Investing With Synthetic Stock

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When we talk about synthetic stock we are really talking about stock options. Synthetic stock is a way to establish a long position in a stock with substantially less investment capital than if you want to buy the stock outright. Synthetic stock also carries risk. “Buying” synthetic stock is done by purchasing calls on the stock in question and then selling puts on the same stock in order to reduce the cost of the calls. The cost of this approach is less than buying calls and greatly less than buying the stock. The risk of investing with synthetic stock lies in the possibility that the stock will fall in price.

Understanding Calls and Puts in Options Trading

If you are interested in investing with synthetic stock you need to start by understanding calls and puts in options trading.

What Is a Call?

A call is an option contract in which the buyer gains the right to purchase a stock at the price stated in the contract, known as the strike price. He or she can do this at any time during the duration of the contract for an American style option and at the end of the contract for a European style option. The seller of the call contract earns a premium but takes on the obligation of selling the stock at the strike price if the buyer exercises the contract. With a long-term options contract such as a LEAPs option that can run three years the buyer may simply choose to leave the contract open as the stock price goes up.

What Is a Put?

A put is an option contract in which the buyer gains the right to sell a stock at the price stated in the contract, the strike price. For American style options this can be at any time during the duration of the contract and for European style options at the end of the contract. The seller earns a premium for which he or she takes on the obligation of selling the stock at the strike price even when the stock has fallen significantly in price, creating a substantial loss.

Basically you buy a call or sell a put when you think a stock will go up in price and you sell a call or buy a put when you think that the stock will fall in price.

Using Call Options to Invest

Because we are talking about investing with synthetic stock, we are talking about using call options to invest. A good example for investing with synthetic stock is Amazon.com. The stock has had a great run and the company has dominant positions in all of its business sectors. As such it would seem to be a great long term investment. One of the problems is that Amazon.com stock sells for more than three thousand dollars a share, $3,292 as we write this. However, one can purchase call options on Amazon.com for substantially less than what it costs to buy the stock. How much less depends on the strike price that you choose. Calls that are substantially "out of the money" because they are priced much higher than the price of Amazon.com today can be purchased for pennies a share.

What Happens When You Buy Synthetic Shares?

In order to make money using call options to invest, you need to buy enough options and hold them long enough for the strategy to gain a reasonable profit. LEAPs call options can be contracts that run up to three years. However, you are tying up your money for three years too. To further reduce your investment you can also sell put options. This is what happens when you buy synthetic shares. You are buying call options in expectation of a profit and selling put options to reduce the cost of the investment. Provided that the stock, like Amazon.com goes up in price over the next couple of years you will gain a profit similar to what you could have gained by buying the shares but you will have done so for a greatly reduced price.

Is Investing With Synthetic Stock Safe?

Options trading can help investors leverage their investment capital which is what happens when investing with synthetic stock. But, some options strategies carry a risk. Selling puts to allow you to buy more call options and control more shares also puts you at risk of loss if the stock falls unexpectedly in value. If we look at where Amazon.com was five years ago at $772 a share and where it is today $3,392 a share, we can see how well a synthetic stock strategy can work for some who gets in before a nice rise in a stock price.

But, if we look at just this last year, when Amazon.com started at $3,191 a share and has peaked at $3,531, $3,443, $3,471, and $3,719 only to land back at $3,292 today, we can see the risk of investing with synthetic stock. This investment strategy offers a way to leverage a small amount of investment capital into huge profits but comes with the potential for huge risk.

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