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Introduction

Business magnate, investor, philanthropist, and billionaire.

What do these words have in common?

They've all been used to describe Warren Buffett, one of the wealthiest men in the world.

Born in Omaha, Nebraska, Buffett took an interest in business at a young age, leading him down an educational path that started at the University of Pennsylvania and continued at Columbia Business School, where he became obsessed with the principles of value investing – a concept pioneered by Benjamin Graham, a man whom Buffett idolized.

After developing a strong foundation at Columbia, Buffett moved on to the New York Institute of Finance in hopes of further sharpening his skills. It was there that he actually met Graham and developed a partnership with the investing magnate. Their work together eventually led to the acquisition of Berkshire Hathaway, which at the time was a modest textile manufacturing firm.

Using the company's existing name, Buffett transformed Berkshire Hathaway into a diversified holding company, meaning that it was used primarily to purchase majority shares in other corporations.

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In doing so, Buffett shortly turned what once was a small manufacturer into a multi-billion-dollar operation. He snatched up businesses (both big and small) that he saw as undervalued, with plenty of room to grow.

And grow they did.

With Berkshire Hathaway's management savvy and injection of capital, Buffett quickly became known as somewhat of a kingmaker. Since then, he's racked up several nicknames throughout his career, one of which being the "Oracle of Omaha" – a title that stuck as he still resides in his hometown, living a highly frugal lifestyle in spite of his immense wealth.

Chasing growth at all costs, Buffett has shown over the years that nearly all of Berkshire Hathaway's pet projects have benefited from his guidance, partially due to his company's ability to provide much-needed short-term stability to young, ambitious businesses.

In recent years, though, his celebrity status has started to eclipse his business dealings as Berkshire Hathaway has taken a backseat to Buffett's personality – something that's shone through in numerous interviews with the financial media.

He's no stranger to controversy and takes deep personal pride in always speaking his mind, repercussions be damned.

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That’s why back in 2002, it shouldn’t have surprised investors to hear what Buffett had to say about derivatives – investment contracts (like options) that derive their value from the performance of an underlying asset.

“I view derivatives as time bombs, both for the parties that deal in them and the economic system. Basically, these instruments call for money to change hands at some future date, with the amount to be determined by one or more reference items, such as interest rates, stock prices, or currency values,” Buffett wrote in the 2002 Berkshire Hathaway Annual Report.

“For example, if you are either long or short an S&P 500 futures contract, you are a party to a very simple derivatives transaction, with your gain or loss derived from movements in the index. Derivatives contracts are of varying duration, running sometimes to 20 or more years, and their value is often tied to several variables.”

Buffett disciples often repeat this quote as proof that trading derivatives – options, futures, etc. – is a bad idea. If the world’s most successful investor won’t touch them, why should anyone else?

What Buffett fanboys (and girls) won’t tell you, though, is that he sold 30,000 put options (the equivalent of 3 million shares) on Coca-Cola (NYSE: KO) back in 1993 for $1.50 apiece, with a strike price of $35.00. Then, he sold an additional 20,000 when the trade started working out in his favor.

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Back then, in April 1993, Coca-Cola stock was trading at roughly $39.00 per share – a price point that Buffett viewed as overvalued. If the share price fell $4 to the strike price of $35, the option buyers (the counterparty) would "put" their shares to Buffett who would be forced to buy them at $35.

And though that would seem like an undesirable outcome for Buffett, given his belief that Coca-Cola's stock price was too high, he didn't care. He knew Coca-Cola was still a good long-term investment. Buying shares at $35 was, in his opinion, a fair price.

Selling the put options also allowed him to buy the take over at a 10% discount *and* collect a premium of $1.50 per contract for a total of $7.5 million in premium. It didn't matter where Coca-Cola shares were trading at upon expiration. That $7.5 million was his to keep.

In essence, the put option sale allowed Buffett to get in on KO at a better price while generating a significant amount of premium in the process.

This strategy, though somewhat simple, is one that's been replicated by plenty of successful options traders over the years.

Buffett's gambit ended up working out *very* well for him and Berkshire Hathaway. He's "run this play" several times now quite successfully.

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There's no reason that you can't "steal" this strategy and do the same to potentially buy stocks 10 to 20% below market value.

But to sell puts, you first need to understand some options basics. That includes how to buy and sell both calls and puts.

Options

Options, unlike stocks, allow investors to actively interact with stocks without actually trading them. They allow traders to control shares of stock without owning any stock at all.

Pretty neat, huh?

Options contracts can do this because they give the buyer the *option*, not the obligation, to buy or sell an underlying asset or instrument at a specified strike price prior to or on a specific date.

That might sound a little confusing if you're not familiar with derivatives, but it's really quite simple and easy to understand once you get the hang of it.

a. Call Options

Investors buy call options because they think that an underlying stock will rise in value. Sellers of call options, on the other hand, believe that an underlying stock will decrease in value or remain the same.

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Like we talked about above, call options allow buyers the *option* (not the obligation) to buy 100 shares of an underlying stock at a designated strike price (a term we'll define in a moment).

As an underlying stock rises in value, so too does the value of the call option, but at a greater magnitude. Because of this, it can be quite easy to rack up significant gains in a short amount of time. However, losses can pile up quickly as well, so risk management becomes extremely important for call option buyers.

On the other side of the coin, call option sellers make money in a different way. They collect the contract's premium while being obligated to sell 100 shares of an underlying stock to the contract owner at the agreed-upon strike price.

For that reason, selling options contracts is a little more nuanced. The stock doesn't have to move in order to generate a gain for the call contract seller, but they don't have the *option* to buy it like the contract owner does. Instead, they've got the *obligation* to sell at the strike price upon contract maturity, which is obviously less desirable.

b. Put Options

Opposite call options are put options contracts, which are bought by investors who expect an underlying stock to decrease in value. Sellers of put options, on the other hand, believe that an underlying stock will rise in price or stay the same.

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Put options work just like call options, but in reverse. The nice thing about put options is that they allow investors to “short” a stock (make money off a stock’s decline in value) without having to trade on a margin like they normally would have to.

By using both types of options contracts, traders can execute advanced trading strategies that reduce risk while maximizing potential gains over a shorter time frame than would normally be possible with stocks alone.

Now that you understand the two types of options contracts available, we also need to cover the specific vocabulary you’ll come across when working with options.

Options Trading Terminology

Strike Price

The “strike price” of an option is simply the price at which an options contract can be exercised. If it helps, you can think of it as the “anchor” or “baseline” of a contract. For a call option, if an underlying stock goes *above* the strike price (plus the contract premium you paid), the call option becomes profitable.

If the value of an underlying stock stays below the strike price (or drops further) at the time of expiration, the call option will expire, worthless.

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Because owning a call option doesn't mean you actually own the stock, a significant enough drop in an underlying stock price close to expiration will cause the contract's value to evaporate in a hurry.

That might sound scary, but as long as you buy call (or put) options far enough away from expiration, you'll be able to get out of unprofitable contracts without losing 100% of the position if they are sold before the expiration month.

Buying to Open

When you buy an options contract, you're "buying to open" the position. As the owner, you have the right to place an order to sell the contract back into the market, exercise the contract, or let it expire.

Selling to Close

When you sell an options contract back into the market, you're "selling to close" the position.

Selling to Open

When you sell an options contract (in an attempt to earn a profit on the contract premium), you're "selling to open" the contract. Remember, though, when you sell options contracts, you have the obligation, not the option (like when you're the buyer), to sell at the strike price.

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Buying to Close

If you wanted to buy back a contract that you sold, you'd be "buying to close" the position.

Exercise

Like we discussed earlier, options contract owners have the right to *exercise* their contract, let it expire, or sell it back into the market prior to expiration. If the contract is "in the money" (meaning the underlying stock is ABOVE the strike price for a call, BELOW the strike price for a put), then the contract owner is likely to exercise that contract.

However, as you'll soon see, for buyers it's preferable to simply sell the options contract back into the market. Options traders (buyers) typically don't exercise their contracts, as they're only interested in executing options trading strategies.

Assignment

Option contract sellers, regardless of whether they're selling calls or puts, can be assigned stock at any time if their option is "in the money", meaning that the underlying stock's price is ABOVE the strike price in the case of a call, or BELOW the strike price for a put.

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For example, if I sold a put option, I'm contractually giving the right for the put owner (someone else) to sell or "put" themselves the stock at the strike price before expiration.

In layman's terms, assignment gives the options contract seller notice that the contract owner has decided to exercise.

Premium

As you've probably figured out by now, the premium is very important to options contract sellers. After all, that's what they're receiving as payment for selling to open options. Buffett received $7.5 million in premium by selling KO puts.

The price of the premium is different from contract to contract. It's dependent upon the current value of the contract, the underlying stock's price, the underlying stock's volatility, and the amount of time remaining until expiration (time value).

Time Value

The closer an option is to its expiration date, the less time value it has. The further away an option is from expiration, the higher the time value will be. Simply put, options lose time value as they approach expiration.

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“In the money” vs. “out of the money”

When it comes to simply trading (buying) options, you’ll typically want to target ones that are “in the money”. For a call, that means its strike price is BELOW the underlying stock’s current price. For a put, that means its strike price is ABOVE the underlying stock’s current price.

To sell puts like Warren Buffett did, you’ll want to target puts that are “out of the money” with strike prices BELOW the underlying stock’s current price. Buffett’s KO puts had a strike price of $35 vs. the underlying share price of $39.

Because of how options are valued, 1-strike “in the money” options stand the best chance of generating profits off directional trading. There are fewer surprise value spikes, and in general, they’re much easier to track than trading “out of the money” options.

But to sell puts to execute Buffett’s strategy, “out of the money” puts are the way to go.

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When To Buy Or Sell Options Contracts

We covered this when talking about the different types of options contracts, but it might be helpful to plot out a simple graphic of what to do (buy or sell) based on your expectation of an underlying stock's future behavior. In Warren Buffett's case, he sold out of the money puts, which is a bit of an exception to the rule. Nonetheless, this chart can help conceptualize the different strategies and their uses.

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To reiterate, let’s look at exactly what each scenario above entails.

Expecting the stock to rise? Buy a call option

Since you think the underlying stock will rise, you decide to buy to open a call option. Because you’re the buyer, you pay the premium, and now have the right to buy 100 shares at the strike price if you exercise the option. You can also let the option expire or sell it back into the market prior to expiration.

Expecting the stock to fall? Buy a put option

You’re convinced that the underlying stock is about to drop. Maybe it was some bad news, or possibly a formation you identified on the price chart. Either way, you’d want to buy to open a put option – entitling you to the same rights as if you bought to open a call option.

Expecting the stock to fall or stay at the same price? Sell a call option

After some analysis, you determine that the underlying stock is unlikely to rise. It doesn’t matter if chops sideways or falls. All it has to do is not “go up” – something you’re almost sure of. In that case, you’d want to sell to open a call option in hopes of collecting the contract’s premium as profit. Remember, though, as the seller, you have the obligation to sell 100 shares at the strike price if assigned.

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Expecting the stock to rise or stay at the same price? Sell a put option

If you find that the underlying stock is locked into a slow uptrend and looks unlikely to fall dramatically, then selling to open a put option might make sense. The same rules apply as if you sold to open a call option.

Buffett sold out of the money puts because KO was trading at $39, a level he saw as overvalued. Any puts with a strike price above $39 would've been considered in the money. By going out of the money, Buffett simply needed KO to not fall too far below $35 (the price at which he would take over shares). That allowed him to snag the stock at a great price while generating $7.5 million in premium, right before KO shares took off in the years that followed.

For Buffett, he wasn't necessarily predicting that KO would rise or stay at the same price. He just needed it to drop a bit to $35 to be "put" the KO shares from the counter-party. If you're looking to execute Buffett's put selling strategy, sell out of the money puts with strike prices 2-3 strikes away from the current price.

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Tips For Placing Options Orders

Now that you're equipped with a solid foundation of options knowledge, as well as the more advanced techniques used by options traders, we need to cover a few final tips when it comes to actually placing orders.

Sadly, not all options are created equal. Some stocks simply don't have enough attention to generate sufficient options trading activity. Novice investors will often try to buy options on stocks that are thinly traded, only to get "trapped" within their options contract.

So, when it comes to your own trading, try to only look for options that meet the following criteria:

The open interest is greater than 1,000

Open interest indicates the total number of option contracts that are currently being offered. These contracts have been traded but not yet liquidated via assignment, being exercised, or an offsetting trade.

For options traders, open interest is extremely important as it shows us how liquid an option truly is. For general use, you want to target options that have an open interest higher than 1,000. You can definitely go after contracts with open interest below that number, but gauging their price may be more difficult.

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The bid/ask spread is less than 10%

When you go to place an order for an option, you'll see two prices displayed – the bid and the ask. The bid represents the most that buyers are willing to pay, while the ask shows us the minimum that sellers are willing to sell at.

If the ask is more than 10% higher than the bid, you might want to consider walking away from the option. For example, if the bid on a call option is $1.00 but the ask is $1.20, I might be worried about whether that represents the option's true value or not.

In the example above, the bid/ask spread is 20% - far too high for my liking. Like with our open interest rule, you can still go after trades where the bid/ask spread is greater than 10%.

Conclusion

I hope that after learning a little bit more about Warren Buffett's success story and his put selling strategy, you've gained a better understanding of why he's been able to achieve so many great things with Berkshire Hathaway, a small firm that at one time only dealt in textiles. He might not bill himself as an options trader, but the truth is that Buffett keeps coming back to this "well" time and time again.

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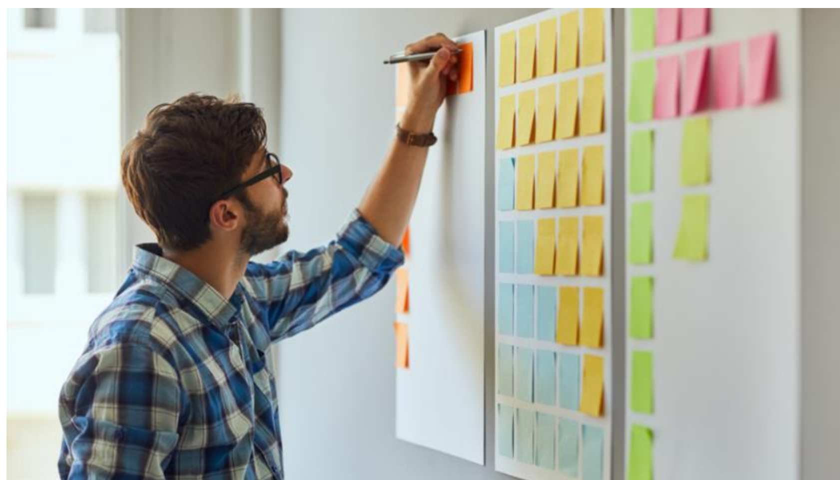
Having a multi-million dollar corporation helps him execute large-scale, often stunning results with his strategy, but there's no reason that these same concepts can't be used by ordinary investors – be it in a large portfolio or just as a speculative project for fun.

By using Buffett's put selling strategy in your own investing, you too could be taking the first step towards gaining a new perspective in the stock market. Just like Buffett did after decades of avoiding derivatives.

Turn A Small Account Into A Large Account With This 1 Sneaky Trick...



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