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## Selling Secured Put Options to Buy the Underlying Stocks

Amidst the correction the Canadian stock market is experiencing for more than a year now, many investors are looking at the opportunity to purchase quality stocks for the long term. Buying shares in such an environment exposes investors to short-term losses since no one can forecast when the market will stop its decline and start a new uptrend. This is the reason why many investors place limit buy orders below the current stock prices in order to buy shares at lower prices. Essentially, investors are waiting for their price!

However, this trading strategy requires discipline and courage as many investors could be tempted to change their mind when the stock price approaches to their purchase price. Take for example an investor who wants to buy a quality stock on price weakness. At the current market price of \$20, the investor believes that ABC stock is too expensive and that a better buying opportunity would present itself if the stock price drops to \$18. The investor's decision may be based on fundamental and/or technical reasons. The investor thus decides to place a limit buy order at a price of \$18 for 100 shares. Soon after, the ABC stock price resumes its decline and approaches the investor's limit buy price of \$18. Facing a wave of sellers, the investor decides to cancel their buy order at \$18 and place a new limit buy price of \$17. As anticipated, the price of ABC stock drops and touches \$17.50. The investor is happy with their decision and now believes that they will be able to buy the stock at their revised price of \$17. The investor already foresees the savings of \$1 they will get compared to the original buy order of \$18. However, the market rallies unexpectedly and the stock price bounces back above \$18 to \$18.50. The investor now realizes that they have lost an opportunity to buy the stock at a price of \$18 and that lowering the original buy price of \$18 was a mistake. The investor proceeds to cancel the limit buy order of \$17 and places a new limit buy order at a price of \$18, with the intent to not touch the order again.

An option trader looking at this scenario could tell our investor that placing a limit buy order below the current stock price obliges them to buy the stock. Among all the available options strategies, the sale of a secured put option replicates the investor's strategy illustrated above. Indeed, the writer (seller) of a put option contract has the obligation to buy the underlying stock at the 18-strike price if the holder exercises his right to sell. As compensation for this obligation, the writer (the seller) receives a premium. Essentially, the seller of the option engages in a contract to buy ABC shares at a price of \$18 from the buyer of the option for a premium. The result of this strategy is the same as waiting for the price of the stock to drop to \$18. However, selling the put option contacts is equivalent to being paid to buy the underlying stock.

Table 1 below shows the two scenarios (placing a limit buy order to buy ABC shares at \$18 compared to selling a put option with a strike price of \$18). We observe that the risk, following a decline in the ABC stock price, is similar in both cases, with the added advantage that the investor receives a premium for selling the put options. In contrast, if the price of ABC shares remains above \$18, the investor will not buy ABC stock at \$18 in either scenario. Hence, selling put options wins since the investor benefits from collecting a cash premium upfront if the shares are not bought.

**Table 1 – Comparing the two scenarios**

ABC stock price = \$20	Limit buy order at \$18	Sale of a put option with a strike price of \$18
Stock price below \$18	Buy the stock at \$18 Risk = \$18 per share	Buy the stock at \$18 Risk = \$18 per share less the premium received
Stock price above \$18	No stock purchase	No stock purchase Profit = Premium received

**A CONCRETE EXAMPLE**

**Figure 1 – National Bank on April 27, 2012**



Suppose an investor is interested to buy the shares of National Bank (NA). On April 27, 2012, a sell signal is triggered on National Bank following confirmation of a “head and shoulder” pattern (see Figure 1). The downside target price for NA shares is close to \$72 whereas the stock price is at \$77.27 on that day.

In such a context, the investor is not in a hurry to buy the shares at the current price. The investor estimates that a price of \$74 would be a better opportunity to buy the NA shares. The investor has two alternatives: wait for his target price and place a limit buy order to buy the NA shares at \$74 or sell a put option obligating them to buy NA shares at a price of \$74. The investor decides to sell a secured put option contract. Looking for quotes on MX site at [http://m-x.ca/nego\\_cotes\\_en.php](http://m-x.ca/nego_cotes_en.php), the investor finds that put options expiring on June 16, 2012, with a strike price of \$74 can be sold at the quoted price of \$0.65 per share.

The investor decides to sell 10 contracts with the obligation to buy 1,000 NA shares at the strike price of \$74 until expiry on June 16, 2012 (if the holder exercises their risk to sell). For taking on this obligation, the investor receives a premium of \$65 per option contract for a total of \$650 for the 10 contracts sold (\$0.65 per share x 10 contracts x 100 shares per contract).

**Figure 3 – National Bank on June 15, 2012**



As depicted in the above figure, the target price of \$72 (projected by the “head and shoulder” pattern) was quickly reached. Consequently, we can affirm that the limit buy order at \$74 would have been filled—allowing the investor to acquire 1,000 NA shares at a price of \$74.

In the case of put options, the investor has to wait for exercise by the holder (at the latest on the expiry date of June 16, 2012). On June 15, 2012 (the last trading day before the expiry date of June 16, 2012), NA shares closed at a price of \$72.97. Therefore, we can affirm that the holder of the put options would have exercised their right since they can sell the NA shares at the 74-strike price. This is \$1.03 more per share compared to the closing price \$72.97. Consequently, our investor must buy 1,000 NA shares at the striking price of \$74. Since they have already received a premium of \$0.65 per share, the average purchase price is reduced to \$73.35.

The purchase of NA shares on the stock market was realized at a price of \$74, whereas the purchase of NA shares through put options allowed the investor to buy NA shares at a price of \$73.35. We can affirm that the secured put strategy allowed the investor to purchase NA shares at a lower price compared to buying them directly on the stock market.

## CONCLUSION

Investors wishing to buy a quality stock below current market value can do so by placing a limit buy order below the current market price or by selling secured puts at a strike price equal to the target stock price. The writer (seller) of the put options is therefore obligated to buy the underlying shares at the contract striking price. In exchange, the writer receives a premium that reduces the purchase cost of the shares while offering a small protection in case of a larger than expected drop in the underlying share price. The premium received is equivalent getting paid to buy the underlying shares. Whether the put options are exercised or are worthless at

the expiry, the sale of secured puts allows buying the underlying shares at a lower price compared to a direct purchase on the stock market. Selling secured put options on quality shares represents an attractive strategy for investors.

To know more, see the "Writing Secured Put Options" strategy available at [http://www.m-x.ca/f\\_publications\\_en/options\\_strat7\\_en.pdf](http://www.m-x.ca/f_publications_en/options_strat7_en.pdf).