9 Covered Put Buying

Chapter 1 on the basics, chapter 6 on puts and chapter 8 cover the material you need to know before you tackle this chapter.

9.1 Buying Puts as Insurance on Long Stock Positions

Another reason to buy puts is for downside protection on stock you already own. In effect, the long put acts as an insurance policy against a possible drop in the stock's price.[1] The cost of the puts reduces your net profits, but may be prudent in certain circumstances.

Example

You own shares of Nate's Hardware Store which are selling for $42. You buy a March $40 put for 2-points. No matter how much Nate's goes down by March expiration, the most you can lose is 4-points, since the put will gain a point for every point the stock declines below $40. You will lose 4-points because you spent 2-points on the put, and will lose 2-points from the share price decline from $42 to $40.

If the stock increases instead of declines, you lose 2-points of upside — the price of the protective put.

Figure 9.1 compares the different outcomes of holding stock versus stock plus a protective put. If the stock declined below $38, you would be better off (potentially much better off) owning the combined position. On the upside, the put purchase proves to be small drag on your profits.

9.1.1 Who Should Buy Protective Puts?

Insurance costs money, and covering every stock position in your portfolio with a protective put at all times will significantly impact your earnings. Even the most cautious investor would be advised not to engage in a full scale program of "put insurance".

One circumstances where buying protective puts may be justified are negative macro-economic events. As we all know, macro-considerations can cause a broad market decline, even if the individual companies are still performing well. If you also have long-term holdings where capital gains taxes would prove significant, selling puts in a strong bear

[1] The combination of long stock plus long call is also known as a "synthetic long call" because the profit graph is the same shape as a long call.

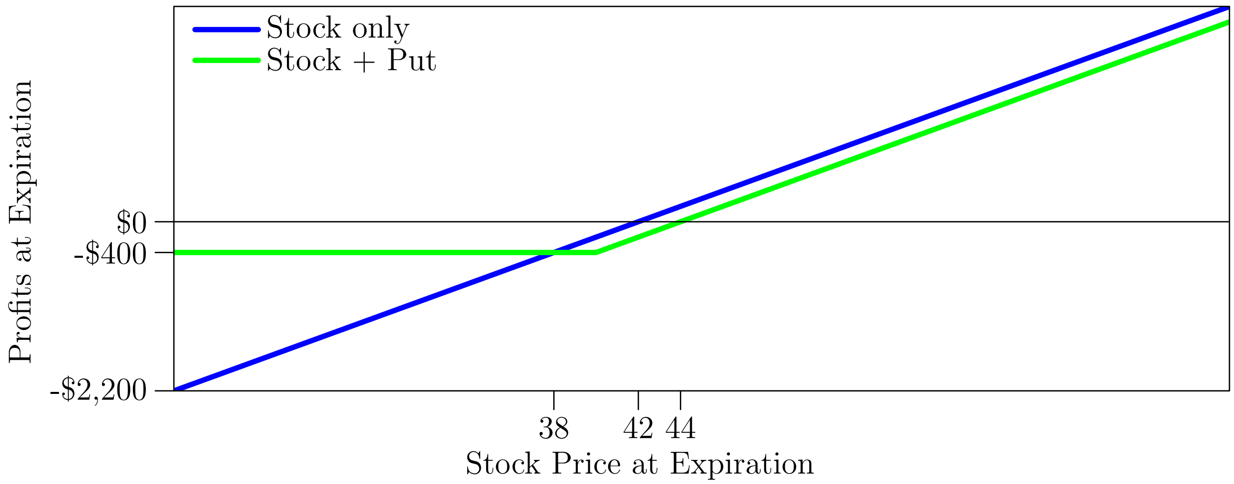

Figure 9.1: Profit graphs comparing a stock only position with stock plus a long put for protection.

market may make sense for you. This allows you to protect your profits and still benefit from holding shares when the market recovers.

You may own shares in a company which has reached a "make-or-break" point in their business cycle. This may be a decision from a government agency, a lawsuit, or other circumstance where, should the circumstance move against the company, might send the shares into a bottomless pit. The uncertainty of this situation can be dealt with very nicely with a protective put. Selling the put protects your current profits in case of a disaster, while allowing you to benefit from most of the upside.

Using Puts Instead of Stop-Loss Orders.

A stop-loss order is an instruction to your broker to sell shares if the stock price drops below a certain limit. Many outstanding investors, notably Peter Lynch, have written about the perils of the stop-loss order and advised investors not to use them. Stocks often move down 10% or 20% while making an overall upward move that will eventually provide great profits to their owners. If your stop-loss order triggers in the course of such a move, you may end-up having to repurchase shares at a higher cost-basis. You will also pay more commissions and probably more frequent taxes. Do this often enough and most of the advantages to stock ownership are gone.

For investors who are addicted to stop-loss orders, a protective put would probably be a much better choice.

9.2 Protective Put Selection

Out-of-the-money puts cost much less, but provide less protection. Near-to-the-money and in-the-money puts cost much more, but provide substantial downside protection. As with any insurance policy, you must balance the cost of the insurance against your best estimate of losses without the insurance.

Buying a put which is very far out-of-the-money is more like disaster insurance. There are definitely circumstances where this would make sense, but for most stocks, the purchase of a way out-of-the-money put is simply wasted money, no matter how little it may cost you.

EXAMPLE

A stock selling for \$45 has a March \$35 put which sells for \$0.50. While the purchase of this put will have a minimal impact on future earnings, the purchaser will lose 10.5 points if the stock fell to \$35 or below.

On the other hand, a deeply-in-the-money put provides huge amounts of protection, but will greatly limit any future profit potential.

EXAMPLE

The same stock selling for \$45 has a March \$50 put selling for \$5.50. This gives protection below \$39.50 which is good, but it also means that the stock must now rise to \$50.50 before the shareholder starts recognizing additional profits. This may prove unlikely.

For most cases, neither of these is a good strategy to follow. Generally speaking, *a slightly-out-of-the-money put will probably provide the best balance of protection without limiting the profit potential of owning the shares.*

If you compare the profit graph of the long put + long stock position to the profit graph of the long call, you will find they are exactly the same. This means that the combination of long stock + long put is *equivalent* to the long call position. This doesn't mean they are the same in every detail (for example, a share holder would receive dividends, while the call buyer would not), it only means that profit potential of each position is the same. Thus it should not come as a great surprise to learn that just as the slightly in-the-money call offered the best balance of risk and reward for covered calls, the slightly out-of-the-money put will offer the same balance of risk and reward to the shareholder who is looking to protect his stock position.

9.3 Tax Considerations

Under current tax laws, the purchase of a long put to protect your stock can impact your taxes. If you are a short-term holder at the time you buy the put, you eliminate any holding period you may have accrued. In addition, the holding period does not begin again until the put is sold.

Example

Let's assume that you must hold a stock for 12-months before it is considered a long-term holding by the IRS. If you had held a stock for 11-months, and then purchased a put, you would negate your entire 11-months of holding time for tax purposes. Furthermore, if you held the put for four months before you sold it, these months would not count towards your new holding period.

In other words, you can hold the stock for 15-months, and your holding period is still counted as zero for tax-purposes. Isn't that charming?

If you are already a long-term holder of the stock at the time you purchase the put, or if you buy the put at the same time as you buy the stock and identify it as a hedge, there is no tax-effect.

Tax laws change and your personal circumstances can also affect them. The file

http://www.optionseducation.org/resources/literature/files/taxes_and_investing.pdf.

which is updated regularly, contains much useful tax information for investors.

9.4 Using Puts with Covered Calls: The Collar

Covered calls were discussed in chapter 2. If you aren't familiar with that strategy, please read that chapter before continuing.

Simultaneously selling a call against stock you already own and also buying a put is called a **collar**. Since the covered call already provides downside protection from the premium you receive, you can buy a farther out-of-the-money put. In some cases, the premium from the covered call will pay for the purchase of the put.

If you are interested primarily in the downside protection of the covered call, this strategy will probably appeal to you. Of course, the purchase of the put does reduce the additional income you can receive from selling the calls against your stock.

Example

A stock selling for $29 has an April $30 call selling for 3-points. There is also an April $25 put selling for 1/2-point. If you sell the call, you have a maximum profit of 4-points if the stock closes above $30 by expiration. You receive protection against losses down to the break-even of $26.

If you use some of the call premium to purchase the April $25 put, you reduce your profit slightly to 2.5-points, but have greatly increased your downside protection. The break-even point of the call is raised by the put purchase to $26.5, and the put protects you anywhere below $25. Therefore the most you can lose, even if the stock should drop to zero, is 1.5-points.

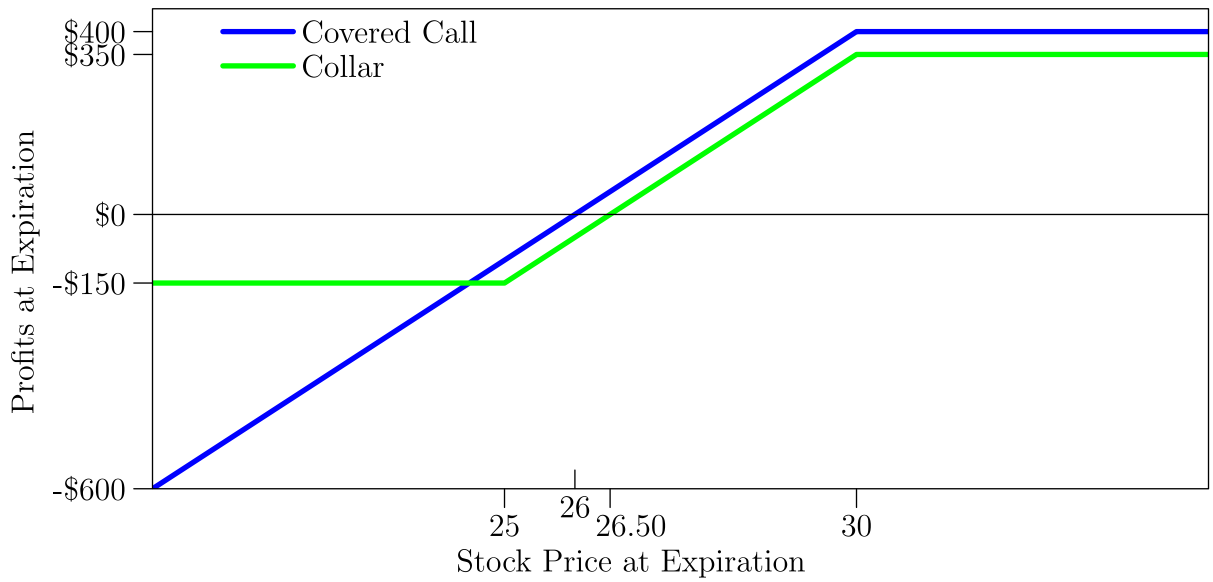

Figure 9.2: Profit graphs comparing a covered call position with a collar.

Figure 9.2 shows the profit graphs for both the covered call and the collar. As discussed above, the graph illustrates that the break-even point is raised slightly and the profits are reduced slightly. However the maximum risk is very small. Before deciding to use a collar, carefully calculate the total costs involved. There is a detailed example of the covered call calculation in section 2.6.3, which shows how to include commissions and any dividends that will be received. To this you must add the cost of the put plus commissions.

There is a lot to recommend the collar. If it can be done at a relatively low cost, it makes the strategies in section 2.8 for dealing with losing positions obsolete. Consider the rolling down strategy: The disadvantage of rolling down in a covered call position is that it reduces your upside if the stock reverses direction and begins to climb. This is not a problem with the collar. With the collar you also completely eliminate the potential misery of a locked-in loss. With a collar you need not take any action at all and can just leave the position alone to make money for you if the stock recovers.

Against these advantages must be stacked the fact that your overall rate of return will be reduced. And it is arguable that the downside "gain" you receive from the collar is of little benefit in the majority of cases, since the odds of a stock falling dramatically are small compared to other possibilities, such as falling slightly, staying the same, or rising. On the other hand, many investors have difficulty controlling their emotions when faced with even a small loss. The collar can free these investors to deal with the situation more rationally, since it can so effectively reduce dramatic losses.

If you compare the profit graph of the collar to the profit graph of the bull call spread, you will see that these are equivalent positions.

9.4.1 Partial Collars

You can get quite creative with collars, particularly if you have large positions.

EXAMPLE

You own 1,000 shares of of a stock which is selling for $41. You sell 5 March $45 calls for 2-points each, and 10 March $35 puts for 1-point each. The sale of the calls completely covers the cost of the puts, protecting your entire position below $35, while leaving half of your position with unlimited profit potential.

The lower the strike you use for the put, the fewer calls you will need to sell to pay for them. Of course, the lower the strike, the less downside protection you have, but since this falls into the category of "disaster insurance", and you are getting it for free, this may help you sleep better at night without costing you anything.

9.5 Up to the Minute Summary

- Purchasing a put while owning shares of the underlying acts as an insurance policy against price decline in the shares.
- Insurance costs money. Buying a put on every stock you own is probably a waste of money.
- Puts can be used instead of stop-loss orders.
- Slightly out-of-the-money puts usually provide the best balance of protection and potential profit.
- Purchase of a put while owning the stock can affect your holding period for tax purposes.
- Selling a collar (a long put, short call plus underlying stock) can help pay for the cost of the protective put.

1. Collars eliminate the need for extensive follow-up action in a covered call position.
2. Collars will reduce your overall rate of return.
3. Collars can be used as “disaster insurance”. Disasters may be unlikely, but having insurance against them can make some investors sleep better at night.
4. If you have a large stock position, partial collars can be employed to protect the entire position, but leave room for more profits.

9.6 Chapter Glossary

Collar A position involving the purchase of a protective put and a short call. It is safest if it is combined with a covering long stock position, to keep from owning a naked call.

Synthetic Call A long put combined with a long position in the underlying stock. This has the same profit graph as a long call position.