Earn Income While Waiting For A Pull-Back

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Earn Income While You Wait For A Pull-Back

By Scott Chan
March 12, 2018

Last week, we discussed writing (selling) covered calls as a way to try to boost the return in one's portfolio. This week, we take a look at another way to use options to earn extra income.

Despite volatility over the past month, the market is still near all-time highs, so chances are good that most investors have at least a stock or two that "ran away" but they still want to buy if the price dropped. The strategy that we are about to discuss is especially fit for this scenario. We are referring to writing a put.

The Basics

When you write a call option, you are selling to the option buyer the right to buy a stock from you at a specified price. In the case of writing a put, you are selling to the option buyer the right to *sell to you*, per contract, 100 shares of the underlying stock at the strike price on or before the option's expiration date.

The premium you get for selling the option is yours to keep no matter what. If the stock price remains above the strike price, then the option will simply expire worthless because it would make no sense for the holder of the put option to sell the stock to you at a below-market price.

On the other hand, if the stock falls below the strike price, the put holder can sell the stock to you at the above-market strike price.

Cash Securing Your Position

Because you may have to buy the stock at the strike price, when you sell a put it is best to set aside enough cash in your account to cover the potential purchase. This is called a cash-secured put. There is a good chance your broker will automatically set aside the appropriate amount of buying power anyway.

That brings up a drawback to put-writing. For as long as the put option position is open, the cash set aside to secure the put is locked up, so you cannot deploy it elsewhere. Therefore, this strategy is not for the aggressive investors who like to squeeze every penny out of their buying power.

Rather, put-writing fits better for more patient investors who do not mind keeping some powder dry. Additionally, it makes sense to sell puts against stocks you like. As we mentioned above, if there is a stock you like but you think it is overpriced now, selling a put against that stock can earn you income while you wait for the stock to pull back.

Example

For example, let us say stock XYZ is selling for $30. You like the stock a lot but you don't want to buy it unless it fell to $25. In this case you can sell a $25 put.

The premium is yours to keep no matter what. If the option is exercised, you buy the stock at a price you would have bought it anyway. Remember, you come out ahead as long as the premium is greater than the difference between the strike price and the market price.

So, in the above example, if you sold the option for $1 and XYZ is trading at $24.50 when the option is exercised at $25, your effective cost basis is $24 per share ($25 strike price minus the $1 premium). So, you effectively still bought the stock at a lower price than if you bought it in the open market. (For simplicity, we are ignoring commissions and fees in the calculation.)

If you decide that put-writing fits your investment goals, check with your broker to see what the option-level clearance and margin requirements are. Each broker's requirements can differ.

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