7 Put Selling

Chapters 1, 2 and 6 cover the basic background required for this chapter.

7.1 Selling Naked Puts for Income

To engage in this strategy, you should be neutral to bullish on the underlying stock, since you will make money only if the underlying stays the same or rises in price. Unlike a naked call seller, whose risks are unlimited, the naked put sellers risk is the same as the owner of the stock — limited by the fact that share prices can't drop below zero.

As the seller of a put, you accept the obligation to buy the underlying stock at the strike price of the put. You are compensated by receiving the put premium. At expiration, if the underlying's price is above the strike, you won't be assigned shares and you keep the premium. However, the obligation to purchase shares if the stock price falls is a downside risk that must be considered when entering a naked put position.

Example

You find stock selling for $30 a share, and a 6-month $30 put on the stock selling for 4-points. If you sell the put, you can make $400 less commissions if the stock is at $30 or above at expiration. Should the stock drop, your potential losses are limited only by the fact that the stock can't drop below zero. Here is a table showing returns and losses for a variety of stock prices at expiration:

Stock Price	Gain (Loss)
10	($1,600)
20	(600)
26	0
30	400
40	400
50	400

Most brokers require new option accounts to have enough cash to completely cover the cost of assignment plus commissions before you are allowed to sell a naked put. This is called a **cash secured put**. You can count the premium received from the put towards this amount. For the $30 put in the above example:

Cost of shares (100 @ $30)	$3,000
Less Premiums Received	(400)
Plus Stock Commissions if assigned	10
Plus Option Commission	10
Net Security Required:	$2,620

Even if you have a margin account, you will probably be required to secure the puts with cash. If your broker allows you to use margin to secure the puts, the requirement is much less. In the present example, you would only need to have $1,400 in collateral, and it need not be cash.[1] Stocks or other securities can be used. But since most newcomers to options will need to secure puts with cash and not margin, we won't discuss margin requirements further.

7.1.1 Comparison of the Short Put with the Covered Call.

The profit graph of the naked short put is given in Figure 7.1. Notice that this graph is identical to the profit graph for the covered call (Figure 2.2). Two strategies with exactly the same profit graph are called **equivalent**. This does not mean that the strategies are identical in every way, only that the returns will be similar over the same range of stock prices. Put another way: If your view on a stock is neutral to mildly bullish but you can't sell covered calls because you don't own shares, you can achieve similar results by selling naked puts.

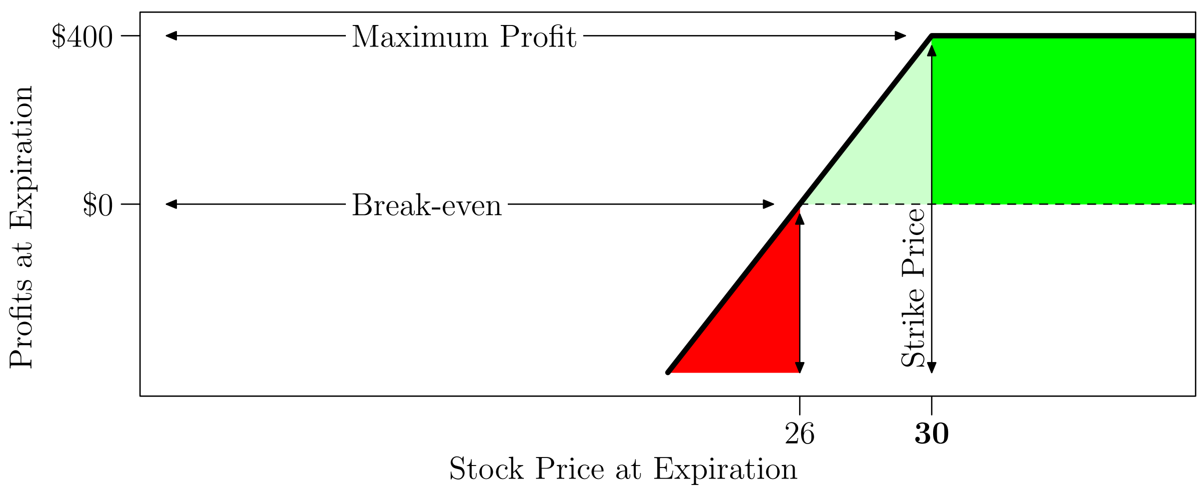

Figure 7.1: Profit graph for naked put.

The maximum potential profit from a naked put position is the total premium received, less commissions. To realize the maximum profit from an out-of-the-money put, the underlying stock only needs to stay above the strike of the put. To get the maximum profit

[1] Collateral is calculated as a percentage of the current stock price, so it can change during the time you hold the put.

from an in-the-money put, the stock must rise to at least the strike price of the put. If the stock doesn't go up, you must buy back the put to avoid assignment, which will reduce your profit. This is exactly the same as the situation with covered calls. For both covered calls and naked puts, when you open a position with a strike price that is above the stock price, there is a better chance of getting the maximum profit. The only difference is that when the strike price is above the stock price, the put is in-the-money, while the call will be out-of-the-money.

Selling an in-the-money put gives greater potential profits. It pays more more up front — in-the-money-options are always more valuable. But remember that if the stock price does not go up, you will need to spend at least some of that money to buy the put back. Like an out-of-the-money call, the in-the-money put provides greater potential profits but less chance of actually achieving them.

Your downside risk is greater with an in-the-money put. Recall that the deltas of in-the-money options are higher than the deltas of out-of-the-money options. This means that if the share price goes down, the repurchase cost of the in-the-money put will go up faster than the repurchase cost of the out-of-the-money put. Selling an in-the-money put can potentially lose you money at a higher rate of speed. This is also similar to selling an out-of-the-money call, which provides less downside protection than an in-the-money-call.

It is sometimes argued that there is an advantage to covered calls over naked puts for dividend paying stocks. It's true that the covered call seller will receive the dividend as part of his stock ownership, while the naked put seller will not. But as been mentioned before, call premiums are decreased in dividend paying stocks, while put premiums are increased, so there is less of a difference between these two situations than appears at first glance.

It may seem like there is a big difference between selling a naked put and selling a covered call, but this is probably more rooted in perception than reality. Covered call selling is certainly familiar to investors who are used to holding stock. Selling naked puts is considerably less familiar. Even though the strategies are equivalent, it is rare to find an investor who participates in both.

7.1.2 So I Sold a Naked Put, Now What?

If the underlying drops, you may need to take some action to protect yourself. The simplest is to just close the position, usually at a small loss. Because in-the-money puts lose time value premium pretty quickly, you may find that your loss is actually small if the stock goes against you.

With covered calls, it is generally a good idea to roll down whenever reasonable. This is because there is an existing stock position to consider. Buying back the covered call may still leave you with a loss in the stock — rolling down the call can help with this. And closing the covered call position completely may involve extra commissions. The situation is different with naked put selling. You don't own any stock, so your only loss is from the put. You could roll the put down, but there may be opportunities elsewhere in the market that are better. You should consider this and take advantage of them if you find them.

The same considerations apply to rolling forward. Because you also own stock when you have a covered call position, it is a big advantage to roll forward when you have a covered call. This gives you more premiums without disturbing your stock position. Rolling forward can also be profitable with puts, but because the put seller doesn't have an underlying stock position, he should evaluate all possibilities before doing so. It may be more profitable to sell a put against another stock.

7.1.3 Evaluating Naked Puts

There are many differences of opinion on how to evaluate the returns from selling naked puts. Many investors feel that they aren't really investing anything, since the puts are secured with collateral from their portfolio. However, particularly when the puts are secured with cash, in my opinion it is more honest to include the total amount of collateral required when calculating the return. With puts, as with calls, there are two returns to consider: the maximum potential return, and the return if unchanged. If the put is out-of-the-money, then the return if unchanged is the same as the maximum potential return. If the put is in-the-money, then the cost to buy back the put at expiration must be included in the calculations.

EXAMPLE

Fuzzy WooWoo's Art Supplies Inc. is selling for $30 and there is a March $30 put which sells for 4-points. You decide before investing that you will close the position if the shares drop to $23. What are the potential returns if you decide to sell 5 puts?

Potential Profit:	
Sell 5 Puts @ 4 points	$2,000.00
Less Commissions	-12.70
Potential Profit	$1,987.30
Break-even:	
Strike Price	$30.00
Less Premium per put ($1,987.30/500)	-3.97
Break-even stock price	$26.03
Collateral required: 500 times 30	$15,000.00
Less Premiums Received	-1,987.30
Net Collateral	$13,012.70
Potential Return:	
Potential Profit	$1,987.30
Divide by Net Collateral	13,012.70
Maximum Potential Return	15.3%

Since the put is out-of-the-money, the maximum potential return is the same as the return if unchanged.

Once the maximum return and break-even points have been calculated for all puts you are considering, you can rank put possibilities by both criteria. If you focus on the list with maximum returns, do not neglect to consider the downside protection the put provides. For example, for a stock selling at $100 a share, a $50 put would pay a huge premium, but offer no safety at all. You should allow at least 5% worth of downside protection, and reject any put that does not provide at least this much.

If you rank your puts by the protection they afford, you shouldn't forget about your profits. For example, a deeply out-of-the-money put would provide little chance of loss, but it would also pay very little. Considering commissions and the collateral required, it would not be worth selling such a deep-out-of-the-money put.

As with calls, to compare puts with different expiration periods against each other, you must annualize the returns, comparing them to your personal minimum yearly return before you invest. More discussion of this topic can be found in subsection 2.6.4.

More advanced put selection would also consider the volatility of the underlying stock, but this would take us out of the realm of an introduction to options.

It is never a bad idea to consider the fundamentals of the underlying stock when you are looking at any option play. Knowledge of the stock and the company will only help, because the stock is always your best friend when it comes to moving the price the way you want it to go. Examine the stock as closely as if you were going to buy it, looking at its financials and the economics of the business.

7.2 Using Puts to Buy Stock Below Market

Another use for selling naked puts is to potentially acquire shares at below market prices. Limit orders can be used to do this, but selling puts is often better. Puts can give you a better chance to get the shares, and if you don't get them, the put premium compensates you for your disappointment.

Example

You see a $30 stock that you would be willing to buy if it reached $25. If you open a good until cancelled limit order to purchase the stock at $25, the stock must actually reach $25 in order for your order to be executed. The stock may drift around between $25 and $30 for the duration of your order, and you will never get the stock.

But if you are able to sell a naked put with a strike of $30 for a premium of $5, the chances are good that you will get your shares. If the stock closes anywhere below $30 at expiration, the shares will be assigned to you. Meanwhile, since you were paid $5 for the put, the effective purchase price of the shares is $25.

If the share price doesn't cooperate, and continues upwards to close at $33 by expiration, you keep the $500 you were paid for selling the put, and can try again. And you have made some money while you waited.

Selling puts to obtain stock can modify the criteria for selecting puts. If you are more interested in the stock than the premiums from the put, you may be more willing to consider an in-the-money put.

EXAMPLE

Arlo's Organic Methane Manufacturing Company shares are selling for $48. You would be willing to purchase shares anywhere below $50, but of course would like the lowest price you can get. There is a March $50 put which is selling for $4.75. Ignoring commissions for the moment, this would give you an effective purchase price of $45.25.

If you also believe that Arlo's shares are unlikely to drop below the next strike price ($45), this gives you even more encouragement to purchase the in-the-money put.

If you are highly interested in obtaining shares, you should be more willing to roll-down if the stock drops further. This will usually be a net-debit transaction, so you need to consider your total costs carefully. If your purpose is to acquire shares, rolling forward for a net credit, even if the put is in-the-money, should be considered. This will reduce your effective purchase price in the shares by the amount of the credit received.

Just as you shouldn't chase a rising stock forever when you have a covered call against it, you should also use good sense when you chase a stock on the downside. In some cases, it may be best to accept the loss. If you have lost interest in the stock, you can buy the put back and accept the loss. If you are still interested in the shares, you can accept the loss by paying a higher than market price for them. If the difference between your effective share price and the market price is not too great, it can usually be made back fairly quickly by selling calls or by dividend payments from the shares.

7.3 Use Caution With Naked Puts

Naked put writing is a relatively safe activity, but some care is required because it can also be dangerous. Large losses are possible if the stock plummets suddenly. Also, particularly if you are using a margin account, it is easy to over-leverage your position. Many people have been wiped out by selling hundreds of out-of-the-money puts on "safe" companies like IBM or AT&T, forgetting that there is rarely a year that goes buy that doesn't see a serious decline in at least one major companies stock.

This is much less of a problem if your broker requires you to use cash to secure the full amount of the puts. Naked call writing, intelligently used, while a reasonable safe activity, remains inherently riskier than covered call writing.

7.4 Up to the Minute Summary

- Selling naked puts can be used to generate income, or acquire stock at below market prices.
- You will probably be required to have enough cash to purchase the shares, if you are assigned.
- Covered calls and naked puts are equivalent positions.
- Selling an out-of-the-money put is less profitable, but also less risky, than an in-the-money-put.
- In-the-money puts pay more, but also have greater risk.
- Rolling can be profitable, but there is less advantage to roll puts than there was with covered calls, because you don't own the stock.
- It may be more profitable to close a position, even at a small loss, then roll the call. There may be better put selling opportunities available.
- Do not over-leverage yourself when you sell naked calls, and monitor positions carefully to keep yourself from large losses.

7.5 Chapter Glossary

Equivalent Positions Positions with the same profit graph. For example, covered calls and naked puts have the same profit graph, so they are equivalent. This does not mean they are "the same in every way".

Limit Order Limit orders instruct your broker to buy or sell securities above or below a certain price. For example, an order to buy a security with a limit of $25 will only be filled when the price of the security is $25 or less. This can result in partial fills or even not obtaining the desired security. If you sell a security with a limit of $25, it will only be sold if a buyer can be found to purchase your security at or above that price.