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Equity Options
Strategy

MONTRÉAL EXCHANGE

Naked Put

(Uncovered Put, Short Put)

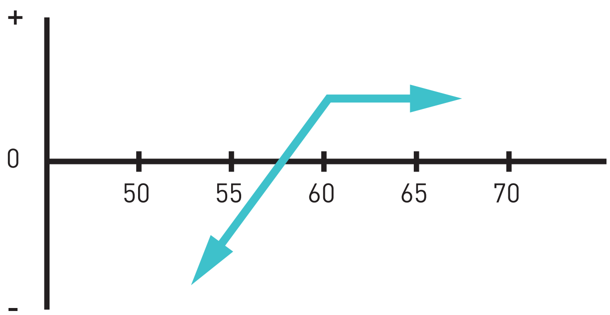
Description

A put writer who has no desire to own the underlying stock, and no earmarked resources for settling should the shares be assigned, is undertaking a highly risky strategy.

An uncovered put strategy expects the put to expire worthless, allowing the writer to keep the premium received at the outset. With a lot of luck, the strategy might work, but an unexpected outcome could be catastrophic. Considering the limited income potential and enormous downside risk, this strategy is not suitable for most investors. There are no guarantees against assignment, short of closing out the put. As for that solution, it might be difficult and costly just when the investor would most want to exit: when the stock moves sharply downward.

How can a short put writer reign in the risk of this investment? First, the investor could set aside the financial resources to take ownership of the stock at any time if assigned. Second, the investor could select a strike price more cautiously; not on grounds of maximizing premium income. Obviously, the higher the strike price, the greater the premium, but the higher the risk of assignment, too.

Naked Put
Net Position



Example

Short 1 XYZ 60 put

MAXIMUM GAIN
Premium received

MAXIMUM LOSS
Strike price - premium received (substantial)

Outlook

The investor is expecting a steady or rising stock price during life of option, and considers the likelihood of a decline very remote.

Summary

A naked put involves writing a put option without the reserved cash on hand to purchase the underlying stock.

This strategy entails a great deal of risk and relies on a steady or rising stock price. It does best if the option expires worthless.

Motivation

The only motive for writing an uncovered put is to earn premium income.

Variations

Cash-secured puts are the same as naked puts, but with two vital exceptions. First, the naked put writer has not set aside the cash to buy the stock if assigned. As a result, assignment would require urgent and possibly costly maneuvers to get hold of enough cash by settlement. Second, the naked put writer has no interest in acquiring the underlying stock. If assigned, the goal would be to resell the stock as quickly as possible to minimize the duration and risk of stock ownership.

Max Loss

The maximum theoretical loss is limited, but it is very substantial. The worst that can happen is for the stock price to fall to zero, in which case the investor would be obligated to buy a worthless stock at the strike price. The effective purchase price, however, would be reduced somewhat by the premium received from selling the put option.

It is conceivable that the investor might have to incur some additional expenses to come up with enough cash to honor the contract on the settlement day.

Max Gain

The maximum gains are very limited, especially relative to the extent of risk. If the position is still open at expiration, the best that can happen is for the stock price to be above the strike price. In that case, the option expires worthless and the investor pockets the premium received for selling the put option.

Profit/Loss

The potential profit is extremely limited. No matter how high the stock price rises, the most this investor can hope to earn is the initial premium. The best scenario for the put writer would be a steady or rising stock price for the whole term, with no news announcements or other events to trigger greater volatility. If time passes and the put remains out-of-the-money, it would be increasingly likely to expire worthless, relieving the investor of all obligations.

Since the premium constitutes the only benefit, some writers are tempted to write contracts with longer terms and higher strike prices. Both would increase the odds of assignment, which in this case is a very undesirable outcome. The investor would have to scramble to deliver the cash by settlement day, and make urgent plans to resell the stock afterward. The delay between assignment and notification add to the overall risk.

Potential losses are extremely large, limited only by the fact that the stock's value cannot fall below zero. At that point, the loss would be the strike price, less the initial premium received.

Breakeven

At expiration, the strategy breaks even if the stock price is below the strike price by the amount of the premium received, i.e., the option's intrinsic value equals the price at which the option was sold.

Breakeven = strike – premium

Volatility

An increase in implied volatility would have a negative impact on this strategy, all other things being equal. Even if the investor felt that it had no correlation to a greater future risk of assignment, it would normally raise the cost of buying the put back to close out the position.

Time Decay

The passage of time will have an extremely positive impact on this strategy, all other things equal. Every passing day diminishes the mathematical likelihood of an at-the-money or out-of-the-money put becoming in-the-money by expiration.

As expiration approaches the option moves toward its intrinsic value, which for out-of-money puts is zero.

Assignment Risk

The risk of assignment, whether early or at expiration, is this investor's chief worry since the investor has neither the ready cash for this purpose nor a desire to own the underlying stock. A cautious selection of strike price and careful ongoing monitoring are the best ways to decrease the odds of a costly surprise, but buying to close the put is the only way to eliminate this risk. Early assignment, while possible at any time, generally occurs when the put option goes deep into-the-money.

Expiration Risk

This risk applies, too. The option writer cannot know until the Monday following expiration whether assignment occurred or not. Since the goal is to resell the assigned stock as soon as possible, the delay of a weekend exposes the investor to interim stock price risk, as well as possible inconveniences in bridging the need for cash from option settlement until the subsequent stock sale settlement.

Comments

This strategy is second only to naked calls in its level of risk, and not suitable for most investors. It requires posting a significant margin to initiate the transaction, but the risk is well in excess of that initial margin, and an unfavorable market move could force the investor to post additional margin on very short notice or to liquidate their position at a substantial loss.

Related Position

Comparable Position: **Covered Call**

Opposite Position: **Long Put**