

HOW TO
SELL PUTS
LIKE
WARREN BUFFETT



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While best known for simply buying and holding stocks—if not entire companies—Warren Buffett is no stranger to using more advanced investment strategies as well.

Investors who follow in Buffett's footsteps with these more advanced moves can see tremendous profit potential as well.

For instance, while Buffett often warns against the dangers of derivatives, he will sometimes make an investment using options. An option is a derivative in the sense that its value is derived from something else, in this case, a specific stock.

Buffett's use of options, however, is similar to the "low risk/ moderate return" strategy that's made him a fortune in the insurance industry.

That's because one of his methods for using options is a safe strategy that offers a trade-off between a modest short-term win, and potentially bigger wins down the road.





THE SECRET TO BUFFETT'S OPTION SUCCESS

THE SECRET? The use of put options. Specifically, by *selling* put options.

This strategy can be a bit of a head-scratcher. But the theory is simple.

Put sellers are simply saying they'll take on the risk of going long a company and buying shares, but *only if it falls to a certain price first*.

It's a lot like selling an insurance contract. Put sellers like Buffett are getting paid up front. And if the share price doesn't move under the strike price of the option, they can keep all the premium without having to buy shares. That's similar to how an insurance company gets to keep their annual premiums even if a motorist doesn't get into an accident in a given year.

On the other side of the trade are put buyers, who expect the share price of an underlying stock to decline. If it declines, they'll make money. If it drops enough, they can "put" shares to the put seller, who then owns shares.

In that scenario, the put seller still gets to keep the premium they sold, but now they own shares. If the share price moves back up, they have an opportunity to make money from future capital gains on the shares. And as shareholders, they'll be entitled to any dividend payments along the way.

While most small investors may start with 1-2 options contracts at a time (each option contract is for 100 shares), Buffett's large cash hoard has allowed him to scale up his trades. In 1993, for instance, looking to buy additional shares of **Coca-Cola (KO)**, Buffett sold put options on 3 million shares worth, or 30,000 contracts!

Later, in 2008, looking to buy **Burlington Northern-Santa Fe (now wholly owned by Buffett)**, the Oracle of Omaha sold put options that obligated him to buy 2.2 million shares.

HOW PUT-SELLING PUT SEVEN FIGURES IN BUFFETT'S POCKET

Admittedly, that money really went to all shareholders of **Berkshire Hathaway (BRK-A)**, not just Buffett. But let's walk through his Coca-Cola trade in more detail.

In 1993, Coca-Cola traded just under \$40 per share. Buffett was looking to add to his existing holdings, but only if he could get \$35 or under.

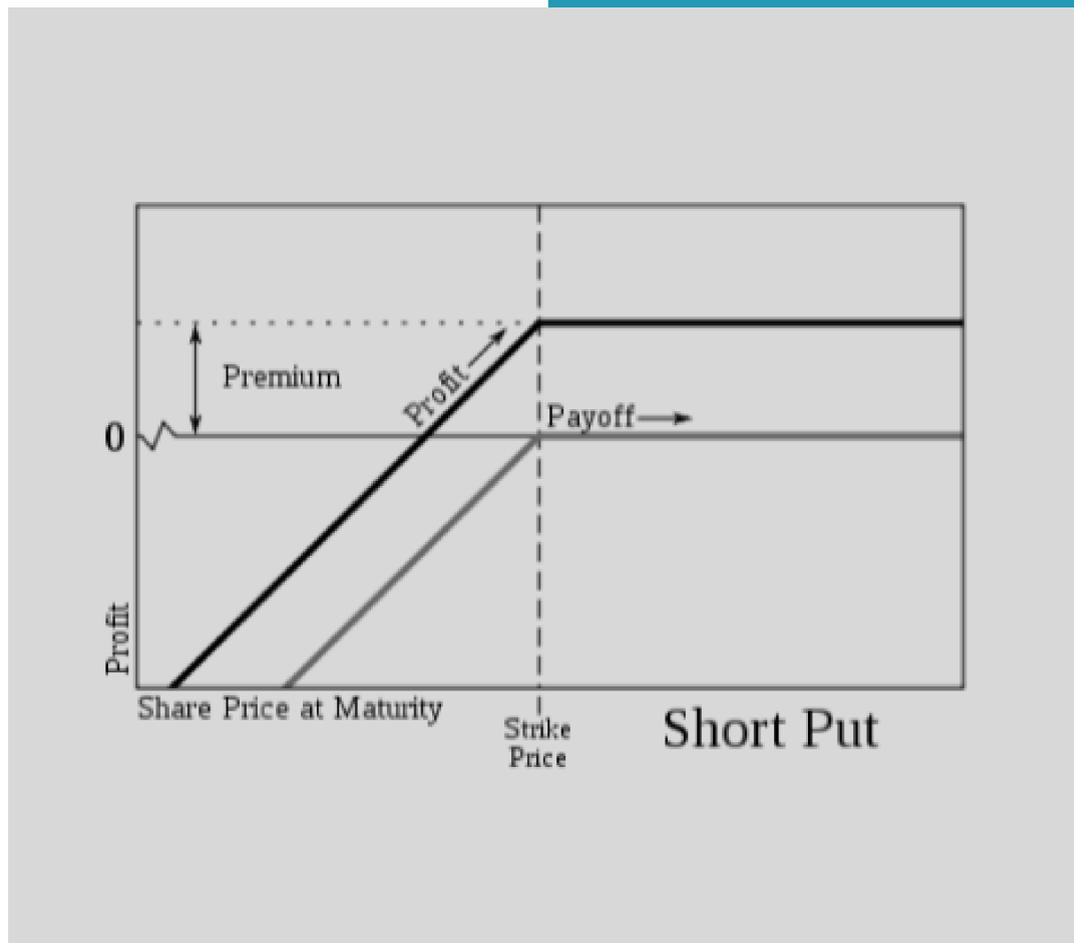
Rather than wait for that opportunity, Buffett saw that he could sell put options with a \$35 strike. At that price, he could get about \$1.50 per share in premium (or \$150 per contract). So even if the price didn't go down to \$35 anytime soon, he could make \$1.50 against the "risk" of buying Coke at \$35, for a 4.28 percent gain in just a few months.

If the price did go under \$35, he'd be obligated to buy at \$35. But backing out the \$1.50, he'd really be getting in at \$33.50. That's a slightly better price than where he wanted to buy in the first place!

By selling these puts, Buffett brought in \$7.5 million in options premium—which was his to keep either way.

That's the power of using a put sale strategy. Either way, he would have won.

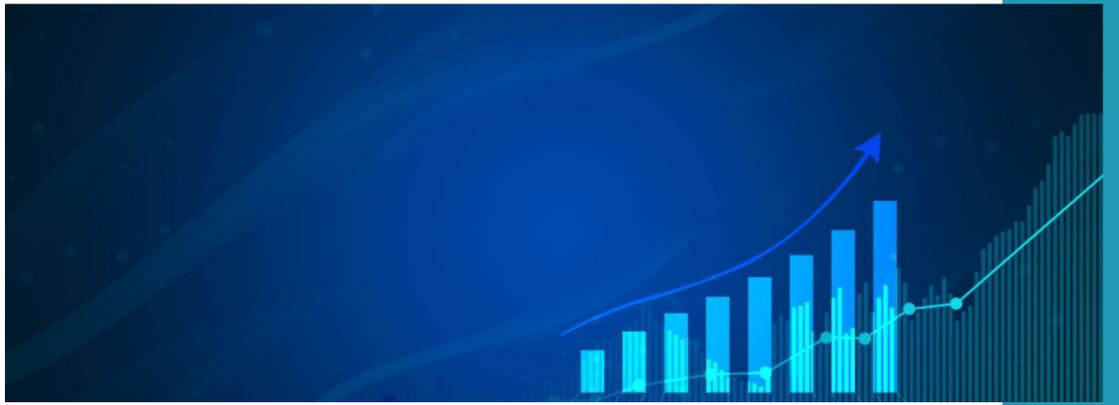




Put selling allows investors to collect premiums betting against the decline of a company's price. If it falls below the strike price, the put seller is obligated to buy shares at the strike price. Done correctly, this can be minimized to increase income-earning potential in a portfolio.

It's akin to playing a game of baseball focusing on getting base hits and putting runners on base. It's not as exciting as trying to have every batter hit a home run, but it's more likely to run up the score over time. This "base hit" investing strategy is classic Buffett, and those looking to expand their portfolio toolkit should start with simple put sale trades.

While it may not create 10,000 percent returns like some riskier call options do, the chance of making money—no matter what happens with an underlying stock—is significantly higher. That's exactly where investors are likely to get great returns over time.



HOW TO USE OPTIONS LIKE BUFFETT

There are a few key things that investors need to understand before implementing this strategy, however. Done properly, this can help boost a portfolio with low risk. Done poorly, it can leave an investor on the hook and tank their portfolio.

That's why there are a few simple ground rules for using a put sale strategy.

**First and most important:
know your portfolio limitations!**

While put selling done right tends to result in a large number of collected premiums compared to the number of times an investor is actually put shares, extreme market events can and do happen.

As with all things leverage, a little bit is great, but too much can be destructive! If you have \$30,000 in cash and you're selling put options that may require you to take on \$50,000 in shares, if everything goes wrong at once, you may dig yourself into a financial hole.

Put sellers looking to collect a premium must always consider that they may be put shares of a company. If they don't have enough cash or leverage to cover the cost of buying those shares, they may end up facing margin calls and seeing other parts of their portfolio liquidated.

This is the biggest danger with this strategy, but as long as you make sure you don't over-leverage your account this way, you'll do just fine.

Second, only consider companies you'd be happy holding for the long-term

A follow-up to the first key thing to know, if you're going to sell put options as a strategy, you are obligated to buy shares until the option expires or you buy the option back to close the trade.

That means you should only use it on companies you would be willing to buy with your cash/margin on hand at the strike price you're selling at.

That way, if you're not put shares, it's no big deal. You can collect your premium and be on your way. But if you are put shares, you should still feel fine with that happening too. Remember, this is a strategy used by investing pros like Warren Buffett to make extra income, but he's also looking to buy cheaply for the long haul.

Some companies are a good trade, and may look like attractive short-term candidates. But if they're not companies you'd want to hold in your portfolio indefinitely, then it's a better bet to focus on companies you wouldn't mind owning, even if the premiums or potential returns are lower there.

Third, **BE PATIENT.**

Option premiums can vary, depending on market volatility, specific stock volatility, and other factors. Using this strategy on the same stock all the time may not produce worthwhile returns due to low option premiums. This strategy works great after a market drop over 10 percent from all-time highs, or when a specific company you're looking at has a poor day due to earnings, a news event, or other factor that doesn't change your long-term view.

By waiting for the market to look dour, option premiums are higher. When you're on the sell side, you want option premiums as high as possible! Time premiums on an option always go to zero. As a put-seller, we're interested in selling as much premium as possible whenever the market is fearful.



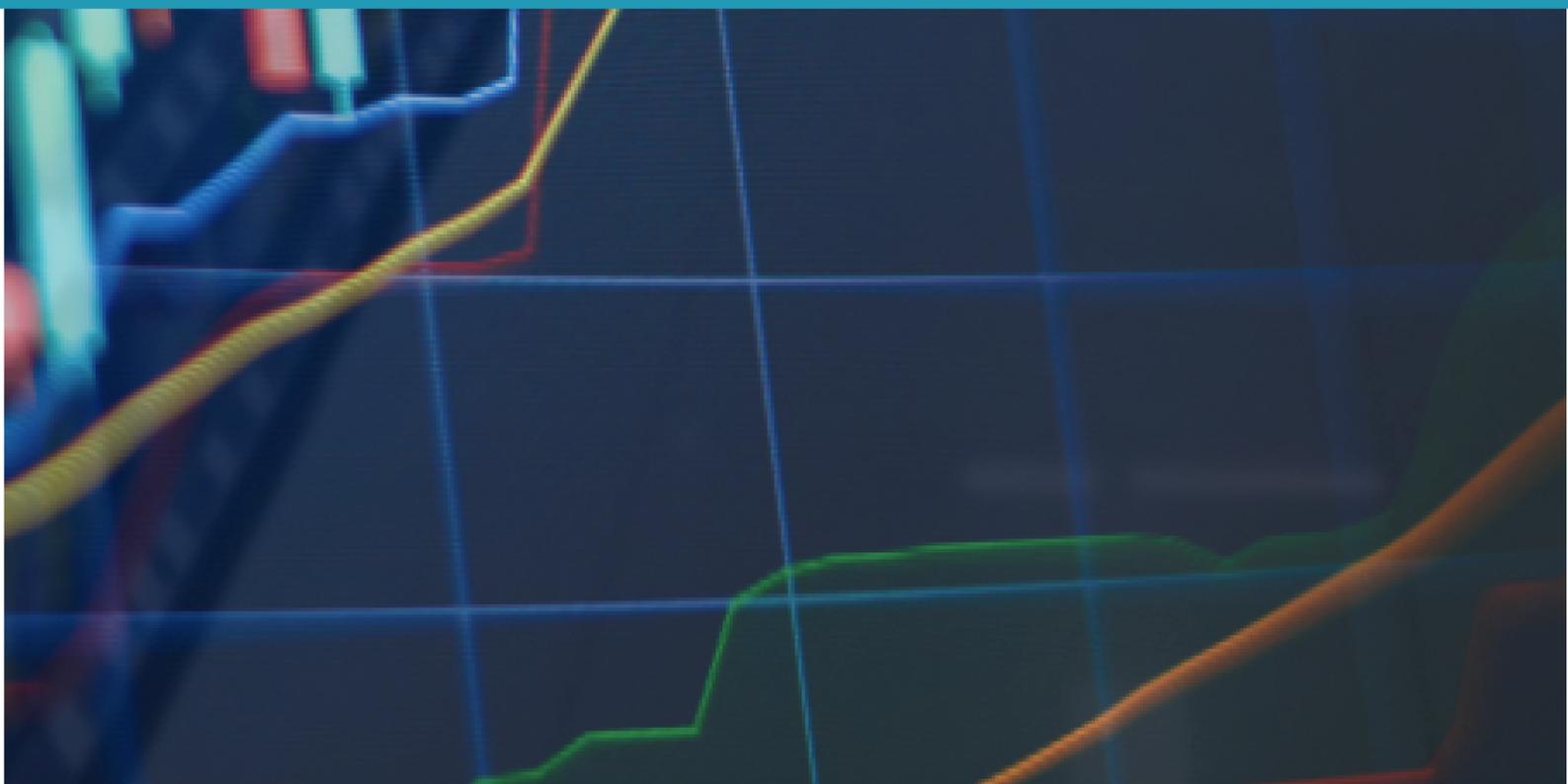
CONCLUSION:

ADD THIS BUFFETT-APPROVED STRATEGY TO YOUR PORTFOLIO

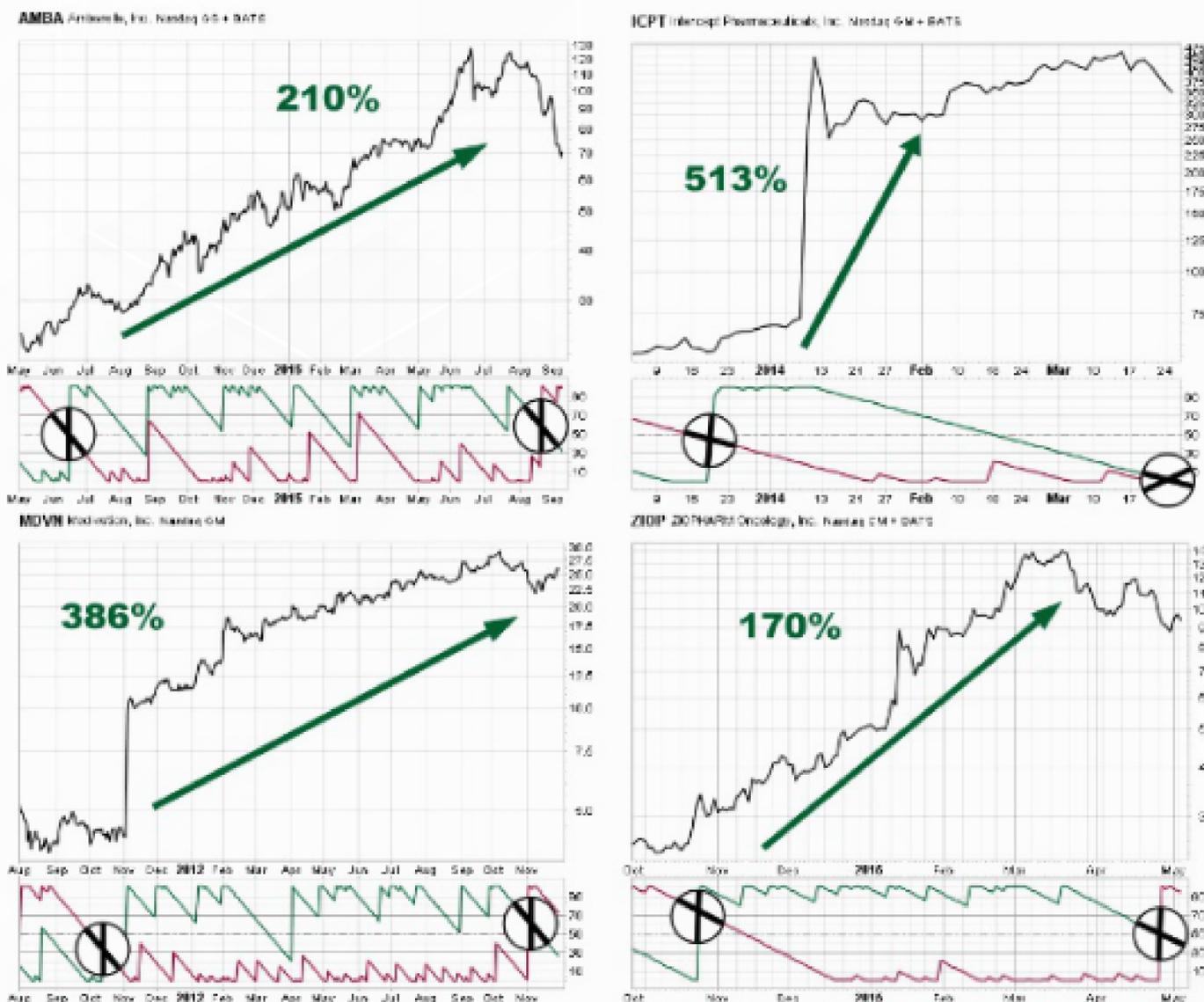
Put-selling is a somewhat misunderstood investment strategy. Done wrong, it can wreck a portfolio. But so can any other investment.

Done right, it allows investors to earn extra income on their portfolio's cash, and target specific companies to buy at a specific price. Investors who use this strategy and wait for high premiums can earn up to an extra 20 percent per year, but a more conservative target increases the chances that you just collect premiums without having to buy shares.

Warren Buffett works with bigger numbers, but even he recognizes the power of making an extra 5 percent on a trade. The sooner you start employing this tool, the sooner you too can start to reap the rewards of this low-risk/moderate-return strategy.



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