Buying put options as an insurance policy (protective puts)

SITUATION

The covered call writer's stocks are protected against moderate declines in value since the loss arising from a depreciation of his stock portfolio would be wholly or partially offset by the sold call option premium revenue. There are, however, shortcomings to hedging positions by writing call options:

- The investor's stocks are protected only to the extent of the call option premiums received. Thus, the investor is not protected against large drops in the price of these shares unless he writes call options with consecutively lower strike prices, thereby assuming a greater risk of being assigned.

- Since the investor may have to sell his stock if exercised by the call option holder, he must forego the benefits of a rise in the value of the stock above the strike price of the option sold, so long as the call option positions he has written are still "open".

Put options alleviate many of these problems, since they enable the holder to obtain unlimited downside protection while retaining most of his upside potential. Further, the investor's stock will not be called away since he is the holder of the option.

OBJECTIVE

Locking in a profit or hedging the value of existing portfolio positions.

STRATEGY

An investor holds 1,000 shares of MNO Bank. The MNO shares have increased substantially in value since the investor acquired them and are now worth $32.00 per share or $32,000.00 (1,000 x $32.00). The investor wants to continue to hold the shares for their long-term potential but is concerned that they may decline over the summer if a widely-forecasted market correction occurs.

To hedge his MNO stocks, the investor buys 10 MNO JUN 32 put options at a premium of $1.60 per share or $1,600.00 total for the 10 puts. He has, therefore, assured himself of a selling price of $30.40 per share (i.e. strike price of $32.00 minus premium paid of $1.60) if MNO stock drops in value.

RESULTS

Scenario 1: MNO's stock price falls to $26.00 and put options can be sold at a premium of $6.00.

The loss of $6.00 per share on the drop in stock price is partially offset by an option profit of $4.40 (i.e. $6.00 – $1.60) if the investor sells 10 puts.

Date and Transaction	Price per Share of MNO	Options	Shares
February 26: buy 10 MNO JUN 32 puts at $1.60	$32.00	$(1,600.00)	$(32,000.00)
May 20: sell 10 MNO JUN 32 puts at $6.00	$26.00	$6,000.00	$26,000.00
Loss on stock			$(6,000.00)
Options profit		$4,400.00	
Net loss		$(1,600.00)	

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Note that the options profits substantially cushion the investor's stock losses. He could have obtained better protection by purchasing an in-the-money series like the MNO JUN 34.5 but at a higher premium cost. It should be noted that the investor could exercise his 10 puts (rather than reselling them) and sell his 1,000 shares of MNO stock at $32.00 each. The choice would be made according to his feelings regarding the future price of the stock and commission fee consideration.

Scenario 2: MNO's stock price increases to $40.00.
In this case, the 10 puts would be worthless. The investor's 1,000 shares would have appreciated by $8,000.00 (i.e. 1,000 x ($40.00 – $32.00)), more than offsetting the cost of the 10 puts. Had the investor's hedge consisted of writing calls rather than buying puts, he would not have participated in the full benefits of this increase.

Had MNO stock risen to $40.00 per share, the investor might want to consider purchasing puts with a $40.00 strike price to lock in the profits arising from the latest appreciation in MNO stock. Many investors use this strategy on an ongoing basis to protect their investment profits without liquidating their stock position.