

Module 4:

Strategy #2: Buy stocks at a discount by selling naked puts



Module overview

- A trading strategy that uses options to get paid while waiting for stocks to pullback

Value investing with options

- Value investors buy stocks that are undervalued
- In a bull market, it might be difficult to find stocks that are undervalued
 - This can lead to large amounts of cash piling up
- Selling put options offers a solution to this problem

Warren Buffett used this solution

- In April 1993, Buffett sold Dec \$35 puts on 3 million shares of Coca-Cola for \$1.50 each
 - KO was at \$40 to \$45 a share at the time
 - Buffett generated \$4.5 million in income
- Two possible outcomes of trade:
 - If Coca-Cola stayed above \$35 per share, he keeps the cash
 - If Coca Cola dropped below \$35, he buys the the stock at \$33.50 (\$35-\$1.50 option premium)
- The options expired worthless but Buffett continued selling puts
- Eventually KO came down to the price he was willing to pay and he bought the stock

Follow Buffett's strategy

- Determine the price you are willing to pay for a company
- If the market price is below your price, buy the stock
- If the market price is above your price, sell puts
 - With this strategy, you get paid to wait
 - If the stock does fall, you are buying at a price you predetermined to be the right price
 - This strategy also forces you to act when the market declines and avoids inaction caused by fear

Strategy details

- When you sell a put, you are accepting an obligation to buy shares at a predetermined price for a predefined amount of time
- If the stock price falls below the put strike price, you will have to meet that obligation
- When you sell a put, you obtain immediate income
 - The premium the buyer pays for the option
- Your broker will require a “good faith” deposit from you to ensure you meet your obligation

Margin requirement

- Good faith deposit is called margin
 - It is not a margin loan and you do not pay interest on this amount, in fact you earn interest on cash in your account if you hold the deposit as cash
 - The margin could also be the value of securities in a margin account
- In general, you will need about 20% of the strike price as margin. For a put with a \$50 strike price, you will need \$1,000 ($20\% * \$50 * 100$ shares)
- Actual formula is
 - $(20\% \text{ of the underlying stock's market value} + \text{the option ask price} - \text{any out-of-the money amount}) \times 100 \text{ (per contract)} \times \text{the number of contracts}$
 - Because you will generally sell out-of-the-money options, the amount required will usually be less than 20%

Entering and exiting trades

- You will use a “sell to open” order to initiate the trade
- At expiration, if the put is worthless, no action is required
 - You keep the premium and your broker releases the margin deposit
- At expiration, if the put is in-the-money (the stock is trading below the put’s strike price), the broker will deliver the shares to your account and debit cash to pay for them

Prior to expiration

- You can always exit a trade with a “buy to close” order
- This can be done to cut losses or if you change your mind about buying
- This can also be done to book profits and free up margin for other trades

Example

- Tesla (TSLA) is at \$250 and you would like to buy it at \$225
- A put expiring in one-month with a strike price of \$225 is trading for \$5.80
- You sell one contract and receive income of \$580 on a margin deposit of about \$4,500
- If TSLA is below \$225 when the option expires, you buy at an effective price of \$219.20
- If TSLA is above \$225 at expiration, you can sell another option

You can be paid well to wait

- For TSLA, the \$580 income on a \$4,500 margin deposit is a return on margin of 12.9%
 - This is for a trade lasting one month
 - TSLA is a volatile stock and returns will generally be lower but typically amount to 2-3% a month. This is still an annualized rate of return of more than 24-36% on your margin deposit

Bottom line

- You can use a put option to buy stocks at a discount
- The added advantage is that you are being paid to wait
- This strategy works well with a value investment strategy

To implement Strategy #2

- Identify buy candidates using any valuation technique
- When a stock is overvalued, consider selling puts to get paid to wait
- Use put options expiring in 1-3 months to maximize income while waiting for a pullback
- Strategy #2 is designed to buy stocks at a discount
 - The Bonus Strategy focuses on selling puts to generate income
 - The difference between Strategy #2 and the Bonus Strategy is that the Bonus Strategy does not focus only on stocks you want to own. Income is the focus of the Bonus Strategy

What's next?

- Strategy #3: Create dividends from stocks you own by selling covered calls