Ideas for managing risk and enhancing returns

Negotiating the High Seas

Making money in a bear market with options

Len Yates

04/01/2004

I was just thinking the other day about how stormy the markets are these days, and in my mind the connection was made to the movie "The Perfect Storm". Later that very day the January issue of Futures magazine landed on my desk with the headline "The Perfect Economic Storm?".

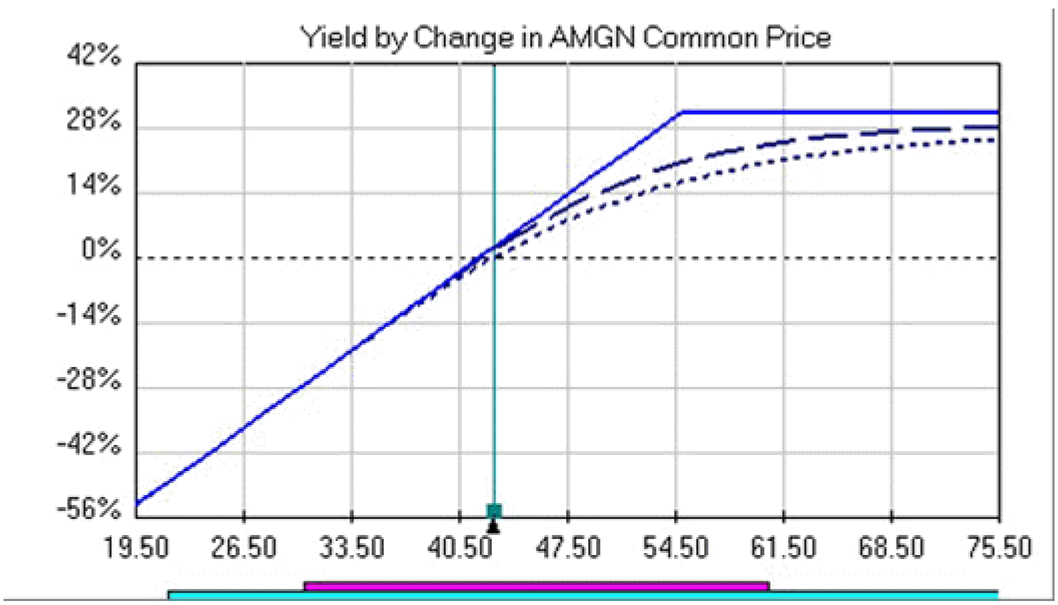
It's a horrendous bear market. Stock investors are clearly not making money.

However, is it possible to protect your stocks, and even make money, using options? What is the best way to use options in a market like this? Good questions. When implied volatility (IV) levels are at all-time highs, option buyers have to know that they're playing with fire. When the market quiets down (and sooner or later is *has* to), IV's (and options prices) are going to come down.

So how can the options trader position himself so that the coming IV decline works in his favor? In a word, by finding ways to sell options.

Covered Writing

The obvious (and safest) way to sell options is "covered writing" – where you sell calls against your existing stock holdings, or buy new stock holdings and sell calls against them. These are "covered" calls, because you own the underlying. Still, the drawback to covered writing is that if the stock falls *a lot* further, beyond a certain point your short calls do not help cushion the fall. Also, should a decent rally develop, your upside potential is capped by the short calls. The picture below shows the risk graph of this trade using Amgen (AMGN) as an example:



Spreads

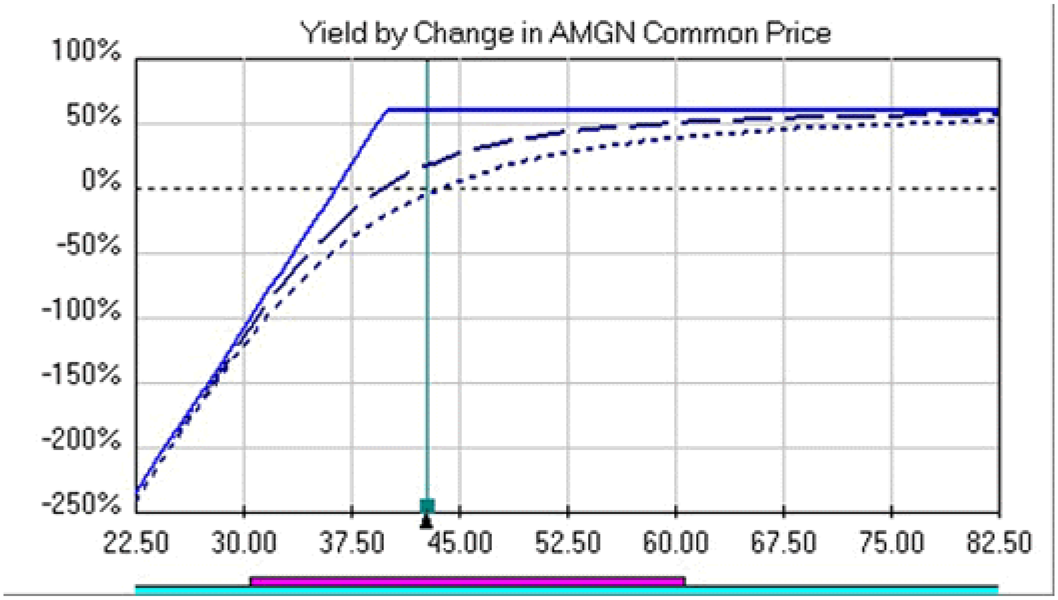
Another way of selling options is to use spreads for directional trading instead of outright option buying. While this may not allow you to benefit from any decline in IV, at least the effect of the decline is neutralized. In fact, if you use credit spreads rather than debit spreads, you may actually be able to put a potential IV decline in your favor (a little bit). That's because the more pricey short leg of the spread ought to decline faster when IV drops.

Ever Considered Writing Naked Puts?

Another way of selling options, very popular with well-heeled investors, is to sell naked puts on stocks the investor wouldn't mind owning. Typically, at-the-money or just out-of-the-money puts are sold. Then if the stock stays around the current price, or advances, the investor keeps the (currently generous) options proceeds after the option expires worthless. If the stock declines, the investor eventually gets assigned shares. In that case, the cost basis for his shares is the put strike price minus the options proceeds.

For example, Amgen is currently trading at $42.75. An out-of-the-money put with a strike price of 37.5 can be sold for 2.75 ($275 each). The $275 is yours to keep, no matter what. Worse case, you'll end up paying $3,750 for 100 shares of stock. Subtract the $275, and your effective basis is $3,475, a price of $34.75 per share. Not a bad deal!

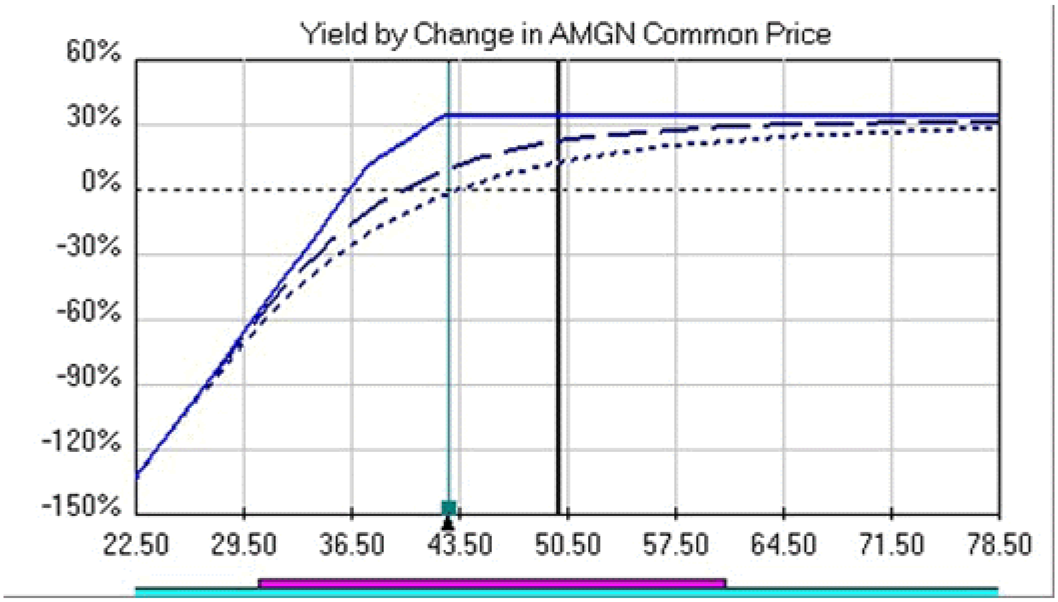
As you can see below, the risk graph is the same shape as the covered write strategy, but requires a lot less capital while offering a higher yield:



The only drawback to this strategy is that if the stock moves higher after you sell the naked puts so that you're never assigned, since you don't own the shares you won't participate in the rally. Thus, selling naked puts cannot be counted on to get you into the best performing stocks. In fact, it may tend to get you into less than the best performing stocks. (Well, at least ones that decline first before moving up.)

Are you looking for sideways movement in the Nasdaq for the rest of this year?

A beautiful strategy for this scenario is a combination of the above two strategies. When you add a naked put sale to a covered write, you get what is called a covered combo, a strategy I have written about before. The covered combo is always a fantastic strategy to use at extreme volatility levels.



In the covered combo example in Amgen above, with the stock at $42.75, you're paying an effective price of only $35 per share. The prospective yield on this 113-day investment, if the stock holds up, is 34% (111% annualized). Wow!