NASDAQ) system.

Year	Revenues	Oper. Inc.	Net Inc.	Per Share				P/E Ratio
				Earnings	Dividends	Stock Price		
						High	Low	
1993	981	181	55.5	1.24	Nil	58 3/4	18 3/4	47-15
1992	900	151	80.4	1.87	Nil	38 3/4	14 3/4	21-8
1991	829	154	43.1	0.98	Nil	40 3/4	14 3/4	42-15
1990	692	147	23.3	0.54	Nil	39 1/4	12 1/2	73-23
1989	556	106	68.0	1.61	Nil	33 1/2	18	21-11

Lotus Development Corporation's Daily Stock Price Returns, 1993

