

# Who Should Consider Using Protective Puts?

- *An investor who currently holds a stock, but does not want to sell because he believes the stock may rise in value. This investor would like to be able to participate in the rise without risking all of his profit (if any).*
- *An investor who is considering purchasing a stock but is concerned with downside risk.*

## *Introduction*

Today, investors are often concerned with the many uncertainties of the stock market. During bull markets, investors are worried about market corrections, and during bear markets, they are worried that their stocks could fall further. This uncertainty can lead to a reluctance to invest, and strong up moves might be missed. Buying puts against an existing stock position or simultaneously purchasing stock and puts can supply the insurance needed to overcome the uncertainty of the marketplace. People insure their valuable assets, but most investors have not realized that many of their stock positions also can be insured. That is exactly what a protective put does. Typically, by paying a relatively small premium (compared to the market value of the stock), an investor knows that no matter how far the stock drops, it can be sold at the strike price of the put anytime until the put expires.

**Although a protective put may not be suitable for all investors, this strategy can provide the protection needed to invest in individual stocks in volatile markets because it ensures limited downside risk and unlimited profit potential for the life of the option.**

## *Definition*

Buying a protective put involves the purchase of one put contract for every 100 shares of stock already owned or purchased. A put gives the owner the right but not the obligation to sell the underlying security at a certain price (the strike or exercise price) up to the expiration date. Puts (and calls) are available with expirations of up to eight months on over 2,000 stocks, and for over 400 stocks as far out as three years. The options that expire up to three years in the future are called LEAPS<sup>®</sup>, Long-term Equity Anticipation Securities<sup>™</sup>.

Purchasing a put against stock is similar to purchasing insurance. The investor will pay a premium (the cost of the put) to insure against a loss in the stock position. No matter what happens to the price of the stock, the put owner can sell it at the strike price at any time prior to expiration.

*Let's take a look at what happens to a protective put position as the underlying stock moves up or down. Commissions have not been taken into consideration in these examples; however, they can have a significant effect on your returns.*

## How to Use A Protective Put As Insurance

### I. Buy ZYX at \$50

First, let's look at buying a stock without owning a put for protection. If stock is bought at \$50 per share, as soon as the stock drops below the purchase price the investor begins to lose money. The entire \$50 purchase price is at risk. Correspondingly, if the price increases, the investor benefits from the entire increase without incurring the cost of the put premium or insurance.

When only the stock is bought, there is no protection or insurance. The investor is at risk of losing the total investment.

### II. Buy ZYX at \$50, Buy ZYX 50 Put

Let's now compare buying ZYX stock to buying ZYX with a protective put. In this example, ZYX is still at \$50 per share. A six-month put with a strike price of 50 can be bought for \$2.25 or \$225 per contract ( $\$2.25 \times \$100$ ). This put can be considered insurance "without a deductible," because the stock is purchased at \$50 and an "at-the-money" put with the same strike price, 50, is purchased. If the stock drops below \$50, the put or insurance will begin to offset any loss in ZYX (less the cost of the put).

	Buy ZYX	Buy ZYX with 6-month 50 Put
<b>Stock Cost</b>	\$50	\$50.00
<b>Put Cost</b>	\$ 0	\$2.25
<b>Total Cost</b>	\$50	\$52.25
<b>Risk</b>	\$50	\$2.25

No matter how low ZYX falls, buying the six-month put with a 50 strike price gives the investor the right to sell ZYX at \$50 up until expiration. The downside risk is only \$2.25: the total cost for this position, \$52.25, less 50 (strike price). This strategy gives an investor the advantage of having downside protection without limiting upside potential above the total cost of the position, or \$52.25. The only disadvantage is that the investor will not begin to profit until the stock rises above \$52.25. If ZYX remains at \$50 or above, the put will expire worthless and the premium would be lost. If just the stock had been bought, the investor would begin to profit as soon as the stock rose above \$50. However, the investor would have no protection from the risk of the stock declining in value. Owning a put along with stock ensures limited risk, while increasing the breakeven on the stock by the cost of the put, but still allowing for unlimited profit potential above the breakeven.

### III. Buy ZYX at \$50, Buy ZYX 45 Put

If an investor would like some downside protection on a stock position, and is willing to have a deductible in exchange for a lower insurance cost, buying an "out-of-the-money" put may meet this need. ZYX could be purchased at \$50 along with a 6-month put with a 45 strike at a cost of \$1 or \$100 per contract. This put gives the owner the right but not the obligation to sell ZYX at \$45 no matter how far the stock drops in value during the life of the contract. Buying the put with a 45 strike and purchasing the underlying stock at \$50 is similar to buying insurance with a \$5 deductible. If ZYX declines, the put will partially offset the loss in the stock below a price of \$45. The investor has two choices: exercise the put to sell the stock or sell the put. If the investor believes that ZYX has finished declining the investor may choose to sell the put. Below \$45, the put will be worth at least the difference between the current stock price and the strike price. The profit earned from the sale can be used to offset some of the loss in the stock, while holding onto ZYX in anticipation of the stock rising again. However, once the put has been sold, the investor no longer has downside protection on the stock position.

The only disadvantage to this strategy is that the investor will not profit from this transaction until ZYX rises above \$51. Had just the stock been bought, the investor would begin to profit as soon as the stock rose above \$50. But by purchasing the put, the most that can be lost on this position by expiration is \$6, and the investor still retains all the gain in the stock above \$51.

	Buy ZYX	Buy ZYX with 6-month 50 put	Buy ZYX with 6-month 45 put
<b>Stock Cost</b>	\$50	\$50.00	\$50
<b>Put Cost</b>	\$ 0	\$2.25	\$1
<b>Total Cost</b>	\$50	\$52.25	\$51
<b>Risk</b>	\$50	\$2.25	\$6

Buying the stock without put protection, with an “at-the-money” put or with an “out-of-the-money” put have different advantages and risks. Puts allow an investor to select the risk/reward best suited to that individual.

This strategy does not place a cap on how high the stock can be sold. Owning a protective put against a stock position ensures limited risk without limiting profit potential (above the breakeven) for the life of the contract.

### *Protective Puts Give You Options*

If ZYX had been purchased at \$50 without a put and the investor was right (ZYX rose to \$65) what could the investor do? Without knowledge of the protective put, there are two choices: Hold onto ZYX and hope that it continues to go up or sell it now and take the profit. Now a third choice: buy a put. A put with a strike price of 55 might cost \$0.25 (\$25.00).

This 55 put gives the investor the right to sell ZYX at \$55. With this position the investor can continue to hold the stock hoping it will rise further, while knowing that the investor can always sell it at a profit of \$4.75 (sell at 55 strike price - \$50 stock purchase cost - \$0.25 put cost) no matter how far the stock falls. Other investors could consider buying other puts that might cost more but also protect more of the accumulated profit.

Keep in mind that protective puts do expire, sometimes before they provide any insurance value. To benefit from a protective put strategy over a long period of time, an investor can either buy LEAPS®, which are simply long-term stock and index options, or, if they are not sure how long they will want insurance, they could repeatedly buy short-term puts. Repeatedly buying or “rolling” short-term puts gives the owner the flexibility of easily adjusting the strike price as the stock moves but may result in a higher cost than initially purchasing a LEAPS® put.

### *Summary*

The potential volatility of the equity markets can be of great concern to investors. The purchase of a protective put can give the investor the comfort level needed to purchase individual securities. This strategy is actually more conservative than the purchase of stock. As long as a put is held against a stock position there is limited risk; you know where the stock can be sold. The only disadvantages are that money cannot be made until the stock moves above the combined cost of the stock and the put, and that the put has a finite life. Once the stock rises above the total cost of the position, however, an investor has the potential for unlimited profit.

## Protective Put Worksheet

Date _____	
Stock _____	Stock Price _____
Strike Price _____	Option Price _____
Expiration Month _____	Days to Expiration _____
Annual Dividend _____	Dividend Date(s) _____

### Initial Cash Required

### Cash Account

- |  |                |
|--|----------------|
| 1. Purchase _____ shares @ _____                               | _____          |
| 2. Plus Stock Commission                                       | + _____        |
| 3. Plus _____ Contracts @ _____<br>(# of Puts x Premium x 100) | + _____        |
| 4. Plus Put Commission   | + _____        |
| <b>5. Total Investment</b>                                     | <b>= _____</b> |

### Option Exercised - Maximum Risk (Stock At Or Below Strike Price)

- |   |                |
|---|----------------|
| 6. Sell _____ Shares @ _____ Strike               | _____          |
| 7. Less Stock Commission                          | - _____        |
| 8. Plus Projected Dividend(s) on<br>_____ Shares. | + _____        |
| 9. Less Total Investment (Line 5)                 | - _____        |
| <b>10. Maximum Risk</b>                           | <b>= _____</b> |

### Breakeven Point At Expiration

- |   |                |
|---|----------------|
| 11. Total Investment (Line 5)                                       | _____          |
| 12. Less Projected Dividend(s) on<br>_____ Shares                   | - _____        |
| <b>13. Net Cost</b>   | <b>= _____</b> |
| <b>14. Breakeven Per Share*</b><br>(Line 13 divided by # of Shares) | <b>= _____</b> |

\*At any price below breakeven, there will be a loss, and above the breakeven, a gain on the total position, stock and puts.



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