

MARCH 24, 2009, 10:24 P.M. ET

Turning Back the Clock to When Stocks Were Low

By JAMES B. STEWART

With stocks in their sharpest two-week rally since 1938, I'm suddenly hearing from investors who want to know: Is it too late?

Where were they two weeks ago, when I explicitly urged them to buy? If they'd been following the Common Sense system, which I've outlined repeatedly over the years, they'd be thinking of selling, not buying, now that the S&P 500-stock index is 17% above its recent lows. They'd be selling higher after buying lower, which is the essence of the Common Sense approach.

I hope they've learned an important lesson. Nonetheless, I have a strategy for these latecomers.

There is, of course, no certainty that the rally will continue. For all I know, it's already run its course. Despite initial enthusiasm over details of Treasury Secretary Timothy Geithner's toxic-asset plan, it isn't as if the systemic problems afflicting the global economy have been solved in the past two weeks. (Nonetheless, plenty of Geithner-bashers owe him an apology.) It's always useful to remember that no one can know where the market is headed in the short term. Though many investors long for it, they can never have the comfort of certainty when investing in stocks. All we know for sure is that over time, stocks have yielded the highest returns among investment classes.

Viewed from that perspective, stocks appear attractive even after the recent run-up. As of this week, they were still more than 50% off the highs reached in October 2007. Someday the averages will again hit new highs, and by then, the Dow Jones Industrial Average at 8000, the S&P 500 at 800, and the Nasdaq Composite at 1550 will look like stocks were bargains.

Even so, there's a lot more risk in the market today than there was two weeks ago, when stocks seemed priced for catastrophe and the mood on Wall Street was as bleak as I've ever experienced. One way to reduce that risk is to buy stocks now but also sell calls on those stocks, a strategy known as selling covered calls. It's especially attractive now since volatility remains high, which means investors can sell calls for a rich premium. This strategy has the effect of lowering the purchase price -- in effect, turning back the clock to a time when stocks were cheaper. Yes, there is a price to be paid: Investors must be willing to cap their gains.

Before showing exactly how this works, I should stress that this is a conservative strategy that reduces risk rather than heightens it. Some people panic every time I mention

options, as if it were one step from casino gambling. Some options strategies are high risk, but none that I'd ever recommend.

Recall that in February I first recommended buying Amazon.com stock, then selling for around \$62. I thought the price was a little rich then, so I waited to buy until a little over two weeks ago, when the stock had dropped modestly to \$60. As I reported then, I still thought Amazon was fully priced, so I bought the stock at \$60 and simultaneously sold calls, which conveys the right to buy those shares at a specified price for a specific time period. (Selling a call is the opposite of buying one.) I sold the July 80 calls for \$4.50 each. That means that if Amazon shares are trading at \$80 or above when the options expire in July, I will deliver the shares and collect \$80 for each. I will also keep the \$4.50 I got for selling the calls.

Here's another way of looking at it: My net price for the shares was \$55.50 (\$60 minus \$4.50). If I have to deliver the shares in July for \$80, my gain will be \$24.50. That's a 44% return in five months. What did I give up in return? Anything above 44%. But in this environment I'm not going to be greedy. I'll be delighted with a 44% return in such a short time, which is nearly 150% annualized.

By this week Amazon had jumped to about \$73, and the July 80 calls were \$7.10. So if you buy the stock and sell the call at those prices, your net price is \$65.90 a share. That's about where Amazon was trading two weeks ago when I urged readers to buy stocks. As I said, it's like turning back the clock to the time you should have been buying. If you have to deliver the shares for \$80 in July, your gain will be \$14.10, or 21%. How bad is that?

You can do this with any stock that has options. You also can choose from an array of strike prices and expiration dates depending on your appetite for risk. You can do the math; the higher the potential return, the greater the risk. And if Amazon or whatever stock you buy isn't trading at or above the strike price when the options expire, you'll still own the shares, but at a lower cost than if you had just bought them outright. That outcome would be fine with me, since I continue to believe Amazon is a good long-term investment. I only recommend this approach for stocks you'd be happy to own for the long term.

So if you feel you missed the recent rally, don't despair. It isn't too late to join the party.

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