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INVESTMENT INCOME STRATEGIES

CASH-SECURED PUTS

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Have you ever been planning on making a big purchase, but were hesitant to pull the trigger because you felt that the current price of the item was a little high? Maybe you were worried that you would buy the item, just to see it go on sale in the weeks following. You probably found yourself asking, what should I do? Do I buy it now, even though I think it's overpriced? Do I wait and see if the price drops? How long am I willing to wait for the price to drop? Most importantly, can I afford to wait it out and take-on the risk of the price increasing? These questions to this scenario are also applicable to investing, especially when it comes to buying stock in a company.

For example, let's say that you are interested in buying a stock below its current market price. Perhaps, you are intrigued by the company's long term growth potential, but the stock price has recently increased significantly in a short amount of time. As much as you want to own the stock because of its future prospects, you would much rather prefer to buy it at a lower and, in your opinion, more reasonable price. So, what can you do? Well, one option would certainly be for you to input a **Buy Limit Order** at your desired price. However, if the stock never reaches that specific price, the trade will never get filled, and your cash will have been sitting without being invested during such time.

What Is A Buy Limit Order?

A buy limit order is an order to purchase an asset at or below a specified asking price, allowing investors to control their purchasing price. It's important to note that a buy limit order will only be executed if the asset reaches the specified asking price.

As we all know, time is money, so, wouldn't it be nice to get compensated while you wait for the price of the stock to decrease? After all, by waiting, you are taking on the risk that the price of the stock will never decrease to your desired level again. As it turns out, with a cash-secured put, you actually can.

What is a Cash-Secured Put?

The cash-secured put option strategy involves an investor writing (also known as selling) a put option while simultaneously setting aside enough cash to buy the stock, or exchange-traded fund, if the put contract is exercised by the buyer of the contract. Hence the term, "Cash-Secured". The seller of the put option is bullish on the underlying stock in the long-term and is hoping for a temporary downturn in its price, so therefore, their goal in selling the contract is for it to be exercised by the contract buyer, requiring them to buy the stock at the specified strike price. When the investor sells the put option, they receive a cash payment from the option buyer, which is referred to as premium. The buyer of the contract is paying this premium to acquire the right, but not the obligation, to sell you shares of stock any time before the contract's expiration date if the stock price is below the specified strike price.

The put seller will be obligated to buy shares of XYZ stock at the specified strike price when the contract gets exercised by the put buyer, or if at the contract's expiration date, the underlying security is at or below the strike price. Compared to buying a stock outright, where one would have to pay the current market price to have guaranteed ownership, selling a put option allows an investor to generate some income while they wait to potentially own the stock at a lower price.

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Put Seller is obligated to buy shares of the underlying security if:

- On the contract's expiration date, the stock price is below the strike price (European Style)
- The stock price is below the strike price before the contract's expiration date and the put buyer exercises the contract (American Style)
- The stock price is equivalent to the strike price before the contract's expiration date and the put buyer exercises the contract (American Style)

American Style Option Contracts: Can be exercised at any time prior to expiration
European Style Option Contracts: Can be exercised ONLY at expiration

To get a better understanding of how a cash-secured put strategy works, let's take a look at a few hypothetical scenarios.

Assumptions:

- XYZ stock is currently trading for $55 per share
- An investor is interested in buying XYZ stock, but believes that its current stock price is overvalued. Such investor believes that the fair value of the stock is actually $50 per share, and therefore, is only interested in buying the stock at that level or lower.
- Instead of waiting for the price to potentially drop, the investor writes 1 put option (1 option contract consists of 100 shares) with a strike price of $50 that will expire in three months. The Put Option is an American Style Option.
- The investor simultaneously sets aside the $5,000 ($50 x 100 shares) needed to purchase the stock if the option does in fact get exercised by the buyer of the contract.
- The investor (who we will now refer to as the Put Seller) immediately receives a premium of $150 or $1.50 per 100 shares

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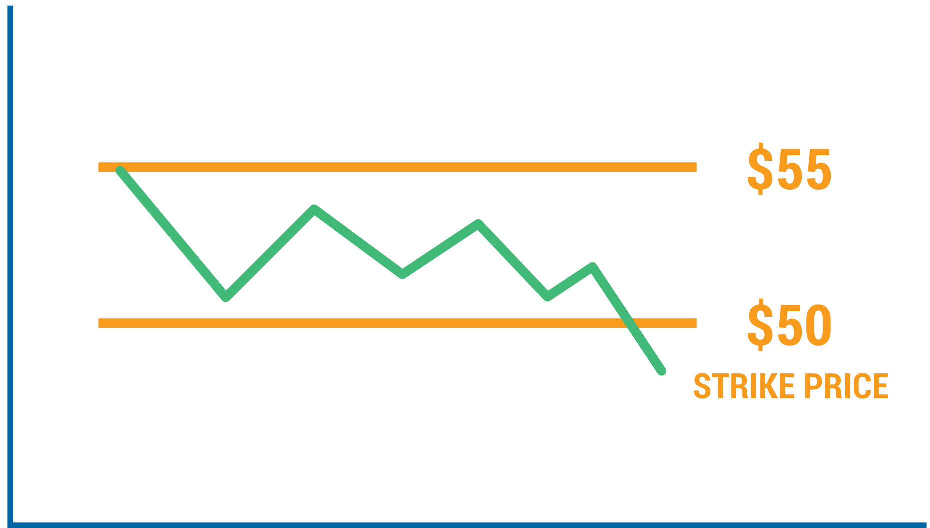
SCENARIO 1

The stock price drops to $50 or slightly lower and the Put Buyer exercises the contract.

For this scenario, let's say that after two months the price of the stock falls to $49.25 and the contract gets exercised by the Put Buyer. The Put Seller would use the $5,000 in cash that the Put Seller set aside at the beginning of the contract to buy 100 shares of XYZ stock at the agreed upon strike price of $50. Adding in the premium that the Put Seller received when the Put Seller originally sold the contract ($1.50 per 100 shares), brings their overall cost basis to $48.50 per share ($50 - $1.50). This is an ideal scenario for the Put Seller as the Put Seller was able to accomplish the original goal of buying shares of XYZ stock at a lower price while also receiving income for waiting.



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SCENARIO 2

The stock price remains above $50 over the course of the contract. The Put Buyer never exercises the contract and the contract expires worthless after three months.

While this isn't the best case scenario for the Put Seller, who's ultimate goal in selling the contract was to acquire more shares of XYZ at a lower price, it's certainly not the worst case either. Let's say that when the contract expires, XYZ's stock price is trading at $53 per share. The Put Seller wouldn't accomplish the Put Seller's initial goal of acquiring XYZ stock at $50 or lower because the stock price never reached or went below the strike price over the course of the contract. However, the Put Seller still collected $150 in premium. Which is more than the Put Seller would have made had the Put Seller only waited and not sold the put option. Remember, the $5,000 that the Put Seller had to front was sitting in a cash account at the Put Seller's brokerage earning little to no interest. By incorporating this strategy, the Put Seller was able to earn a 3% return on that capital in only a 3-month time frame. While there is risk involved (because the value of the selected stocks may drop below the strike price even though that was not what was expected), for some investors just looking to use a cash-secured put strategy to generate additional income, this is an attractive option . Instead of selecting underlying stocks that the Put Seller really wants to own, a Put Seller just looking for additional income would select stocks whose value the Put Seller believes won't drop below the strike price over the course of the contract.

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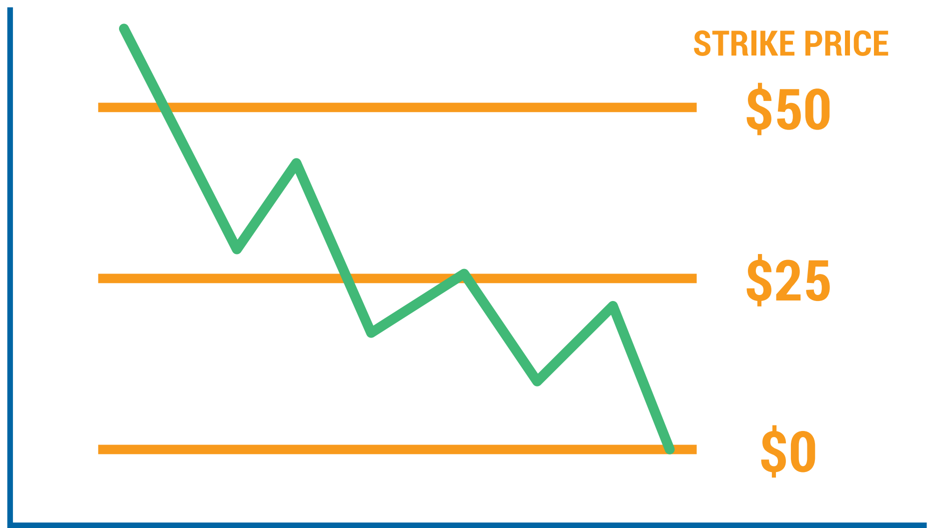
SCENARIO 3

The stock price drops dramatically below $50

The ultimate risk of a cash-secured put strategy is that the underlying stock price drops to $0 during the contract. While this is a highly unlikely scenario in most cases, it is still a realistic risk that Put Sellers need to be aware of. If the stock price were to actually fall to $0, the Put Seller would lose almost all of the $5,000 that the Put Seller originally set aside when writing the contract in order to make it "Cash-Secured". This is because the Put Seller would be obligated to buy XYZ stock at the strike price of $50, equaling a total loss of $4,850, once you factor in the premium that was collected. ($5,000-$150).



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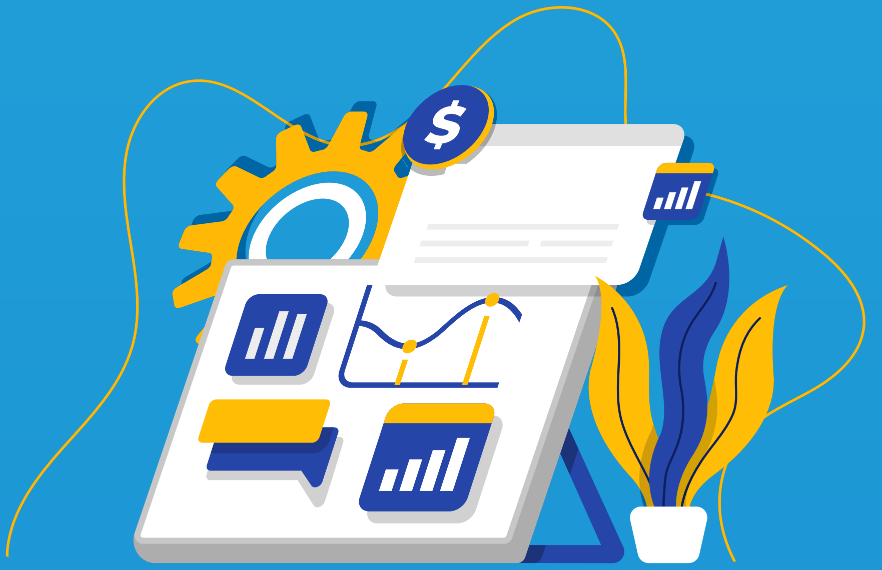

SCENARIO 4

A stock price falling from $55 to $0 in a three-month time frame is extremely rare, but it's still important to understand that the risk of it happening does in fact exist. When deciding whether or not to execute a cash-secured put strategy, it's best practice that the Put Seller be comfortable and willing to buy the underlying stock at the specified strike price. Investors considering a Cash-Secured Put strategy should also realize that by waiting for a favorable price decline, they are also potentially missing out on any gains in the stock in the case that it rises significantly over the course of the contract.

If you would like to speak with an advisor regarding the contents of this piece or other financial planning and investment matters, please reach out to StrategIQ today.

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