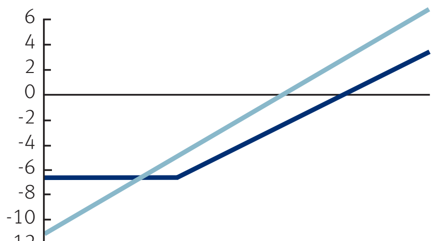
Option strategies—buying protective puts

Wealth Management

Bearish strategies

The buyer of a put option has the right, but not the obligation, to sell the underlying stock at a fixed price (the strike price) for the life of the option. Because the value of a put option benefits from a decline in the underlying stock price, many investors use puts to protect their stock positions. In many respects puts, when used in this fashion, can be viewed as insurance policies.

- **Why—**Investors looking for ways to reduce their exposure and protect the value of their equity positions may consider purchasing a protective put option, as an alternative to selling shares. The put purchase reduces downside exposure while allowing for continued upside potential.
- **Strike price—**The strike price of the put option determines the level at which the investor may choose to exercise and sell their shares. Put options with higher strikes prices afford greater protection for the underlying stock. These higher strike puts will also have higher premiums. Like an insurance policy, a put with a strike price that is less than the stock's price can be viewed as having a deductible. Because the put affords price protection below the strike price, investors who purchase out-of-the-money puts assume the risk of the difference between the stock price and the strike price. Also, like an insurance policy, the further out-of-the-money (higher deductible), the lower the premium. The investor must weigh the trade-off of the lower premium and the higher deductible.
- **Expiration—**Because the option will have a finite life, it will be important to choose an option with an expiration date that more than covers the time frame that the investor feels the stock is at risk.



40	41	42	43	44	45	46	47	48	49	50	51	52	53	54	55
-10	-9	-8	-7	-6	-5	-4	-3	-2	-1	0	1	2	3	4	5
-6.5	-6.5	-6.5	-6.5	-6.5	-6.5	-5.5	-4.5	-3.5	-2.5	-1.5	-0.5	0.5	1.5	2.5	3.5

Stock
Stock + productive put

Protective put example

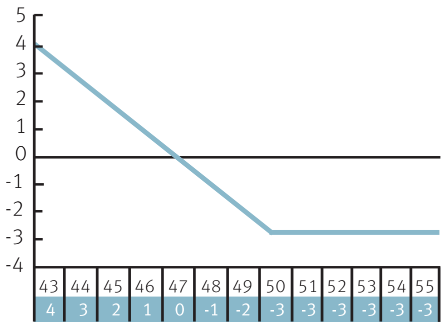
With the underlying stock trading at $50, an investor looking to reduce the risk of holding the shares may choose to purchase a put option. After reviewing the stock's performance and potential, the investor decides to purchase the three-month put with a strike price of $45. This will allow the investor to sell the stock at the strike price ($45) should the price decline over the next three months. For this right, the investor will pay a $1.50 premium ($150/contract). In this example, the $5 difference between the stock price and the option strike price could be viewed as the "deductible" for this insurance. The investor's risk is eliminated below the strike price minus the option premium (45 - 1.5 = 43.5). Conversely, if the stock finishes above the strike price, the put will expire worthless. If the stock moves higher over the life of the put, the investor's only risk is the loss of the option premium.

An interesting observation can be made about the protective put position from this chart. The chart above looks similar to the long call strategy. In fact, it is. Buying a put against a long stock position creates the same risk reward profile as the long call. In the previous example, the long stock/long 45 put has the same profit/loss potential as being the long call with a 45 strike. Both of these positions have limited risk and (theoretically) unlimited potential.

- **Speculation—**Put options may also be used to speculate on a decline in a stock's price. Investors using puts in this fashion should take into consideration the same factors when buying any option contract. The strike price will be an important consideration as this is the level at which the stock may be sold upon exercise. The expiration date for the option must cover the time frame that the investor believes the stock is likely to decline.

Long put example

An investor who thinks ABC stock is overpriced at $50 and will decline over the next two months decides to purchase a put option as a way to profit from the move. They choose a put with a $50 strike price (at-the-money) and a three-month expiration date (more than covering their expected time frame) at a $3 premium. If they are correct, they will profit if the stock price declines below the strike price minus the premium paid (50 - 3 = 47). The investor will profit point for point as the stock declines below this level.



Long put

Conversely, the investor's maximum risk if the stock price rises is limited to the price of the option.

A few things to remember

- Like any insurance policy, the premium paid is an out-of-pocket expense. This, combined with any out-of-the-money portion of the option, will be the investor's risk.
- As with all options strategies, the expiration date of the option should more than cover the investor's time frame.