

## >: Selling Naked Puts - GREAT way to buy battered stocks!

*Tuesday, January 22, 2008 / Chris Rowe*

This is the bloodiest market we've seen in over 5 years. There will be times when you want to step in and buy stocks at basement bargain prices. But in bloody market's like this, there's a better way to buy stocks than going out there and just entering the order to buy ("X" number of shares) of your favorite stock.

Instead, you can have someone pay you for the right to sell you your favorite stock.

Today I'll show you a trick that will allow you to to either collect on overpriced stock option premiums, and/or buy your stock at an even bigger discount than you saw at first glance. It's a strategy called "selling naked puts."

Don't be intimidated and trash this article if you aren't familiar with options. I'm going to help you understand why this strategy is not only very useful, but very simple...

### RISK/REWARD

When you sell naked put options, you are taking on the same risk that you are taking when you buy the stock outright, (minus the amount of money that you received for selling the put option - which means you are taking on even less risk than outright stock ownership). But the profit is limited when you sell a naked put option.

### PROFIT POTENTIAL

When you buy a stock, you only profit when the stock moves higher. When you sell the naked put, you can profit when the stock moves up, sideways or even down by a small amount.

### BOTTOM LINE

When you sell naked puts, your profit potential is limited but it is more likely that you make a profit. However, if you sell/write a naked put option, and it's exercised, you'll be obligated to buy the stock in which case you'll have unlimited upside potential.

### MECHANICS

If you buy 100 shares of XYZ at \$30.00, you'll pay \$3,000.00. But what I'm saying is you can instead have someone pay you \$200.00 for the right to sell you 100 shares XYZ at \$30.00.

First you must understand that most stocks have put or call options which allows the owner of the put or call option to either sell or buy (respectively) a stock at a certain price. These different options have different expiration months and strike prices.

between now and February 15th (the third February of the month which is the last trading day before this option expires).

Sometimes put options are used as "insurance" against a possible decline in a stock. If Bob Jones owns XYZ stock which is at \$30.00 but is afraid the stock might drop significantly, he may purchase the right to sell XYZ at \$30.00 by purchasing a put option.

Let's say Bob purchased the put option for "\$1.10". Since it represents 100 shares, Bob is paying \$110.00. He gave up \$110.00 for the peace of mind knowing if XYZ drops to \$15.00, he will exercise his right to sell XYZ at \$30.00 (even though it trades in the market for \$15.00.)

Bob Jones paid \$110.00 for that insurance. But what if Bob was incredibly frightened by the stock market because overseas market's dropped by 6 - 8% overnight? He might be willing to pay \$2.00/ put option (\$200.00 instead of \$110.00). There is a whole market full of people like Bob Jones out there. This explains how options become more expensive in a scary market. And that's why it makes sense to SELL (or "write") options in a market like this one. (You want to sell when prices are high and buy when they're low.)

Now that we've gone over the concept of put options from the BUYER'S point of view (the buyer/owner has the RIGHT to sell stock at a certain price) let's consider the benefits of being the SELLER/WRITER of put options (which means that you are accepting payment in return for your obligation to buy the stock at a certain price).

Selling naked puts:

Since put options are more expensive than usual, consider selling puts on the stock that you like. Here's how:

Traditionally, a person who thinks EMC will trade higher might buy 100 shares at the recent price of \$16.98.

But if you like EMC (Symbol: EMC) you might instead sell (write) the February 17 put option. That means you are accepting the obligation to buy EMC from someone at \$17.00/share if they decide to sell it to you. 99% of the time, when someone BUYS a put option, they will only exercise it (use their right to sell EMC at \$17.00) when the stock falls below the strike price (of 17).

At the time of this writing, the EMC February 17 put option is trading at \$1.00 - \$1.05 (so someone is willing to pay \$100.00 for the right to sell 100 shares of EMC to you at \$17.00). Why would you sell/write this put option instead of buying 100 shares of the stock?

Benefits of selling puts...

First off, if you are already considering the purchase of EMC at \$16.98, then you wouldn't mind if someone first paid you \$100.00 for the put option, and THEN sold you EMC for \$17.00 (probably because it went down).

The math is simple. If you buy 100 shares of EMC at \$17.00 after someone has paid you \$100.00 for selling them the put option, you have really purchased 100 shares of EMC for \$16.00/share (not including trading expenses).

EMC is at \$16.50, the Feb 17 put option is 50 cents in-the-money. If EMC is at \$14.00, the Feb 17 put option is \$3.00 in-the-money and so on.

The amount by which an option is in-the-money is referred to as "intrinsic value".

To understand the advantages of selling options, it's important to understand what "extrinsic value" aka "time value" is. Options lose their extrinsic value as time passes. Therefore, an option seller/writer benefits from the deterioration of extrinsic value due to time passing - a process known as "time decay".

The "extrinsic value/time value" = the price of the option - the amount by which the option is in-the-money.

If EMC is at \$16.98, that means the Feb 17 put is 2 cents in-the-money. Since we can sell the Feb 17 put for \$1.00/put option, we know that that put option has 98 cents of extrinsic value.

(\$1.00 put option - 2 cents intrinsic value = 98 cents extrinsic value.)

When you sell/write an option, you want to do so with an option that has lots of extrinsic value because as the process known as "time decay" happens, the seller of the put option profits.

KEY POINT: Time decay benefits the seller/writer of an option whether the stock and option moves up, down or sideways. Either way, time decay is happening.

After you sell/write a put option, there are three possible outcomes:

OUTCOME #1. The stock moves up: If this happens, the put option that you have sold/written will lose value. And this is a good thing because when you sell/write a put option to open, you have essentially sold short a put option. And when you sell-short something that loses value, you are making money.

For example: If you sell something at \$1.00 and buy it back at 25 cents, you make a profit of 75 cents.

So if the stock moves higher causing the put option you have sold at \$1.00 to move lower to 25 cents, you can buy that put option back. You would enter the order as a "buy-to-close".

If you purchase the put option to close, you will have closed out the position, and you will no longer have an obligation to anyone to buy EMC at \$17.00/share. The trade is done and the contract ceases to exist.

In this scenario, you have two things working in your favor. EMC is moving higher, and time is passing, both of which cause the put option you have sold to lose value. There is one other bonus that most people don't think about: Because the stock started moving higher (or stopped tanking) people become less fearful causing the put option to get even cheaper. As we've just said, fear is what causes people's willingness to pay even more for options.

when the February 17 put option expires, the put option will have expired worthless, and you will no longer have an obligation to anyone to buy EMC. But if the stock moves back down below \$17.00, someone may exercise their put option and therefore sell you EMC at \$17.00.

Remember, your break-even price of EMC is now \$16.00 (\$17.00 purchase price - \$1.00 premium received for the put option you sold/wrote).

OUTCOME #2. The stock moves down: If this happens, the put option that you have sold/written will increase in value. Now this is different than when you sell-short a stock that moves higher because in this case (of being the seller/writer of a put option), your position is NOT losing value. Instead, you can be sure that someone who owns the EMC February 17 put option (who remains anonymous) would exercise their right to sell EMC to you at 17. When this happens, you will check your stock account and you will notice that you have automatically bought 100 shares of EMC at \$17.00 (even though it is trading in the market at a price lower than \$17.00).

You shouldn't have a problem with this scenario because you were willing to buy EMC when it was trading at \$16.98 anyway right?. Now you will have bought it at \$17.00 after receiving \$100.00 for the put option you sold. That means that although you were going to spend \$1,698.00 on EMC stock, you have now spent \$1,600.00 (\$1,700.00 when someone exercised their put minus the \$100.00 you received from the person who bought the put option you sold).

OUTCOME #3. The stock moves sideways: Chances are the stock won't be at exactly \$16.98, but for the sake of the explanation, since EMC is at \$16.98, the put option will probably expire worthless. This means that you collected \$100.00 and if you like, you can repeat this process again and again collecting more premium each month.

Special note:

- Why I said "at \$16.98, the put option will probably expire worthless": Options are automatically exercised if they are in-the-money by 5 cents or more. In our example, if on options expiration day EMC is at \$16.95 or lower, anyone who has sold/written EMC February 17 put options will find EMC stock in their account (because they automatically will have been sold the stock). So at \$16.98, the "automatic" exercise wouldn't happen, but someone may or may not exercise the put option you sold/wrote as the 2 cents would probably not be worth the trouble.

I hope this isn't confusing, and if it is, it pays to read up on it more. If you have never done this before, ask for some help from your broker, and be sure to understand the cash requirements (in the case that the put option is exercised and you end up buying the stock).

Please feel free to leave comments.

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