Personal Finance

How to Buy Stocks at a Discount

By Jim Fink, CFA

Discover this easy way to buy shares at a discount, and you'll never pay retail for stocks again!

For years, institutional investors have been using a little known trading trick to buy stocks below their current market price. In essence, they believed that (to paraphrase the late "Queen of Mean" Leona Helmsley) "only the little people pay retail."

Now hundreds of thousands of retail investors have discovered this simple trick—and are using it to snatch up great stocks at a discount. And once you learn how to do it, you may never pay retail for a stock again.

What's the secret? Simple—you sell put options on that stock.

Let me explain…

As we all know, buying stocks can be frustrating, particularly when the stock price falls directly after you purchase it. To reduce this risk, you can sell a put option on the stock rather than purchase the stock directly.

Selling a put option allows you to specify the "discount" price you're willing to pay for a stock—and also collect income up front when you sell it.

If the stock doesn't fall below the discount price you're willing to pay, you don't have to buy the stock. And you get to keep the income you collected from selling the put.

If the stock *does* fall below that discount price, then the put option you sold gets "exercised." That means you have to buy the stock, but you get to buy it at a discount.

How does it work? Selling a put option is a lot like setting up a limit order to buy the stock at a below-market price. Unlike a limit order, however, when you sell a put, you get paid up front.

And you get to keep the money you're paid, even if the stock never falls to your "limit" price (i.e., the put's strike price).

If the stock *does* fall to your limit price, then you get to buy the stock. And because you already collected money up front, you're essentially buying that stock at a discount.

Selling Puts or Placing a Limit Order—that is the Question

Let me give you an example. Let's assume we're in the month of June and you're interested in fictional **XYZ Company**, a high-priced stock trading for $135 per share. You haven't purchased the stock because you think it's too expensive at its current price of $135. You only want to buy the stock if its share price falls to $130.

You have two choices: (1) enter a limit order at $130 and wait to see if the stock falls back to that level, or (2) sell a put option right now with a $130 strike price that expires in September for $4.60 per share.

If XYZ falls below $130 before the third Friday in September (which is when the put expires), it will be automatically exercised. That means you will end up purchasing the stock at $130 per share.

But you get to keep the $4.60 per share you received for selling the put. So that means you're actually buying the stock for $125.40 per share ($130 minus $4.60). So you're saving $4.60 per share—which means you're getting a 3.5% discount! So why doesn't everyone buy stock this way? Well, if your stock doesn't fall below the "discount" price you specified, you don't end up buying the stock.

So you don't get to participate in any of the stock's subsequent price gain.

But the same thing happens when you set up a limit order. If the stock doesn't hit the price level you specified, you never buy the stock.

A 3.7% Return in Three Months? Sign Me Up!

Here's the difference, though—when you sell a put, you collect money up front even if you don't end up buying the stock. So you still earn a profit because of that up-front payment.

In our **XYZ Company** example above, you would have earned a 3.7% return ($4.60/$125.40) in less than three months' time!

In contrast, when you set up a limit order, you don't collect any money up front. So you make no profit at all.

The bottom line is that you can reduce your risk by selling puts to purchase stock below the current market price. I'm sure you can see why this strategy should be used by every conservative stock investor!

Be warned, however: Just as you would never sign up to buy more stock shares than you can afford when you enter a limit order, you shouldn't sign up to buy more stock shares than you can afford when you sell puts on a stock.

Many brokers allow you to sell more put options than you can afford to have converted into stock. Don't be tempted by the siren song of excessive leverage!

You can limit your stock purchase by limiting the number of put contracts you sell. Each option contract represents 100 shares of stock, so if you would normally buy 500 shares of stock, you should limit your put sales to five contracts.

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And once you get comfortable with the idea of selling put options, you may want to try buying your first few *Personal Finance* portfolio stocks that way.

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