How Selling Options May Be Safer Than Buying Stock

Today I am sharing a Post that was originally published on Financial Samurai and is a piece I wrote almost two years ago. With the recent market sell-off, I thought it timely to share this post with you because selling options is best when volatility is elevated.

Recent Spike in Volatility

I have always believed that risk is a function of education. The financial media may have you convinced that options are very risky and you may even believe they are weapons of mass destruction. But what if I told you that if you use options the right way (which is not to speculate) that you could actually take less risk using them than by buying stock outright? And in doing so you would increase your probability of profit, reduce your cost basis, and give yourself more than one way to win (profit)? Oh, and you will never be afraid of volatility again? In fact, you would actually hope and pray for it!

There are two option strategies that will allow you to buy Stocks and ETF's below current market prices. The **Covered Call** and the **Short Put** are option strategies that allow you to get long at discounted prices every trading day of the year. The discount prices get even deeper during corrections, when fear drives volatility

through the roof, which inflates option premiums.

Before we get into how options can be safer and more advantageous than buying stock outright, let’s get a few definitions out of the way.

Basic Definitions

Long – Buying stock is synonymous with “getting **long**” stock.

Option – An option is a derivative, which means its value is based on something other than itself (in this case the underlying asset/stock). Make a note that every option for stocks represents 100 shares.

Call Option – As a buyer, a call option gives you the right – but not the obligation – to buy a stock at a certain price by a certain date in the future. You pay a premium for this right. As a seller, a call option gives you the obligation to sell a stock at a certain price by a certain date in the future, should the buyer execute his/her right. You collect a premium for this obligation.

Put Option – As a buyer, a put option gives you the right – but not the obligation – to sell a stock at a certain price by a certain date in the future. You pay a premium for this right. As a seller, a put option gives you the obligation to buy a stock at a certain price by a certain date in the future, should the buyer execute his/her right. You collect a premium for this obligation.

Strike Price – The price at which a put or call option can be exercised.

Expiry – The date the option expires.

In The Money (ITM) – A call is said to be ITM when the underlying’s current market price exceeds the strike price. A put is said to be ITM when the underlying’s current market price is below the strike price.

Out of The Money (OTM) – A call is said to be OTM when the underlying’s current market price is below the strike price. A put is said to be OTM when the underlying’s current market price is above the strike price.

At the Money (ATM) – A call (or put) is said to be ATM when the current market price is equal to the strike price.

Intrinsic Value – The intrinsic value is the difference between the underlying price and the strike price of the option. **Only options that are ITM have intrinsic value**.

Call Intrinsic Value = Underlying Current Price – Strike Price

Put Intrinsic Value = Strike Price – Underlying Current Price

Time Value (or Extrinsic Value) – The value in excess of the intrinsic value.

Time Value = Option Premium – Intrinsic Value

Margin of Safety – The amount a stock can fall from its current market price before you start losing money.

Comparing Three Ways to Get Long Stock: The Old Fashioned Way vs. Selling Options Via a Covered Call or a Put

For this post, let's assume that we are die-hard index investors, and in particular we love the SPY ETF (which represents the S&P 500 index). [Note: This will all still apply to all stocks that have options, but I want to take you through specific examples of how this works (instead of something like Stock XYZ).]

When it comes to getting long on an underlying, I want to compare three choices, all of which have their own tradeoffs. In these examples, we are going to assume that you are investing in a cash-only account and not a margin account (this saves us from needing a whole other conversation around capital efficiency). All examples will be based on a one year holding period. We will also ignore commissions for the sake of simplicity. Lastly, we will assume, where applicable, that a full year's worth of dividends is received.

Below is a screenshot of the SPY and the option prices used in this post for your

reference (from my [Think or Swim Platform by TD Ameritrade]):

Example #1 – Buy 100 shares of SPY @ $189.70 on 10/02/2015 (current dividend yield is 2.18%).

This is the example that I believe most people can relate to and most easily understand. It's been ingrained in us that when you invest, you need to buy something, and in this case, it is 100 shares of an index ETF. In order to buy 100 shares in a cash account, this will require $18,970. With the SPY ETF, you have minimal downside protection, but unlimited upside.

Below you will find the graphical representation of the risk/reward for investing in 100 shares of stock. Notice that the one year breakeven is at $185.56, represented by the orange line in the graphic. This is calculated by taking the purchase price of $189.70 minus the dividend of $4.14 per share. This also represents your theoretical risk per share. I say theoretical because it is highly unlikely that an index fund is going to go bust and be worth ZERO. If this were to happen, it would imply that all 500 companies in the SPY went bankrupt. Your investment going to ZERO

would likely be the last of your concerns if this were to happen, as the world would have likely imploded.

The purple line represents the risk/reward continuum, and you will notice that the reward is upward sloping. Your reward is unlimited to the upside, as it can theoretically go up infinitely.

The only downside protection you have is the dividend you receive while you own the stock, which in this example is 2.18% (or $4.14/share). We will call this your ***margin of safety***, as this is how much value the stock can lose over a one year period, before you start losing any money.

Capital Required = $18,970 (the amount needed to initiate the position)

Potential Reward = theoretically unlimited upside (average return of 8% would be $1,517)

Downside Protection = the dividend @ 2.18% or approximately $4.14 ($414)

1 YR Breakeven = $185.56 (purchase price 189.70, minus dividend 4.14)

Theoretical Risk = $18,556 (assuming you collected the full dividend)

Margin of Safety = 2.18% (185.56 divided by 189.70, minus 1)

Example #2 – Buy One September 2016 $190 Strike Covered Call for $175.77 (buy 100 shares @ $189.70, sell one call option @$13.93), with 364 days to expiry.

Let's explore the covered call next because it still involves the purchase of stock, while also simultaneously selling a call. It is a "covered" call because you already own the stock. When selling a call against your long stock position, I typically like to sell the ATM call 1-2 strikes OTM (i.e. strikes above or at the current market price). These calls are going to have the most extrinsic, or time, value. As a seller of the call you promise to sell the stock at the strike price anytime between the time of the sale and the option expiration date.

In this example, you are selling the $190 call for a premium of $13.93, which obligates you to sell the shares at $190 to the person who bought the call if they decide to execute their option (giving you an effective sales price of $203.93). Either way, you get to keep the $13.93 (or $1,393). Keep in mind that it wouldn't make any economic sense for the call buyer to execute his option unless SPY was trading at $203.93 (his breakeven) or higher (he doesn't start making money until SPY exceeds $203.93).

The premium you collect from selling the call now gives you a **new cost basis** of $175.77 in the event that you don't end up getting exercised to sell your shares ($189.70 minus $13.93).

Of course the trade-off for the reduced cost basis is you capping your upside.

Let's look at four ways this could play out:

1 –The buyer of the call exercises his option to buy the stock from you the same day he buys the option (unlikely, but possible – stay with me). In this case, you don't collect any dividends and you make an instant **8.1% return** ($190 sales price divided by cost basis of $175.77 minus 1).

2 – The buyer waits until the day the option expires to exercise his right to buy the stock from you. In this case, you collect $4.14/share in dividends, which reduces your cost basis from $175.77 to $171.63. You have now earned a **10.7% return** ($190 sales price divided by cost basis of $171.63 minus 1)

3 – The third scenario is that the option expires worthless, in which case you keep both the premium and your stock. Your new cost basis is $171.63 and you can do it all over again.

4 – You also have the option to buy the call back at any time and keep the spread.

Capital Required = $17,577 (the amount needed to initiate the position)

Max Potential Reward = 10.7% or $1,837 ($1,393 premium + $414 dividend + $30 appreciation) divided by risk $17,163)

Downside Protection = the $18.07/share ($1,393 premium collected from selling the call, plus the $414 dividend: $1,807)

1 YR Breakeven = $171.63 (Purchase Price 189.70 – premium 13.93 – dividend

4.14)

Theoretical Risk = $17,163 (assumes you collected the full dividend)

Margin of Safety = 9.5% (171.63 divided by 189.70 minus 1)

Selling a Call Against Stock as Viewed Through the Analogy of Selling a House

Say you live in the Bay Area and the market is on fire. An identical house to yours sold for $1,000,000 three months ago in your neighborhood. It had been listed at $900,000, and through a bidding war actually sold for 11% over asking. You meet with your real estate agent, who wants to list your house at $1,000,000, reminding you how hot the market is, predicting that it will likely sell for a premium. With this, you have already set a goal in your head to sell for $1,080,000.

Just as you finish placing a “For Sale” sign out in front of your house a stranger passing by asks to confirm that you’re the owner and that the house is indeed for sale.

After you confirm, the stranger (we will call him James), explains to you that he is in the market and would like to make you an offer. He offers to pay you $20,000 up front if you’re willing to hold the house for 30 days and sell it to him for $1,080,000 when he returns from his travels around the world. Now remember, if you accept the deal that means that you are locking in a sales price of $1,100,000 (the $1,080,000 + $20,000 fee for holding). Even if someone offers you $1,150,000, you cannot take it.

You agree to the offer James makes. He pays you $20,000 on the spot and now one of three scenarios are to play out:

1. James returns from his trip and exercises his option to buy the house from you at $1,080,000. You had to pass on an offer of $1,120,000 to fulfill the agreement you made with James (leaving $20,000 on the table).
2. James returns from his trip and decides not to execute his option. You keep the $20,000, and sell your house for the next best offer. Your next best offer is $1,060,000 (for an effective sales price equal to $1,080,000 after you add in the $20,000 you get to keep).

3. After James decides to not execute you find out the next best offer is at asking of $1,000,000. You decide not to accept and hold out for a better price. You still just made an easy $20,000, and you kept your house.

Example #3 – Sell One September 2016 $190 Strike Put for $17 (or $1,700), with 364 days to expiration.

Our last example is that of selling a put. Take notice that the risk profile charts for a covered call and a short put are exactly the same shape. This is because they are synthetically the same strategy.

Like the covered call, I typically like to sell the put ATM or 1-2 strikes OTM. In this case, we are selling the ATM $190 put for a $17 premium or $1,700. By selling this put we are obligating ourselves to buy the stock at $190 if exercised. But after you take into consideration the premium collected, our effective long price is actually $173. Again, it doesn't make economic sense for the put buyer to exercise his option if the stock is not trading at or below $173/share.

Let's look at three ways this could play out:

1 –The buyer of the put exercises his option to sell the stock to you. You keep the premium and now own the stock with an effective cost basis of $173/share. You are now free to turn this into a covered call (see above).

2 – The stock finishes somewhere between $173 and $190. You buy the put back for less than you sold it for and keep the difference. You make something between 0% and 9.8%.

3 – The option expires worthless, you keep the premium and you have no position left. You make a **9.8% return** ($17 premium divided by effective cost basis of $173 minus 1).

Capital Required = $17,300 (the amount needed to initiate the position)

Potential Reward = 9.8% or $1,700 ($1,700 premium divided by risk $17,300)

Downside Protection = the $17/share premium collected from selling the put (or $1,700).

1 YR Breakeven = $173 (Strike Price 190 – premium 17)

Theoretical Risk = $17,300

Margin of Safety = 8.8% (173 divided by 189.70 minus 1)

Selling Put Options as Viewed Through the Analogy of Buying a House (The example below was taken from a newsletter I am subscribed to

called “The Palm Beach Letter.”)

It’s your dream home. But it’s listed for $500,000… $100K more than you’re willing to pay. The seller isn’t interested in your $400,000 offer.

So, you come up with a creative solution to keep yourself in the game…

You offer to buy the house for $400,000.

But to sweeten the deal for the seller, you add this carrot: The seller can accept your $400K bid at any time over the next year.

The seller likes this because it gives him time to try to find a buyer who’ll pay more for his house. It also gives him reassurance he’ll still get money from you if he can’t find another buyer.

But in exchange for this new contingency offer, the seller must give you $5,000. And you get to keep this $5,000… whether or not you end up buying his house.

Now, if the seller agrees, one of two things can happen…

1. Sometime over the next year, he’ll agree to sell you the property at your initial asking price of $400K.

Maybe housing prices will fall dramatically… or he’ll need to move quickly… or he just won’t find a buyer willing to pay more.

In either case, you’ll get the house for $400,000. Plus, you’ll get to keep the $5,000 (an effective cost basis of $395,000).

2. He’ll never sell you the house. Maybe he’ll find someone who’ll pay his $500,000 asking price, or he’ll decide not to sell at all. Still, you’ll get to keep the $5,000.

So, while you didn’t get the property you wanted, you’ll generate an easy $5,000 in income.

Volatility is Your Friend

Here is just a quick note on volatility, as it relates to options.

When it comes to selling options, the higher the volatility, the higher the premium you will be able to extract from the marketplace. More premium translates into an increased ***margin of safety***.

Here is a quick example to show you why volatility is your friend when selling options:

On 08/18/2015 when the SPY was trading for $209.98, the October 2015 $200 strike PUT was $2.00 (a put that was $10 OTM) **= Effective long price of $198**

On 8/24/15 when the SPY was trading for $189.55 the October 2015 $179 strike PUT was $6.38 (again $10 OTM) **= Effective long price of $172.62**

During large moves to the downside, fear increases, which in turns increases volatility as investors look to buy protection to decrease their losses (volatility and price have an inverse relationship).

In this real example, the SPY went almost $20 lower, but because of the explosion in volatility (fear), you were able to get 3X the premium for a put that was still only $10 OTM from the current market price.

I should point out that during this move the VIX went from 13.8 to a high of 53.3 and closed at 40.7.

Summary

If this is your first exposure to options, I hope that you will at least keep an open mind as to the possibility of the role they can play in your portfolio. For those that have been brainwashed to believe that options are dangerous, I hope this gives a deeper and more nuanced view of the workings of options. Although they have certainly been misused for speculation (risky business), when used more intelligently by the educated trader they can be employed to actually reduce risk (and thus cost basis).

Like anything in life, there are tradeoffs when selling options. In return for the

premium you collect, you are agreeing to a defined reward, but you also are giving yourself more than one way to win. Think about the examples we went through above. As demonstrated, you can make money if the SPY goes up in value, stays the same, or if it goes down until it reaches your break even point. That is a pretty good tradeoff if you ask me.

These are the two best option strategies to get long stock at below-market prices. With options, every day is a sale in the market, and “Clearance Sales” occur, too, offering extreme discounts when there are big moves down in price (due to increased volatility).

Are you starting to see options in a new light? Would you consider the short put or covered call in your portfolio? What other thoughts or questions do you have?

– 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