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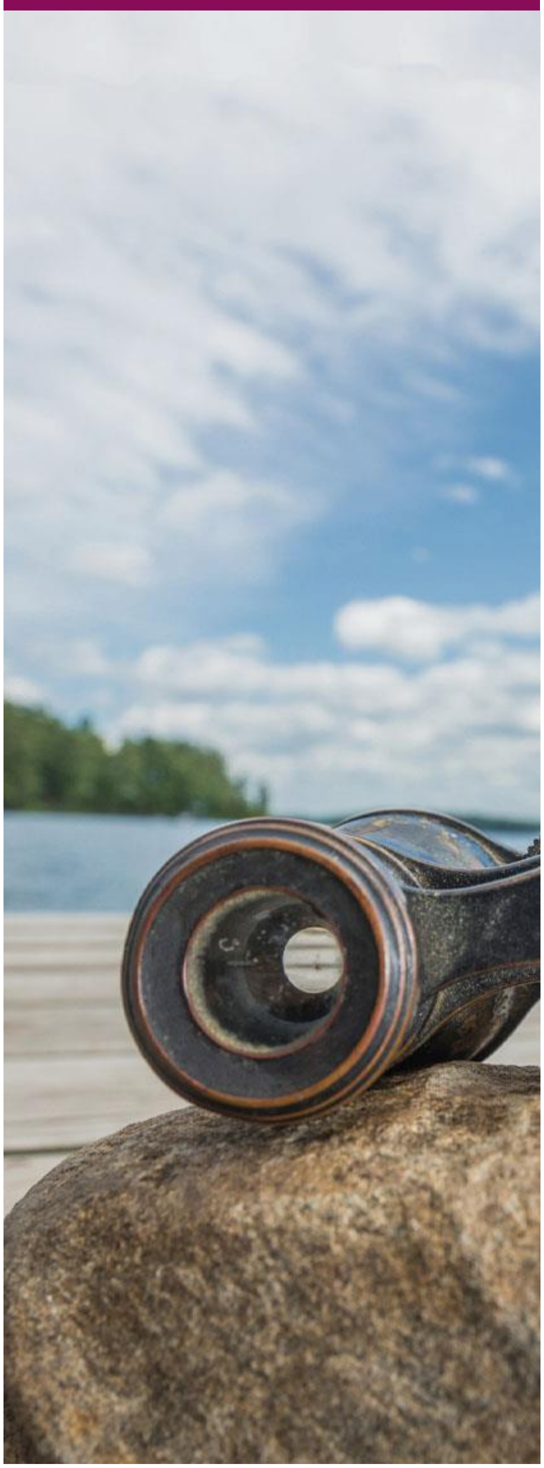
News update



Generating income by writing put options

An option contract is a financial instrument that allows the option buyer the “option” to either buy (Call option) or sell (Put option) an underlying stock position at a pre-determined price (exercise price) for a certain period of time until expiration.

For example, if I owned Microsoft shares and then bought a put option on Microsoft Corp shares with a strike price of US$25 that expires in two months, I have the option of selling my Microsoft shares at US$25 anytime up to the expiration. If Microsoft shares were currently trading at US$30 on the market, I would NOT exercise my option to sell at US$25. It is better to just sell the shares on the market at the higher price. If the market price remained around US$30 at expiration, my option would simply expire worthless.

It is important to understand that statistically, approximately 80% of option contracts tend to expire worthless.

When I buy any option contract, I must pay a cost or premium. For example, the premium for a put option contract on 100 shares of Microsoft might be around US$1.00 per share, or US$100. Like any other publicly traded financial instrument, this premium is partly determined by the collective forces of buyers and sellers on the market. But, option premiums are also determined by the intrinsic value (how deep in the money) and the time value of the contract.

Now, I can also *sell* a put option contract (which is called option “writing”). I would then collect the premium, rather than pay it. However, in this case, the obligation is much higher as I am now obligated to accept the underlying security IF the put option buyer decides to exercise her option. But, if statistically approximately 80% of option contracts tend to expire worthless, put another way there is roughly an 80% probability that I would simply collect the option premium without fulfilling my obligation as the option writer/seller.

Therefore, option writing or selling is another strategy to generate income in a portfolio, in theory similar to collecting dividends from an investment. Of course, there is a significant difference when one sells a put option which is the obligation to accept delivery of the stock. There isn’t a risk to accept a dividend.

Let me provide an example again using Microsoft Corp. shares. If I wrote or sold one put option contract (100 shares) on Microsoft shares with a strike price of US$25 with a premium of US$1.00 per share, I will be *paid* the premium of US$1.00 per share, or US$100 total.

If Microsoft shares fell on the market from the current price of US$30 to US$24, the put option buyer would likely exercise (because she can sell it to me at a higher price than the market price) and I would be obligated to buy the shares at US$25. Please note that if I am indeed “put”, my actual cost per share is US$24 (that is, the US$25 exercise cost less the US$1 premium I received).

If the market price never fell below US$25 before expiry, then the option buyer would not exercise and I simply keep the premium of US$1.00 per share or US$100 total. Note that although the decision to exercise an option is the choice of the buyer, if an option contract is in the money (in the case of a put option, the market price is below the exercise price), there is a risk of an automatic exercise based on option exchange rules. In any case, employing a strategy of writing put options over the course of a year and on a basket of stocks could generate hundreds or even thousands of extra dollars of income within a portfolio.

It is important to understand that I only want to sell a put option on stocks that I don’t mind eventually owning in my portfolio. These are primarily blue chip, large cap stocks. Selling put options is a way to build a portfolio of blue chip stocks at lower, pre-determined prices (exercise prices) while generating income (collecting premiums) along the way.

There are a few other basic rules that must be followed. First, when I write put options, I must make a deposit of cash or other securities into the account (called margin) which effectively provides the buyer some assurance that I can pay for the stock in case the option is exercised. This margin deposit is automatically calculated based on Option Exchange regulatory rules and investment dealer rates. Second, it is important to be able to fully pay for any stock that I am obligated to buy when a put option I have written is exercised. If I cannot pay for the full stock position if I am “put”, I will not write that put option.

Most option contracts can be sold on the market prior to expiry. So, even when I sell a put option, I can remove that obligation by buying back that option contract (called “offsetting”) on the market.

Advantages of writing/selling put options

- A way to build a blue chip stock portfolio while pre-determining your purchase price and final cost.
- It generates premium income in the portfolio.
- I know the maximum risk that I am taking on.
- A profit can be made in up markets, neutral markets and even slightly down markets.
- If I purchase a stock, it is at a lower cost base than the current market price when I sold the option contract.
- Most option contracts are liquid and can be traded on the market.

Disadvantages of writing/selling put options

- The main disadvantage is that I do not actually own the underlying security until the option is exercised by the option buyer. Using the above example, if Microsoft shares actually moves up significantly, I do not participate in the capital gain. My maximum profit is limited to the total premium received (US$100) on selling the option contract.
- I am taking on the risk of potentially owning a stock without the benefit of being guaranteed larger gains beyond the premium received. In fact, once I own the stock, it could continue to fall further, creating losses.
- Not all stocks have options associated with them. Only stocks with a minimum market capitalization and average trading volume, as set by the Options Exchanges, will have options available.

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