Monday, December 26, 2011

"Put"-ing Around With Volatility

Previously we discussed the advantages of purchasing in-the-money Call options during periods of low volatility. The gauge most often used to measure volatility is the VIX (Volatility Index). When the VIX is at extreme lows, it signals that the implied volatility expressed within an options price will also be at low levels, presenting a possible buying opportunity. At high levels of implied volatility, the intrinsic (real value) percentage is reduced due to higher levels of "time premium" priced into the option. So here is how we take advantage of *high* volatility using options to enter a desired position.

Instead of *buying* in-the-money Calls, we *sell* out-of-the-money Puts. A Put is out-of-the-money when its strike price is below the market price. Buyers of Puts have the right to *sell or PUT* the underlying security at the strike price. Sellers of Puts, have the obligation to *purchase* the underlying security at the designated strike price if it is assigned to them. As a practical matter, a Put seller will be required to purchase the security only if the market price of the underlying stock moves below the strike price at expiration of the option. If the stock price is at or above the strike price of the Put at expiration, the option just expires worthless and you, the seller, keep the proceeds of the Put sale you received when you entered the position.

Important! You should only use this method for a stock that you want to own. Because, as described above, the stock will be put to you if the price declines below the strike price. The good news is that you will be buying the stock at a lower entry price than you would have had you bought the stock outright instead of selling the Put. The other good news is that because of the high implied volatility, the proceeds that you received from the sale of the Put further reduces your entry cost of the position.

For example, some time back I sold an Intel $20.00 Put for $1.75 when Intel stock was selling for $21.00. Thirty days later at expiration, Intel stock closed at $19.00. At that point, I was required to purchase the stock at $20.00 (the strike price). My net cost was $18.75 (20.00 – 1.75). The bottom line is that I liked Intel at $21.00 but I like it better at $18.75. If Intel had closed at $20.00 or higher, I would not get assigned (forced to purchase the stock) and I would just pocket the $1.75 while the option expires worthless.