

## Ever Considered Selling Naked Puts?

*Selling high volatility to generate income*

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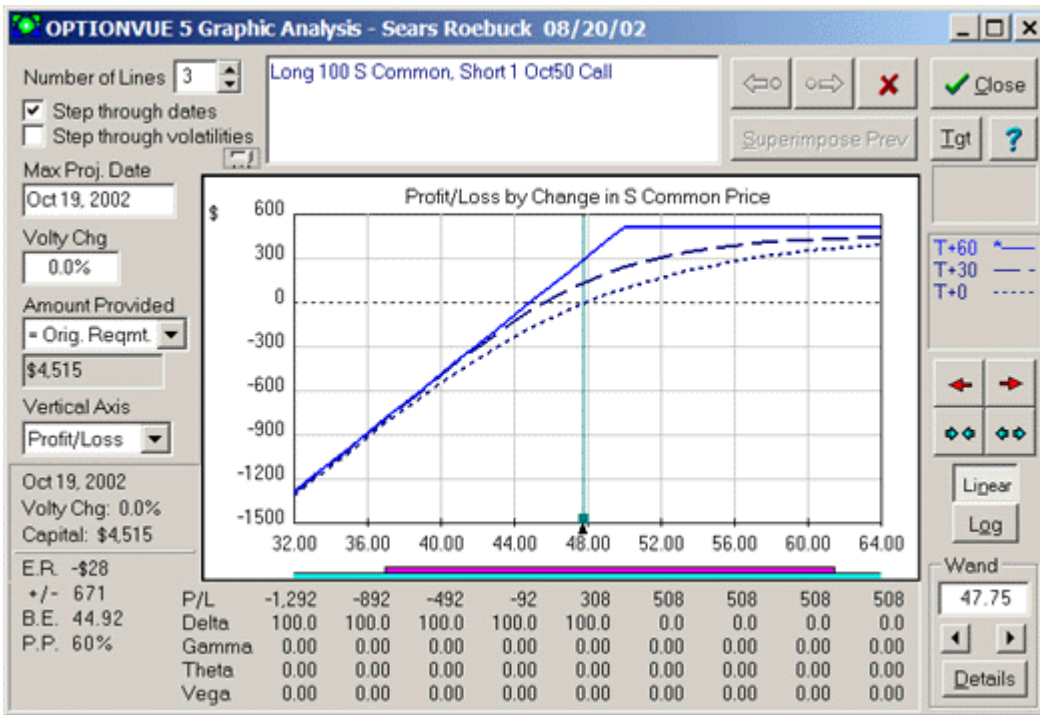
07/10/2003

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". It's been 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? And what is the best way to use options in a market like this?

Very 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 it has to), IV's (and options prices) are going to come down. So what can an options trader do to position himself so that the coming IV decline works in his favor? In a word, by finding ways to sell options.

### Of Course There's Always 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 Sears Roebuck (Symbol: S) as an example:



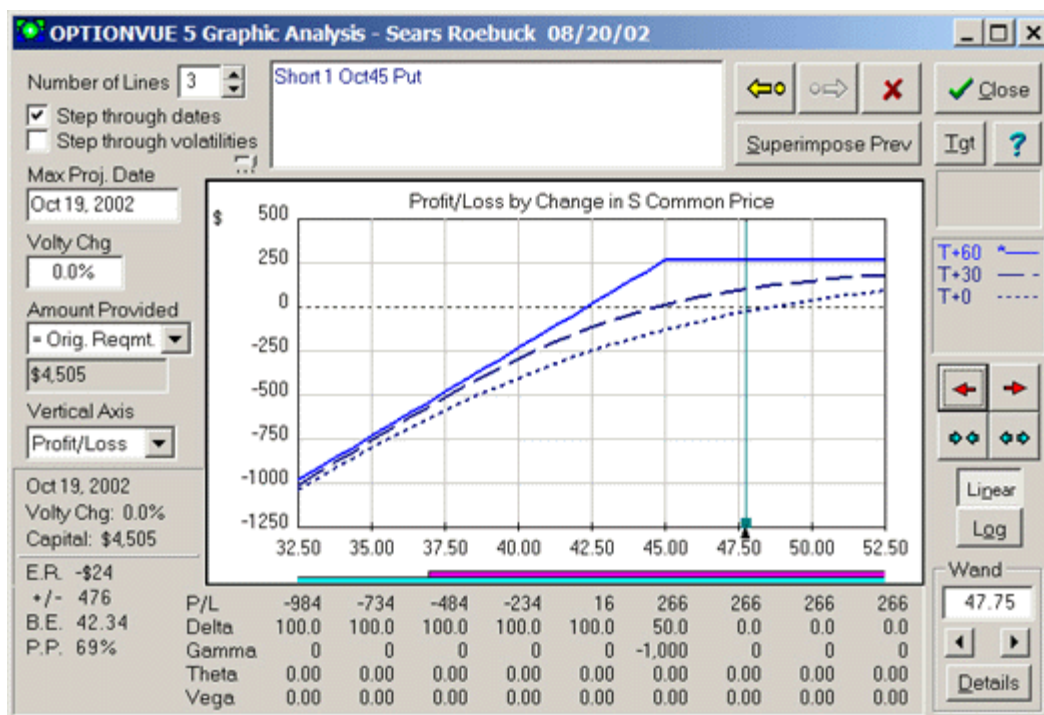
### Selling Naked Puts: The Same Risk with Less Capital

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. If the stock stays around the current price, or advances, the investor keeps the (currently generous) premium after the option expires worthless.

What if the stock declines in price? In that case, the investor eventually gets assigned the shares, and the cost basis for his shares is the strike price of the put minus the premium received. That's why naked put writers should be prepared to buy the stock (and make sure they have enough funds available) before entering the position.

For example, Sears is currently trading at \$47.75. An out-of-the-money put with a strike price of 45 can be sold for 2.50 (\$250 each). The \$250 is yours to keep, no matter what. Worse case, you'll end up paying \$4,500 for 100 shares of stock. Subtract the \$250, and your effective basis is \$4,250, or \$42.5 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:

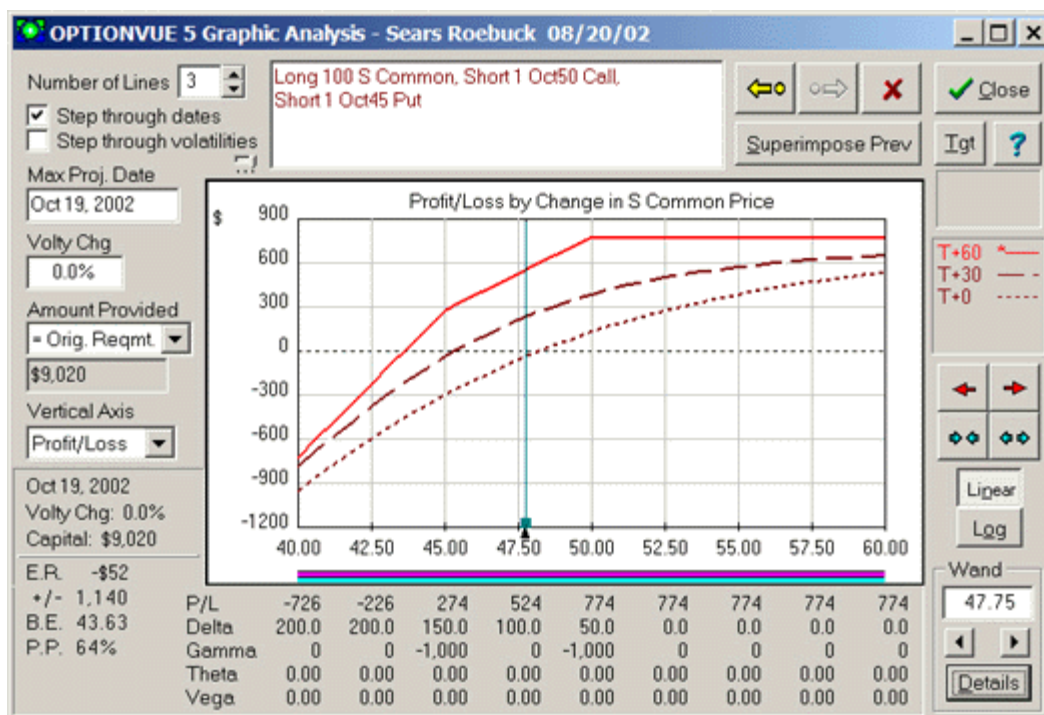


The only drawback to this strategy is that if the stock moves higher after you sell the naked puts, you're never assigned. Since you don't own the shares you won't participate in the rally. Thus, selling naked puts cannot be counted on to get you into the best performing stocks. In fact, it may tend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

### Combining These Strategies for a Covered Combo

What if you are you looking for sideways movement in the market?

A beautiful strategy for that 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. The covered combo is always a fantastic strategy to use at extreme volatility levels.



Look at the covered combo example in Sears above. With the stock currently trading at \$47.75, you're paying an effective price of only \$42.65 per share. The prospective yield on this 60-day investment, if the stock holds up, is 12% (70% annualized). Wow!