Writing secured put options

SITUATION

When writing put options, the investor must be prepared to actually acquire the shares underlying the put options if he is assigned by the put option holder. Thus, he "secures" his put options by a cash deposit or by the proceeds of short-selling the stock.

Even with such a constraint, writing put options can still be a useful means of acquiring stock at below market prices. Indeed, many investors prefer to write put options rather than place limit buy orders at below market rates and wait for a "fill" if the stock should drop in value.

OBJECTIVE

To allow an investor to acquire stock at a net cost below market price. This strategy also increases the return of a portfolio because of the premium received.

STRATEGY

XYZ shares are trading at $27.00. An investor feels the shares are slightly overvalued in the present market but is very positive regarding XYZ shares over the long term. Instead of putting in a limit order to buy XYZ at a price slightly lower than market price, he decides to write put options with an strike price of $27.00.

Accordingly, the investor writes 10 XYZ JUN 27 put options at a premium of $1.15 per share. His revenues are $1,150.00.

RESULTS

Scenario 1: XYZ's stock price drops below $27.00.

At the put option's expiration, XYZ shares are at $26.00. The investor is "assigned" to take delivery of XYZ shares at $27.00 since the holder of 10 XYZ JUN 27 puts decided to exercise his options.

As a result, the investor acquires 1,000 shares of XYZ at a net effective price of $25.85 (i.e. $27,000.00 for the 1,000 shares "put to him" at $27.00 each, minus the previously received revenue of $1,150.00), which is still below the prevailing market price of $26.00. If the XYZ shares drop below $25.85 (i.e. strike price minus premium on February 11), the investor may be obliged to buy XYZ shares at a price that is suddenly well above market prices. This could result in large losses if he did not close out his 10 short XYZ JUN 27 put options position.

Note that, in the case of the uncovered sale of put options, the investor has large downside risks if the stock falls substantially.

Scenario 2: XYZ's stock price stays above $27.00.

The investor retains his option premium revenues but might regret not having purchased XYZ shares at $27.00. He will be in a net favourable situation, however, so long as XYZ shares remain below $28.15 (i.e. price of $27.00 plus premium of $1.15).

Here, the uncovered investor will realize the same profit as the covered investor since both options will expire worthless and will not be assigned.