The Secret to Wealth: Use Other People's Money

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The Secret to Wealth: Use Other People's Money

By Scott Chan (see bio at end)
May 14, 2018

When it comes to the power of leverage, the ancient Greek mathematician Archimedes expressed it aptly: "Give me a lever long enough and a fulcrum on which to place it, and I shall move the world."

Here, I discuss the investment power of leverage, which is just a fancy word for "debt." Through the strategic deployment of leverage, you can give your portfolio a shot of steroids, for exponential gains in relatively short time-frames. How did the rich get that way? By using other people's money!

Of course, when it comes to making money from investing, it helps to start with a large sum of money.

Consider the following example.

Bob starts with a $1 million portfolio. The portfolio returns 10% during the year. He makes $100,000.
Joe has a $10,000 portfolio. The portfolio returns 30% during the year, 3 times better than Bob's portfolio. But, Joe only makes $3,000.
So does this mean that Joe won't be able to make any serious money in the market if he doesn't start out with a large sum of money?
No. Not necessarily.

The Secret Is Leverage

You have probably heard of the term "financial leverage." It means using other people's money to maximize gains for yourself. Leverage is one of the most powerful financial tools available.

One example is borrowing money from your broker to buy stock, called "buying on margin."

However, you don't necessarily need to borrow money to create leverage. By using options, Joe could use leverage without borrowing money.

Let us use a hypothetical example.

Joe really likes stock XYZ, which trades for $30 a share. He wants to invest $1,500 in the stock. He buys 50 shares. The stock goes up to $33 per share in three months, and Joe sells for a profit of $3 per share, or $150 total. That's a 10% return. Not bad.

Boost Returns With Options

But what if Joe used the $1,500 to buy a call option instead of the stock itself?
Let us say an August XYZ call option trades for $1.50 ($150 per contract). Joe can buy 10 contracts with his $1,500.

Staying with the above scenario, if XYZ rallies to $33 as the option expiration date approaches, the call option should be worth about $3.

Let us say it is worth $2.80 ($280 per contract). This means Joe's position would be worth $2,800. If he sells his entire position at that price, he would get back $2,800. Subtract the original entry cost of $1,500 and Joe's profit would be $1,300. The return is 86.7%.

By buying a call instead of buying the stock, Joe managed to increase his return eight-fold. (For simplicity's sake, I ignored trading costs in the example above. If you use a discount broker, the cost of trading should be small.)

The Pitfalls of Exercising Options

You may wonder, why not just exercise the option and buy 1,000 shares of XYZ at $30 and then immediately sell the shares back to the market at $33? Then Joe would make $1,500 ($3 x 1,000 - $1,500). Even better.

In theory, that sounds good. But in real life, the situation is more complicated.

To exercise the option, Joe would need to have $30,000 in cash available to buy the 1,000 shares of XYZ. Even if Joe has a margin account, he would need to have enough equity in the account to cover whatever percentage of the cost of the shares his broker requires. In a small account, that is not realistic.

Since a stock trade settles in two business days, technically you could turn around and sell the stock immediately. But this is known as "free-riding" and will likely cause the broker to lock your account for 90 days.

An alternative would be to close your position incrementally - sell one or two contracts at a time since you would only need to have $3,000 in cash to exercise each contract. The downside to this is that there is no guarantee that the stock price will remain at a favorable level, and the cost of trading will be higher since you have to do multiple trades instead of one.

Therefore, most options traders will choose to simply sell the option.

Leverage Can Cut Both Ways

In our example above, Joe was able to increase his profit eight-fold because the underlying stock moved in his favor. But if the stock price had fallen instead, the value of the call option would fall even more sharply in percentage terms.

Also, time works against the option buyer. With each passing day, the value of an option erodes because there is less time for the underlying stock to move in the option holder's favor. This is known as time decay. And an option could expire worthless. For example, if XYZ is $29.50 at the August expiration, it is worth nothing. In this case, if Joe never closed his position, he would lose 100% of his initial investment.

The bottom line is that trading options can be quite a profitable strategy, but you need to know what you are doing.

If you're interested in learning more about the money-making power of options, click here for a presentation that could change your life.

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ABOUT THE ANALYST

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Scott Chan moved from China to the U.S.A. with his family at the age of ten. He passed the rigorous entrance exam and attended the merit-based Stuyvesant High School, widely held to be the best public school in New York City. He earned undergraduate degrees from New York University followed by an MBA degree from the Zicklin School of Business at Baruch College.