

## “Sneaking Up On A Stock” - April 11, 2009

There's a low-profile, conservative trading technique that we often utilize to “sneak up” on stocks that we want to take a position in. This strategy will be featured in one of our upcoming newsletters, [The Discount StockBuyer's Guide](#).

Have you ever found yourself in a position where you'd like to buy a stock, but its current price is just too expensive, or you' feel that the market has gotten ahead of itself? (Kind of like the present...)

Instead of just buying this stock, take a look at selling put options against it.

To illustrate this strategy, let's look at the data for Kraft Foods, (KFT), which closed this week at \$22.35. First, find out KFT's 52-week range, which is \$20.81 - \$34.97.

Next, go to the "option chain" for KFT, and look up the values for the closest months, seeing if there are any good yields on put strike prices below KFT's 52-week low. Since April and May don't offer much or any premium, go further out in time and look at June's \$20 put premiums, (symbol KFTRD), which are currently worth \$.50/contract, which works out to a 13.22 % annualized yield, (not using margin).

Important note: One option contract = 100 shares of the underlying stock, so, depending upon your broker's policies, you'll have to hold a cash reserve equal to anywhere from approx. 35% - 100% of the underlying shares' cost at the strike price you sell at. For example, at a \$20.00 strike price, a 100% cash reserve for one put contract equals \$2,000.00. Some brokers require less of a cash reserve.

After selling the put(s), you'll receive \$50.00 into your account, (upon settlement in 3 days or less), for every contract you sold. You'd have 1 of 2 outcomes at or near the expiration upon the market close on June 19th, (usually options aren't exercised or assigned until right around their expiration date):

1. Assignment: If KFT declines to approx. \$19.50 or less, (the difference between the \$20.00 strike price and your \$.50 premium, you'd be assigned, (sold), 100 shares of KFT for every put contract you sold.
2. Non-Assignment: If KFT doesn't decline to approx. \$19.50 or less, your cash reserve money gets released, and you've made \$50.00 for every contract you sold, less commissions.

In scenario 1, you'd end up owning KFT at a cost basis of \$19.50, which is 12.75% lower than its current \$22.35 price. There are two ways to view this outcome: Some traders would say, if you'd just waited and done nothing, you would have been able to buy it for \$19.50 or even less anyway, if the market went down.

However, you wouldn't have had the profit opportunity that selling the put gave you, had you just waited for a market downturn. In addition, you've determined your potential buy price at \$19.50, which will give you a 5.95 % dividend yield on KFT, which will probably go ex-dividend on June 23rd, so you may possibly be eligible for the June dividend, depending upon how quickly your broker settles the assignment of the shares.

A good idea before selling puts is to look up the "theoretical value" and the "Delta" of the contract, to determine if it's over or underpriced by the market. Looking at an options pricing model, such as "Black-Sholes", will give you this info.

These models are on many online brokerage accounts now. The delta equals the rate of change in the contract's price, given a \$1.00 move in the price of the underlying shares. In addition, option traders often use the delta for determining how likely the contract will finish "in the money".

The delta for KFTRD, (the \$20 June put), is currently -.2156, meaning that it should decline in value \$.2156 for every \$1.00 rise in KFT. (Puts always have negative deltas, as they have an inverse value relationship to the underlying stock). So, traders would figure that there's currently a 21% chance of you getting assigned KFT, if you sold these \$20 June puts.

The theoretical value, is .483, meaning that the current bid price is slightly overvalued, which is a good thing if you're looking to sell the put.

Timing: Since selling puts is a bullish strategy, it's best to sell them after prices have fallen, since put prices move inversely to the market. For example, anyone who sold an index put against the Dow, or S&P, before the current market rally began in March, probably would have made \$ doing so, since the puts should have fallen as the market rose.

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