

>: How to buy puts. I'll spell it out for you.

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If you have been reading [The Tycoon Report](#)

lately, you have probably gathered that my partners and I are starting to become more cautious as each day passes. Why? I can write hours worth of reading on why, but I won't. If you like, just read [Tycoon Reports](#) for the last week or two.

The bottom line is that we each have different ways (that complement each other) to reduce exposure to a severe market decline while at the same time, not taking a huge gamble. This is serious business. What good is all the money that you make on the upside if you lose it when the market takes that inevitable correction? Today I decided to just publish an old article that I think everyone should read today before it's too late.

You can reduce your exposure by selling part of your long portfolio, and you buy "in the money" put option contracts.

The put option contract gives you the right to sell your stock at a designated price. But most of the time, people don't actually use the put option contract to sell stock at the designated price. Instead, they typically sell it to someone else without any stock transaction taking place. This is similar to the way a futures contract is traded.

A futures contract represents someone's intent to buy sugar, for example. If the price of sugar goes up, the investor would most likely sell the futures contract at a profit, rather than using the futures contract to buy a truckload of sugar and then trying to sell it to the local grocery store.

Most people will tell you that trading options is a very risky strategy. Well, that all depends.

You can put all of your money into one single bio-tech stock about to announce whether or not its only major drug will receive FDA approval. You could also own all of that stock on margin and that is also very risky, but there are more conservative ways of investing in stock.

It all depends on how you approach the strategy, and I will tell you how to approach buying puts in a more conservative fashion.

RULE #1: You must always remember that each option contract represents 100 shares of stock. If your option contract trades from \$7.00-\$8.00, the value of the contract will go from \$700.00-\$800.00. So, 10 option contracts represent 1,000 shares of stock, and so on.

Buying puts has a similar effect to "shorting" a stock (which is betting on the stock's trading lower by selling it first, and buying it back at a cheaper price.) Instead of shorting the stock, you are purchasing an option "contract" that gives you the right to short (or sell) the stock.

Buying "in the money" puts carries MUCH less risk than shorting a stock. As a matter of fact, I think that shorting a stock instead of buying the puts is ludicrous. People pretty much short stock when they want to take a downside bet, and don't understand options enough to feel comfortable using them. Well after this, you shouldn't ever have take the unnecessary risk of shorting stock again.

The most important thing to remember is that if you would only be willing to risk selling-short 500 shares of a \$40.00 stock, you should only buy 5 put options on that same exact stock and nothing more. In other words, 500 shares of a \$40.00 stock is a \$20,000.00 trade.

If you would normally risk selling 500 shares short, then you certainly should NOT buy \$20,000.00 worth of put options (which is a common and sometimes very tempting mistake to make.) That would defeat the purpose of buying puts instead of shorting stock, and if you are wrong, you can lose your entire \$20,000.00. (Which, by the way, is the maximum risk, whereas your risk in shorting stock is unlimited.)

You must remember that you are taking a conservative approach using an options strategy in an effort to reduce your risk.

If the put option is quoted at \$7.00 (each contract representing 100 shares of stock, which means it will cost \$700.00 p/contract,) then you should buy 5 put options (representing 500 shares) which would cost you \$3,500.00.

If you invested that entire \$20,000.00 in the puts, you are buying the right to short (or sell) almost 3,000 shares of a \$40.00 stock. You must keep this perspective.

Which brings me to **RULE #2:**

What do you do with the remaining \$16,500.00 out of the \$20,000.00 that you would have used to short the stock? (Remember, we only used \$3,500.00 on 5 puts at \$7.00.)

LEAVE IT IN CASH, OR PUT IT IN TREASURIES!! Consider it part of this trade, the capital that is impossible to lose (which is pretty much the case if it's in cash.) Reserve it for when you want to trade stock again. Don't use the remainder, not even to buy other options.

Don't forget that you are being conservative here. What I've just suggested that you do with this one position is what you should do with each

position that you play when you replace stock with options.

So what is the benefit of replacing short stock with options? The benefit is simple:

Normally, when you sell a stock short, you have unlimited risk. The mere fact that there is that much risk involved tends to steer investors away, keeping them from profiting from a down market. So at this point, you may be thinking to yourself, "If I did sell a stock short, couldn't I just limit my downside by implementing a "stop loss (an agreement to close out a position, in this case, buy the stock back, at a pre-determined price) with my broker?"

You could, but there are two problems with that line of thinking:

PROBLEM #1:

If you are betting that a stock will trade lower, and you sell the stock short, when the market closes, the company whose stock you shorted may announce that they have been acquired at a higher price, or that they got some sort of major contract. That could cause the stock to open up much higher when the market opens the next day. If that were to happen, you would automatically have to buy back the stock that you have shorted, at a much higher price resulting in a giant loss.

The "stop-loss" automatically triggers once the stock has hit, or traded through a certain pre-determined price. For example: Let's say that the stock that you have shorted closed at \$43.00 and you have a stop-loss order to buy it back if it trades at or above \$45.00.

After the close, they announce some huge deal that causes the stock to open on Monday at \$100.00. Since the opening trade on Monday is at \$100.00, the next trade will probably be the price that you cover your short at. You've then lost \$55.00 p/share more than you thought that you were limited to losing! And if you shorted the stock on margin, both you and your broker are going to have a very bad day.

When you are shorting a stock you risk losing even more money than you had invested in the trade!

PROBLEM #2:

Even if that fluke doesn't occur, what if you have shorted a stock at \$40.00 in the hope that it trades down to \$25.00, and you put in a stop loss order to "cover your short" (buy the stock back) at \$45.00, in an effort to limit your downside to 12.50% (or 5 points)?

The downside here is that your stock can trade up to \$45.15, and you will have automatically bought the stock back and taken your loss. It's never fun to then see that stock trade down to \$25.00 like you thought it would, when you don't realize the 15-point profit because you have closed out (or "covered") your short position AT \$45.15.

Now let's assume again, that you are willing to risk the five points if you knew that would be your MAXIMUM loss when shorting the stock. Well, when you own the right put option on the stock, you are risking about the same amount that you were willing to risk when shorting the underlying stock, but with a put you know that your maximum loss IS about five points.

Example: Suppose the stock climbs to \$45 and then keeps on climbing further to \$49. You can still stick with the put position as your risk is predetermined.

As a matter of fact, chances are that if the stock traded to \$49, your puts would still have some value. If the stock swings up to \$49 but then drops down to the original price of \$40 again, you will be able to recover almost all of your original investment.

If the stock then swings down to \$25, you will realize your profit.

So the benefits are that you know for a FACT what you are risking (unlike when you use a stop loss order on a stock,) and you may be able to profit, even if the stock swings the wrong way before heading in the direction that you wanted it to.

RULE # 3:Buy puts that are deep "in the money". What do I mean by that?

Let's say that a stock that you think is going to trade lower is at \$40.00 p/share. You may have several puts to choose from.

For example study the Option Chain below:

stock-	year	month	strike-price
XYZ -	2006	April	35 put (Trading at \$2.50)
XYZ -	2006	April	40 put (Trading at \$3.75)
XYZ -	2006	April	45 put (Trading at \$5.65)
XYZ -	2006	April	50 put (Trading at \$10.05)

The April 45 put is in the money by five points, because the stock is at \$40. In other words, if I owned a put option contract that gave me the right

to sell XYZ stock at \$45, and at the same time, the stock were trading in the stock market at \$40 (where I could purchase it,) I could make a five-point profit on the difference between the sell and the buy if I were to execute both trades simultaneously. (However, I would almost never use the puts to buy stock. I would simply sell the put contract at a profit after it traded higher.)

Notice that the April 45 put above is trading at \$5.65. The option, which, as I mentioned, is five points in the money, is worth at least \$5.00/share since one can profit \$5.00/share from the difference between where we can sell the stock and where we can buy the stock the same day.

So why is it at \$5.65 and not just \$5.00?

In that \$5.65 put option, \$5.00 which is in the money is called the "intrinsic value". The remaining 65 cents is called "time value". The reason that the option is trading at \$5.65 (65 cents higher than \$5.00) is because the put option is considered to have additional value since it won't expire for another six months. If your stock trades in the wrong direction, you have the luxury of six months to wait it out, and see if the stock does what you want it to. The longer your option has to expire, the more time value may be included in the price of the option.

For example an XYZ year 2007 January 45 put (which expires eight months later than the example above,) might be trading at \$6.65 (\$1.00 more than the example above,) which would mean that it has \$1.65 in time value and still has \$5.00 intrinsic value, as it is still five points in the money.

As illustrated in the Option Chain above, an option contract that is more in the money, will have less time value than one that is less in the money. The price of an option that is not in the money at all will only consist of time value, which means that if the stock trades flat, your option would trade to zero.

Hence, the reason that we look for options that are in the money.

So when you are shopping for options, look for an option that has very little time value in it due to the fact that it is "in the money." The way to find a put option that is in the money, and by how much, is to first look for put options that have a strike price that is higher than the actual stock price. (If the strike price of a put is lower than the stock price, it is not "in the money"; it's "out of the money".)

Then, subtract the stock price from the strike price of the option. In this case: XYZ stock is at \$40, so we look at the yr.2006 April \$45 put since that strike price of \$45 is higher than the stock price.

$\$45$ (the strike price) - $\$40$ (the stock price) = $\$5$ (intrinsic value, or in the money.) Since the option is trading at $\$5.65$, we know that the remaining .65 cents is the time value.

The idea is to use a put option that has very little time value so that your trade is almost solely affected by the stock's price movement and not time deterioration.

Your put option will lose its time value as you get closer to the expiration date. Picking a put option that will give you twice as much time as you believe that you need for your position to work out is also usually a wise idea since trades often don't go exactly as you expect them to, so you want to have a (time) cushion.

In the example above, with an April \$45 put option trading at \$5.65, if the stock trades flat for six months, the most I stand to lose is .65 cents (my time value). That's a small price to pay for all of the benefits that come with this strategy.

If the stock trades up to \$70.00, I only lose \$5.65/share (the value of the put option) rather than lose \$30.00/share (the difference between \$70.00 and the price that I would have shorted the stock which was \$40.00.)

If you read this over and over and you search around on the internet and learn about this technique, it will be more than worth your time. It may save you thousands, or millions.

Think of how many hours you work each day to earn the money that you are investing. If you could save yourself 25% of the value of your stock portfolio, divide that value by how much you earn per hour. Is it worth spending a few hours to understand this?

Once you are familiar and comfortable with it, it's your knowledge to keep for the rest of your life.

You can also apply to become a member of [The Trend Rider](http://www.thetrendrider.com) (whenever we are open to new members) at www.thetrendrider.com and see how I am doing it.

I try to make it easy for you. For example, I recently recommended puts on a large/well-known internet company that is about to trade several points lower even if the market doesn't tank. The puts that I recommended at \$9.20 will likely trade several points higher than where I recommended them. There is even a chance for it to more than double in a very short period of time.

The best part is, not only did the members put up 10-20% of what they would have had to put up to short the stock, but we are in control of our risk,

and can withstand any possible price fluctuation.

It's worth it to learn how to do it. Remember, it can save you from huge losses!

?Profit from the Trend?

A handwritten signature in black ink that reads "Chris Rowe". The signature is written in a cursive, slightly slanted style.

Chris Rowe

Chief Investment Officer

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