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“STOCK FOR RENT”: USING OPTIONS TO INCREASE CASH FLOW

By

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“Don’t put all your eggs in one basket”. You’ve probably heard this expression describing the investment principle of diversification. Without argument, a properly diversified mix of assets will reduce investment risk. However, not all portfolios are diversified. Many people hold single stock positions that represent 30%, or more, of their net worth. These large holdings don’t have to sit idle in a brokerage portfolio, simply collecting dividends and being subject to daily price changes. Instead, there are tools that can be used to maximize the stock’s earning potential while the shares are held. To better understand how, let’s compare owning a large stock position to another familiar investment; real estate.

Near my home sits a residential property scarred from two-years of beating at the hands of the Arizona housing slump. From the street, the home’s wounds are glaring; weeds have replaced grass, flyers litter the doorstep, and a “for sale” sign blows, ignored, in the wind. Month after month, the home has sat vacant; a dead asset on someone’s balance sheet. Each day I pass this home with a rather obvious solution: find a renter! Renting the home could generate immediate cash flow and allow the owner to turn an otherwise dead-asset into something of value.

Similarly, many people own “vacant” stock; large stock positions sitting idle in the portfolio, waiting for an eventual recovery in price. While residential properties are able to lease to a tenant, owners of stocks can generate cash flow by, in essence, renting their holdings within the options market. By selling a call option, the holder of the stock is able to generate increased income from the asset.

Let’s look at a simple example. Assume John owns 10,000 shares of XYZ, Inc. The stock is trading at \$50 but John prefers to wait and sell when the price reaches \$60. As the owner of the stock, he can sell the opportunity for another investor to buy his stock in the future, at a price determined today. This is done by selling a call option. In our example, John can sell a three month call option with a predetermined price (called the Strike Price) of \$60. To own the opportunity to buy the stock in three months at \$60, the buyer of the call option would pay John cash, upfront (referred to as the Option Premium). Let’s assume the premium is \$1.00 per share. John would be paid \$10,000 today for entering the obligation to sell the stock at the \$60 target price. If, at expiration, the stock were to be above the \$60 strike price, the stock would be sold at \$60. John would keep the sale proceeds and the original \$10,000. If the stock were to remain below the strike price, John keeps both his shares of XYZ and the \$10,000 and can repeat the process.

Picking the proper strike price is a critical part of using this strategy. Of course, as in our example above, a person can always pick a strike price that matches their desired sale price. However, if that price is 20%, or more, above where the stock trades today, those strike prices may offer little, if any, income. This is true because option prices are derived by mathematical formulas used to determine the probability that the stock trades over the strike price. The more likely it is for this to happen, the higher the premium of the option. The two main components of this pricing are the amount of time before the option expires and the stock price increase needed to meet the option’s strike price. For example, a \$30 stock has a better chance of trading above \$33 in six months than trading above \$35 in two months. Therefore, the price of the six month option will be much higher than that of the two month option. So, be careful not to pick an option based only on the option premium. This can be a costly mistake and result in unnecessary risk.

To help avoid these pitfalls, a new style of selling covered calls has emerged, and is especially effective with larger holdings. Professionals, experienced in managing options, have access to models that were developed using option pricing formulas. This can more effectively determine the number of contracts to sell, and at what strike price. This methodology removes much of the speculation and randomness that previously made selling covered calls more risky, and tends to produce more consistent income payments.

To most successfully use options, first consider how they fit your ultimate goals with the stock. Make sure you don't limit your long-term appreciation goals merely for a higher income payment today. If using options seems interesting but you are not comfortable making the decisions on your own, seek the help of a professional with experience in managing options and keep in mind the following:

1. The owner of the stock maintains the right to all dividends paid during the option period.
2. Selling call options allows you to maintain appreciation in the stock up to the strike price.
3. The income received for the option premium is kept by the owner of the stock, regardless of the options ultimate outcome.
4. Your downside protection is limited to the income earned on the options. If the stock price drops, you still own the stock.
5. Because option premiums are determined by mathematical formulas, a professional can model various outcomes and remove much of the randomness that could otherwise reduce your profitability.

My neighbor's home remains empty; growing weeds and offering no economic value to its owner. Using a covered calls strategy on your large stock positions can be a tool to help you keep your stock from doing the same.

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