Buying put options instead of short selling stocks

SITUATION

One of the major advantages of options contracts over transactions in the actual stock market is the high leverage provided by equity options in the case where the investor has correctly forecasted the future price fluctuation of the equity. Put options offer such advantages in the case of anticipated stock price declines.

OBJECTIVE

Buying put options to take advantage of a drop in stock prices.

STRATEGY

ABC Bank common stock is selling at $33.50 and ABC AUG 35 put options are available at a premium of $2.75 per share ($275.00 per contract). Forecasting a drop in market price of ABC shares, the investor could either buy ABC AUG 35 put options or "sell short" shares of ABC stock. Note that for simplicity, the financing cost of short-selling is not considered (readers unfamiliar with stock short-selling should consult their broker for more detail).

For purposes of illustration, consider the two strategies in parallel, the purchase of 1 put option or the short-sale of 100 shares. On July 21, the price of ABC stock had fallen to $28.50 and ABC AUG 35 puts were trading at a premium of $7.50 per share. The investor decides to liquidate his position.

RESULTS

Date and Transaction	Price per Share of ABC	Options	Shares
April 28: buy 1 ABC AUG 35 put at $2.75 **or** sell short 100 shares of ABC	$33.50	$(275.00)	$3,350.00
July 21: sell 1 ABC AUG 35 put at $7.50 **or** buy back 100 shares of ABC	$28.50	$750.00	$(2,850.00)
Net Profit		$475.00	$500.00
Return on Investment		172.7%	14.9%

In terms of return, the main difference between these two strategies is the amount invested or the leverage of options. The investment in the options position corresponds to the premium paid, whereas the short-sale requires the maintenance of a minimum margin in the customer's account.

The buyers of puts also face limited risks compared with their counterparts in the actual stock market. What if the price of ABC stock had risen instead? The holder of a short stock position would have experienced losses. The put buyer, on the other hand, could not lose more than the $275.00 premium originally paid. This limited risk feature is very valuable to the investor unable to withstand potentially large losses. Unlike short sellers of stocks, put buyers pay the contract premium and have no further financial obligation.