Example of Buying Into Weakness – Investment Rule #1

> “Dude, suckin’ at something is the first step to being sorta good at something.” -Jake, “Adventure Time”

A few days ago I wrote a post laying the foundation for my 10 rules for investing. In rule #1 we discussed what it means to buy into weakness. After some good dialogue with you guys in the comments of that post, it dawned on me to include a real example of what it actually looks like to buy into weakness. It was a comment by Mr. Maroon that helped spark the idea when she said:

Enter Mrs. Maroon

> When we first started aggressively trying to save money for investments and actively watching our balances, we agreed that the very best approach was to use total market index funds from Vanguard. We don’t have the time, education, or desire to do the research required for much of anything else. And then, oil prices plummeted. For several weeks we tossed around topics about how we should buy into oil since it was so low right now. Eventually the idea took hold, and we bought a chunk of the energy ETF from Vanguard. But we are still very much newbies to the investing world. I’m eager to learn more in the rest of the series!

This comment was really the highlight of my day, because I knew by her response that she fully understood what buying into weakness meant. As Mrs. Maroon pointed out, oil and most companies in the entire sector have gotten hammered over the past 6-months. Below is a chart of the ETF OIH that is made up of a bunch of companies in the oil services sector. And for those not familiar with an ETF, it is basically like a mutual fund that trades like a

stock (with far lower fees, and greater liquidity). I am not a technical analysis guru, I only present this chart because I think the picture speaks for itself when I refer to weakness.

In the chart above you can easily see that the high over the last 12 months was at $58.01 and the low put in January was $31.63 (that's $26.38 lower than the high in July of last year). I don't know about you, but a decline of 45% in price sure as hell qualifies as weakness in my book.

And let me say this loud and clear. If you are patient these kinds of opportunities come more often than you would think. But remember that this usually means buying this when everyone else is telling you to stay away.

So how do you take advantage of this opportunity?

The most obvious option is to just go and buy the stock outright. These days almost everyone has an account with online access to buy and sell stocks (and maybe options???). I wrote this post after the market closed on 2/12/15, but I did in fact buy OIH for $35.56/share. In total I only purchased 100 shares. Now for many of you reading this, that is where you stop. You buy the stock, sit back and collect the dividend (which is currently around a 2.4% yield) and hope it goes up in value. NOT ME, AND HOPEFULLY SOON NOT YOU EITHER!

The Covered Call

The covered what???

The covered call is a strategy whereby you buy 100 shares of stock and you sell a call (an option) against your stock…thus you are covered. In English please…

Ok, let's start with the definition of a call option:

- From the buyer's perspective, a call option is a contract that gives the buyer the option, but not the obligation to buy shares of a certain stock at a pre-defined price by a set date in the future.
- From the seller's perspective, a call option is a contract that gives the seller the obligation to sell shares of a certain stock at a pre-defined price by a set date in the future.

By selling a call against our stock position we are obligating ourselves to sell it at a certain price (known as the strike price) and by a certain date (known as expiration). In return for that obligation we get to collect a payment from the buyer (known as a premium).

So let's take a look at what I did today and walk through it:

Bought: 100 shares of OIH @ $35.38 for a total of $3,538

Sold: 1 call option at the $35 strike that expires 1/15/16 for a premium of $4.38 or a total of $438.

What did I agree to do with this position and how much money can I make?

By selling the call at $35 I have agreed to sell my stock at $35 regardless of the price between now and 1/15/16. Even if it goes to $100, I have to sell it for $35. In return for giving up the upside I was able to collect $4.38/share or $438 total (or about 12.4% of the stock price).

Let me point out that most options expire worthless. This means that there is a good chance that you will get to keep both your stock and the premium you collected and do it again once expiration rolls around. You are effectively buying the

stock at less than the market price.

Effective price = $35.38 (actual purchase price) minus $4.38 (premium collected) = $31/share

Max profit = $35 (obligated sales price) minus $31 (effective price) = $4/share or $400 for 100 shares (that is a 12.9% return on your $31/share effective price, not counting dividends)

I know it sounds too easy and too good to be true. But this is a legit strategy. However, it does have its trade-off, you are giving up unlimited upside and capping your max profit to the premium you received from selling the call.

What if the stock declines in price?

What is great about this strategy is that you now have downside protection built-in. Because your break-even is now at $31/share (not including dividends). You are effectively getting paid to take risk. And look at it this way, it doesn't even make sense for the buyer of the call option to exercise their option (forcing you to sell your stock to them) until the stock is trading at least at their break-even of $39.38 (their effective price $35 + $4.38).

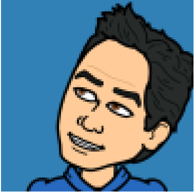
No matter what happens you get to keep the premium you collected. The best case scenario is the stock stays exactly where you bought it and the call expires worthless and you keep doing this over and over again. I have had stocks where my cost basis actually went really close to zero between selling calls and collecting the dividend.

Bring on the questions

I know that was a lot, especially if this was your first introduction to options and in particular the covered call strategy which will be 1 of 2 strategies that we talk about over the next 9 posts in the series of my 10 investment rules.

So ask away in the comments section below.

– Gen Y Finance Guy



Gen Y Finance Guy

Hey, I’m Dom - the man behind the cartoon. You’ll notice that I sign off as "Gen Y Finance Guy" on all my posts, due to the fact that I write this blog anonymously (at least for now). I like to think of myself as the *Chief Freedom Officer* here of my little corner of the internet. In the real world, I’m a 30-something former C-Suite executive turned entrepreneur turned capital allocator. I am trying to humanize finance by sharing my own journey to Financial Freedom. I believe in total *honesty* and *transparency*. That is why before I ever started blogging, I decided that I would share all of my own financial stats. I do this not to brag, but instead to inspire motivate, and also to hold myself accountable. My goal is to be a beacon of hope, motivation, and inspiration for *you*, the reader, by living life by example and sharing it **all** here on the blog. My sincere hope is that you will be able to learn from me - both from my successes and my failures! Read More