A Cheap Strategy to Play Microsoft

409
Articles takes a look at Microsoft and how you can play the stock with options.
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Bill Gates is super rich but his once high-flying software company has been in the doldrums since mid-2002 after falling from the $35 level. The problem with Microsoft (MSFT) has been its failure to grow both its revenues and earnings at the superlative rates the company once enjoyed.

Any company the size of Microsoft, with a market-cap of $242 billion, will find growth an issue because of its size. But this is not to say the stock is dead. Far from it, Microsoft remains a viable long-term software company and is cash rich with $34 billion or $3.28 per share in cash. This gives the stock plenty of financial flexibility to develop or buy growth technologies. Microsoft just announced it would spend $1.1 billion in R&D at its MSN Internet unit in the FY07. And according to the Wall Street Journal, Microsoft is exploring the possibility of taking a stake in Internet media company Yahoo (YHOO) to take on Internet advertising behemoth Google (GOOG).

But with an estimated five-year earnings growth rate of a pitiful 12%, the company has its work cut out for it. Trading at 16.30x its estimated FY07 EPS of $1.44, the stock is not expensive but appears to be priced not as a growth stock.

Its PEG on the surface of 1.51 is not cheap, but if you discount in the cash of $3.28 per share, the estimated PEG falls to around 1,0, a decent valuation. Also, if Microsoft can improve on its estimated 12% growth rate, the PEG would decline further.

The fact is Microsoft at the current price deserves a look. If you want to play the stock but don't want to shell out the $2,347 for a 100-share block, you may want to take a look at the long-term options, also known as LEAPS. For instance, the in-the-money January 2008 $22.50 Microsoft Call LEAPS not set to expire until January 18, 2008 currently costs $380 a contract (100 shares).

This means you risk a total of $380 for the chance to participate in the potential upside of 100 shares of Microsoft over the next 20 months. The breakeven price is $26.30. If Microsoft breaks $26.30, you would begin to make money on your LEAPS. Conversely, if Microsoft fails to do anything, your maximum risk is $380 on the initial option play.

Warning: The aforementioned example is for illustrative purposes only and not to be construed as an actual option strategy. Due to the higher risk inherent in options, I recommend you speak with an investment professional before deciding to employ any strategy involving options.

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