STOCKWARRANTSHQ.COM

Making Money on a Warrant Expiration

A stock with an expiring warrant often represents a great low risk / high probability buying opportunity. A typical pattern for a stock with an expiring warrant is for the common stock to drop in price as the warrant expiration nears and then rebound, or move up, after the expiration. We have traded a large number of these expirations over the years, and, in the vast majority, there is an increase in the price of the common stock once the warrant expires.

The warrant expiration puts pressure on the stock because of the arbitrage that is taking place around the warrant. Large institutions are generally buying the warrant and shorting the stock into the expiration. They then cover their short position with the common shares received from exercising the warrants.

As pressure from short selling abates after the warrant expires, the common stock generally moves to the upside. Think of it as holding a beach ball under water. When you let go of the ball, it “pops” out of the water. Generally a stock has this same reaction immediately after being “let go” by the short sellers/arbitrageurs.

While this is the general pattern, there are five ways you can greatly increase your chances of buying a stock that will “pop” after the warrant expiration. If your stock meets these five criteria, even if there is no pop, it is very unlikely your stock will sink any further, and you can simply sell the position flat (neither losing nor making money) or, at worse, for a very small loss.

How Have Other Stocks in the Sector Performed

One of the best indicators of how a stock will perform post-warrant expiration is how other stocks in the same sector have been performing in recent months. The expiring warrant will generally hold down the price of the common stock, resulting in a skewed price as compared to the other stocks in the sector.

If other stocks in the sector are up 20% and the stock with the expiring warrant is only up 5%, this is a great indicator that the stock may jump immediately following the warrant expiration. We have seen many stocks move up 5-20% in just a few days after a warrant expiration when they have been trailing the performance of their peers in their sector.

This one criteria alone can be a very powerful indicator of whether or not a stock will pop after a warrant expiration. While we definitely use the other indicators, if we had to weight the indicators by importance, this one would be heavily weighted versus the others.

Is the Common Trading Near the Strike Price of the Warrant

The closer the price of the common comes to the strike price of the warrant, the better the likelihood of a pop post expiration. Most warrants (though definitely not all) are issued when a company goes public as a sweetener for investors and to get additional funds for the company in the IPO. Many have a provision that states “if the price of the common stock exceeds $X for a period of Y months, the company has the right to call the warrants.”

In these situations, when a stock exceeds the preset price and the warrants are called, the stock has performed better than the company (or the underwriters) expected. It has often exceeded price targets the company assumed the common stock would not quickly meet. This is great news for the company on two fronts. First, their stock is rising more rapidly than expected, and, second, by calling the warrants, they will get yet another infusion of cash.

From a practical perspective, the underlying common stock has usually built up some nice momentum and is moving up at a good clip. The warrant call by the company has the effect of slamming on the brakes. From the time the warrants are called, the closer the price comes to the warrant strike price the better, much like pushing that beach ball to the perfect underwater depth for a pop.

Let's throw in a few numbers to illustrate. If the warrant has a strike price of $5 (one warrant plus $5 gets you a share of common), and the stock has moved from $3 at the IPO to $7, ideally the stock price, after the warrants are called, will move back toward $5. This gives you a chance to buy a stock that was trading at $7 a short time before for around $5. Often the stock will resume its momentum move, as the warrant call was the only reason the stock paused originally.

This is a good spot to make a point on buying common stock near a warrant expiration. HAVE PATIENCE! Often the stock will immediately drop when a warrant call is announced, or it will begin declining a few months before a normal expiration. While you can trade around the stock the final months before expiration, we've found the best time to establish a position is a day or two prior to the actual expiration date.

Stocks with an expiring warrant generally drop in the final week before expiration, and that is the time to get the best price for a subsequent pop. Some of our best trades have come after getting long either the day before the warrant expires or the actual day of expiration.

Look for Large Volume Into the Expiration

An unusually large amount of volume around the expiration indicates institutions are buying warrants and selling common stock short. This is exactly the feeding frenzy you want to see as the expiration nears.

These institutions will enter an arbitrage position for very small amounts of profit, but, on a large number of shares, the profit adds-up. While making a penny on 1,000 shares is nothing to write home about, making a penny on 5,000,000 shares is perfectly acceptable.

In addition to making a small profit on the arbitrage, the arbitrageur has set himself up to make a very large profit in a very short time should the stock drop. And not only is there potential for a large profit, this bet can be entered at almost no cost (other than the cost of tying up capital for a short and well-defined time period) to the arbitrageur.

If, for some reason, the stock drops to $4, and the long position in the warrants goes to $0, there will be a loss on the warrant, but the short common position will more than make up for the loss. If the short was placed at $5 the result is not only $.01 on 5,000,000 shares, but $1 on 5,000,000 short shares (I'll let you do the math on that one).

So, what does the fact that big money may be playing in a warrant expiration have to do with buying the common stock around the expiration? It's actually fairly simple: the big money is distorting the market for the common stock.

By arbing the stock against the warrant, the arbitrageurs have distorted the market pricing mechanism. Shorting the stock, and buying the warrant, drives the price of the common down over a short time period around the warrant expiration. As the distortion in the market is removed, the stock generally rises back to a price level it would have attained absent the distortion.

In our case, the larger the distortion, which we can measure by looking at unusually large volume, the greater the probability the stock will return to a higher level.

Look at the Stock Ranking in IBD or a Similar Service

Buying a common stock near a warrant expiration is based on a general technical pattern produced by a combination of arbitrage and a high probability of a return to the mean for the underlying common stock. The trade is largely based on technical factors. Having said that, even when trading on technical factors, we prefer to have at least a basic understanding of the company fundamentals underlying the common stock.

An easy way to do this is to check the IBD rank for the common stock against other stocks in its sector. This will give a general picture of the stock, and can be quite telling, especially if the sector in general has been moving up. The best scenario, which I have seen only a few times, is to have the stock be the number one rated stock in a sector. A warrant expiration holding back the best stock in a sector, when the sector has been rising, can lead to an explosive move to the upside.

If you do not subscribe to IBD, you can simply look at a few of the more common measurements of a stocks fundamental performance such as P/E ratio, cash flow, rising / falling earnings, or whatever the prevalent measurement may be for that sector. While the fundamentals are not a major factor in whether or not a stock may pop immediately after a warrant expiration, they may still impact a trading decision.

Fundamentals can help when sizing your position. As with any trade, the size of the position taken is an important factor. A stock with strong fundamentals, and an expiring warrant, may indicate both a larger position should be taken and that the position should be given more leeway from a timing perspective (how long you hold the position before selling).

Is There Single Holder of a Large Block of Warrants?

Finally, look for any announcement from a holder of a large number of warrants as to whether they will be exercising their warrants and then holding their position in the common. As we mentioned earlier, warrants can be a sweetener to entice certain investors to take a position in a stock at an early stage. There may be an investor who holds a substantial number of warrants.

If there is a large investor that has announced she will be exercising warrants and not selling her common stock, this is obviously a positive for the common. It is not always the case, as often warrant investors will simply sell their shares as they rise in price along with the common, but it is a final factor to examine.

In some situations a Venture Capital firm, or VC, will have a large position in the stock or warrants. If the VC is using the warrant expiration to reduce their percentage ownership in the company, this will put additional pressure on the common and is a negative for getting long the common post warrant expiration.

Putting it All Together

In its simplest terms, a warrant expiration provides a catalyst for a stock. The expiration is a clearly defined point in time from which stocks historically have a high probability of moving up. As a trader, I'll take this type of trade every time.

Unfortunately, warrants don't expire every day, so this high probability trade is opportunistic and episodic. Warrant expirations and warrant calls must be tracked, and for most traders who follow a trading or investing system, trading warrant expirations falls outside of both their system and their expertise.

In addition to this challenge, many warrant expirations are in stocks that are either thinly traded or that trade in the Pink Sheets, or both. Mere mention of the Pink Sheets, or Bulletin Board stocks, conjures demons of Ben Affleck in *Boiler Room* for most stock traders.

But for the vigilant and informed, there are also opportunities in large, well-known stocks. We recently highlighted one opportunity in the stock of Ford that took place in December of 2012. Buying the stock at the closing price the day before Ford's warrant expiration would have returned over 20% over the next 15 trading days. For most traders that's a pretty good year!

At stockwarrantshq.com we thrive on educating traders about the opportunities available in warrants. Thank you for joining our group, or, if you came across this report from another source, please come over to stockwarrantshq.com and give us a look. Good luck in your trading!