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Two Ways To Profit From Too Much Fear

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Two Ways To Profit From Too Much Fear

By Jim Pearce
March 9, 2018

The S&P 500 Index closed at 2,677 on March 1, just a few points shy of where it opened on January 2. That means there has been no net gain for index investors over the first two months of this year, despite wild swings in both directions from one day to the next.

Like a hung jury that cannot arrive at a unanimous decision, investors are evenly split on which way the stock market is likely to go over the remainder of the year. Rising inflation may result in wider profit margins for companies in the near term that are able to raise prices. But without a commensurate increase in prices, the long-term ramifications of higher labor and resource costs could more than outweigh the short-lived benefits.

As an investor, attempting to determine how best to profit from the stock market's rapid change in directions is a tricky proposition. Since index investing is, on average, a zero-sum game when the stock market's intermediate-term direction is sideways, a passive approach is not likely to make much headway until a long-term uptrend has been re-established.

Until that happens - and there is no way of knowing how soon that may be - there are some things you can do to take advantage off of heightened volatility. Here are two of my favorites:

Buying Dividends at a Discount

As a general rule, the strategy of "buying dividends" is a bad idea. That is when you buy a stock just before its ex-dividend date, knowing that the price of the stock will drop by the amount of the dividend. In essence, all you end up doing is getting your own money paid back to you as a taxable dividend without any corresponding benefit.

But in a stock market as volatile as this one, sometimes you can have your cake and eat it, too. When the entire market is overreacting to the news of the day, the size and timing of upcoming dividend payments tend to get ignored. If the share price of a stock I like plunges with the overall market a day or two before its ex-dividend date I will buy it, often times seeing its share price rebound with the overall market a day or two later.

That way, I end buying the stock at a price it would normally be trading at after its ex-dividend date while also receiving the next dividend at effectively no additional cost.

Selling Fear at a Premium

Another way to generate a little extra income when the market is having a down day is to sell an out-of-the-money put option against a stock you would like to own at a lower price than it is currently trading. In essence, you receive money now (the option premium) in exchange for agreeing to buy that stock at a predetermined "strike" price within a specified time period.

If the stock never trades down to the strike price then you get to pocket the money without having to buy the stock. But if the stock does end up getting put to you at the strike price, you end up owning it at a lower price than it was originally trading AND you get to keep the option premium. I think of it as allowing other investors to sell their fear to me at a premium, as my colleague Jim Fink explains in this training video.

In both cases, you are capitalizing off of excess volatility by immediately adding a couple of percentages points of gain to your holdings. Occasionally, such as ten years ago when the stock market lost half of its value, a couple of percentage points does not seem like enough to make it worthwhile. But more often than not, a few weeks or months later the market reverts to a less volatile state and the extra gain is icing on the cake.

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