Option strategies – selling puts

Bullish/neutral strategies
A put option gives the holder the right to sell the underlying stock at the option strike price. As a put seller, you obligate yourself to purchase the underlying stock at the strike price for the life of the option. For taking on this obligation, you are paid a premium. Investors sell put options primarily for the following reasons:
1. to earn premium income
2. as a way of acquiring the underlying stock

If the stock price falls below the options strike price, the put may be exercised and the shares “put” to the seller at a substantial loss. Because this may happen any time the put goes in-the-money, investors should be willing and able to purchase the shares at the strike price. This possibility emphasizes the importance of selecting the underlying stock. Investors should sell puts on stocks they would feel comfortable owning, not solely for the rate of return they will achieve through the sale.

Short put example
An investor wants to establish a long position in ABC shares if the price drops to $50. Shares in ABC are currently trading at $52. The investor may choose to enter a limit order to buy the shares at $50. If the stock does not dip to that level, the investor will not purchase the shares. As an alternative, the investor may sell a put option with a strike price of $50. This creates a commitment to purchase the shares at the strike for as long as the option position is open. For taking on this commitment, the investor receives a premium of $2.

If the stock is trading below the strike price, at expiration, the investor will have the shares “put” to them at the strike price ($50). Taking into account the option premium received from the sale, the investor’s effective cost basis for the shares would be $48 (strike price - option premium = cost basis).

If the stock is trading above the strike price, at expiration the put will expire worthless and the seller will realize a $2 short-term gain.

An interesting observation can be made when looking at the chart of the short put position. The short put and the covered call positions have similar chart patterns. If fact, when executed on a CASH BASIS, these two strategies have the same risk/reward profiles.

The overriding concern for both of these strategies is the underlying stock. The investor should feel comfortable about the fundamentals and long-term outlook for the company. Too often, investors concentrate on the rate of return these strategies produce.

Things to remember —
• Selling a put option does not guarantee that the shares will be purchased. If the stock price goes below the strike price before the expiration date but finishes above at expiration, the option may expire worthless and the shares will not be purchased. Because of this possibility, many investors sell puts covering only half the position they would ultimately like to establish. This allows for the purchase of the remaining shares in the event the price declines before expiration.
• As with the covered write strategy, the first consideration of the short put strategy is the underlying stock. Investors should consider selling puts on stocks they want to own, not necessarily on stocks that produce the greatest returns.
• Choose a strike price that matches the target at which you are willing purchase shares. If your opinion changes before the option expiration date for the put you may cancel your obligation to purchase the underlying shares by closing the option position. Keep in mind that this may result in a loss.