

# Hedging with options

Can what is regarded as a high-risk class of investments actually provide protection for a conservative investment portfolio? Yes, and once you know a little about exchange-traded equity options, you'll see how.

## The basics

Strictly speaking, options are *derivatives*, their value deriving from the performance of an underlying security. Options traded on U.S. exchanges give their holders the right, but not the obligation, to buy or sell 100 shares of stock at a fixed *strike price* at any time up to their expiration date. An option to buy is known as a *call*; an option to sell is a *put*.

Options can provide investors with *leverage*—the opportunity to magnify the effect of an investment. A call on 100 shares of XYZ Company can be purchased for much less than the actual shares. But if the price of XYZ rises above the strike price, the option holder can cash in either of two ways: He or she can *exercise* the option, forcing a seller (called an option “writer”) to deliver the stock at the strike price, and then can realize a profit by selling at the market price. Or the XYZ call itself, which then would be “in the money,” can be sold at a profit. However, if the price of the stock doesn't rise above the strike price before the expiration date, the option will expire worthless.

Options also can provide the means for betting against a stock. Buying a put, an investor is able to sell the underlying stock at the exercise price, no matter how low the market price drops. Again, if the price does not drop, the option expires worthless.

Thus, buying an option may be regarded as a very risky investment, with the entire amount of the investment subject to loss if the stock price does not move as anticipated. It may be possible, however, to sell the option at a loss prior to expiration to close out the investment.

Option writers, on the other hand, take on potentially larger risks in return for the *premium* that they receive upon writing the option. Put writers obligate themselves to buy the underlying stock at the exercise price, whatever its market value, opening themselves to large potential losses. Likewise, those who write “naked” calls—without holding the underlying

stock—can obligate themselves to buy the stock at any price in order to deliver it to the call holder at the exercise price.

## **Options as insurance**

The leveraging uses of options are for experienced investors well-versed in sophisticated strategies, and aware of and financially prepared to assume the attendant risks. However there are some relatively simple options strategies that a conservative investor can use to protect portfolio positions.

**Buying “protective” puts.** Suppose that you have a stock holding that has appreciated, and you want to protect your profits should the market turn against you. You could set a floor on the stock price by purchasing a put.

Say, for example, you had bought 100 shares of XYZ stock two years ago at \$30. Now the price has risen to \$60, and you think that the stock has more upside. But the market is choppy, and you’d like some insurance. You might buy an XYZ 55 put (entitling you to sell at \$55 per share) for, perhaps, \$300. Then you could enjoy any further gains from the stock, even selling it at a higher price if you choose. But if the price falls below the strike price, you are assured of realizing \$5,200 (\$55 per share, less your \$300 premium for the put).

**Writing “covered” calls.** As discussed earlier, writing calls when you don’t own the underlying stock, is a high-risk investment. When you do own the stock, however, all you risk is the loss of appreciation beyond your strike price.

Suppose, for instance, that you don’t expect much action from that XYZ stock within the next six months. Writing a call at \$65 and collecting a premium of, perhaps, \$370, you produce a substantial income return if the stock remains below \$65. You might then choose to sell another call. If the price rises higher, however, your proceeds would be limited to \$6,870 (\$65 per share plus your \$370 premium for the call).

Of course, an exercise would force a sale and the recognition of a taxable gain, and this has to be factored into your decision to write a call. Be aware, also, that a covered call gives no protection on the downside, other than the \$370 cushion provided by the premium that you received. For that reason prudent investors often turn to a third strategy.

**Creating an equity “collar.”** A covered call can usually be combined with a protective put, establishing at reasonable cost an acceptable range within which the investor is willing to part with a holding. The premium received for the call goes toward paying the premium for the put. Thus, a floor and ceiling are established.

***Writing puts conservatively.*** Suppose that you are interested in a stock, but think that it may decline in the short term before moving upward. Writing a put below the market price, you would set aside the cash to purchase the stock in a money market fund or a T-bill. If the price then falls, you acquire the stock at your target price. Of course, if the price drops precipitously, you'll still be required to pay the exercise price, so this technique is to be used with caution in volatile markets.

Used protectively or aggressively, equity options add a layer of complexity to investing. Therefore, they are best employed under the guidance of a trusted professional advisor.

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Any developments occurring after January 1, 2008, are not reflected in this article.