OCC – Protective Puts & Stock Repair Strategies

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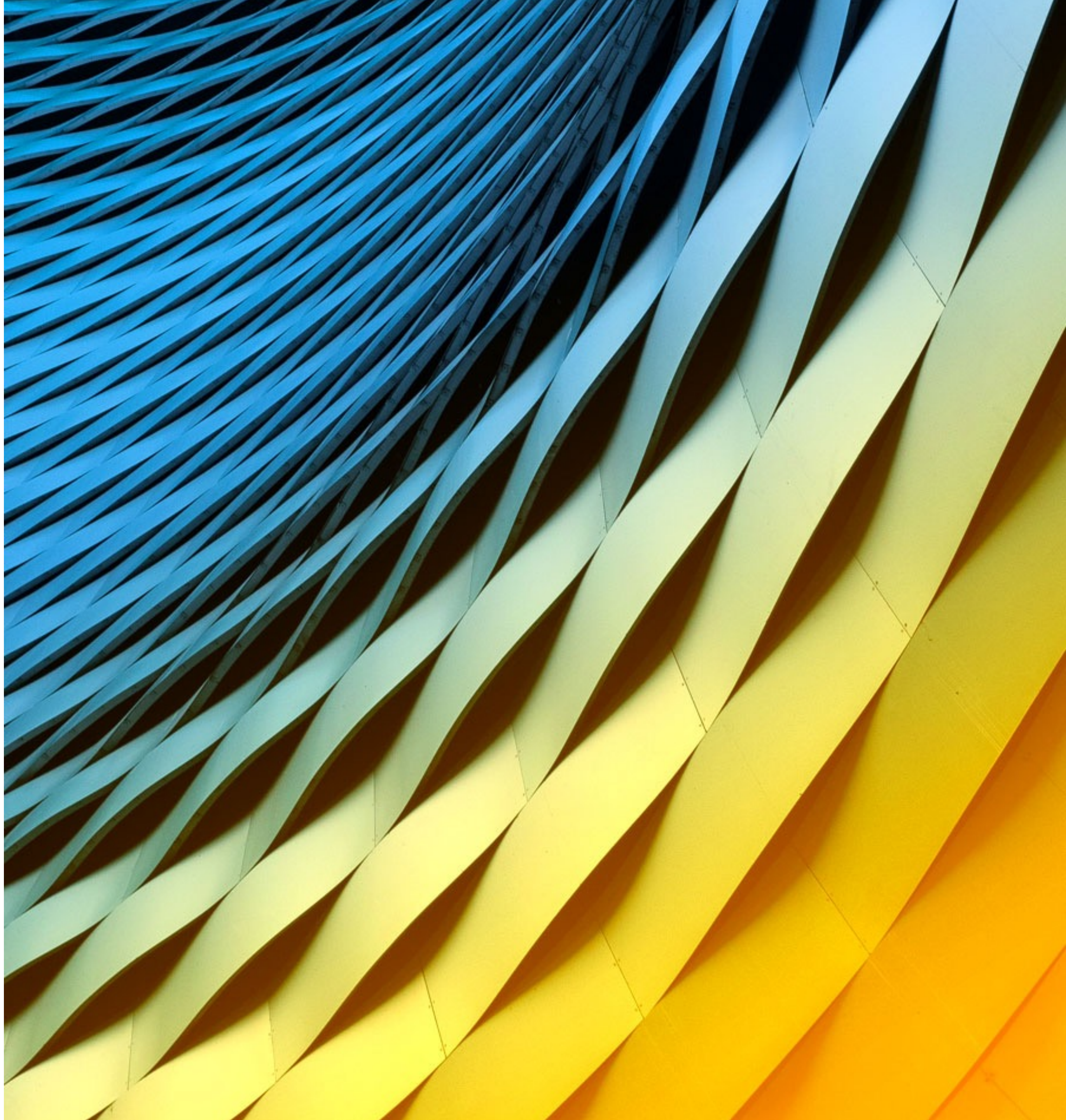

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Presentation Outline

- The basics of put buying
- Using puts to protect a stock portfolio
- The motivation and execution of the Stock Repair Strategy
- Choosing strike prices and managing positions
- Q&A

The Protective Put

Why a Protective Put?

- Investor is bullish on a stock already owned but looking for protection against a downside move

- Establish a floor price at which investor can sell shares, if needed

- Can act like an “insurance policy” on a stock that represents a large % of portfolio

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Rights of Put Buyers

- Options buyers (holders) have rights, not obligations
- Put buyers have the right to sell shares at their strike price
- For this right, they pay a premium to the seller
- When exercising this right, put buyers pay strike x $100 and deliver 100 shares of stock

Similar to Insurance

- Difference between share price and strike price can be considered the equivalent of a deductible
- If shares plummet, investor can sell stock at strike price of the option
- If shares remain flat or rise, the option expires worthless
- Mindset if insurance is not used

Which Strike to Buy?

- Strike selection is a balance of coverage vs. price
  - How much protection do you need vs. how much are you willing to pay for?

Long shares from $56.50

Put Strike	Bid	Ask
$55.00	$2.16	$2.19
$52.50	$1.35	$1.39
$50.00	$0.84	$0.87
$47.50	$0.53	$0.55

How Long Do I Need Protection?

- Time is money—especially in options
- Corporate event (earnings, drug trial results, government contract?)

$56.50 stock with $50.00 Put strike

Expiry	Bid	Ask
15 days	$0.17	$0.21
30 days	$0.39	$0.46
60 days	$0.84	$0.87
90 days	$1.32	$1.41

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Strike vs. Expiry

- How much coverage do you want and for how long do you want it?
- **Scenario**: An investor is bullish but cautious on airline JETX due to upcoming government contract negotiations next month.

If the contract is approved, it's expected that shares will increase 10%. If not, analysts are calling for a 20% reduction. Investor is long shares from $80

Strike vs. Expiry

Long stock from $80 and looking for downside protection over the next 30-60 days:

Expiry	Put Strike	Bid	Ask
March	80	$3.55	$3.80
	75	$1.70	$1.84
	70	$0.70	$0.85
April	80	$4.60	$4.85
	75	$2.65	$2.71
	70	$1.42	$1.49

Strike vs. Expiry

- Based on the investor’s timeframe, protection needs, and overall cost, investor buys 1 April 75 put for $2.70 or $270

- If the contract is approved and stock rallies, the put expires worthless and the investor will lose $270 on the option but gain on the shares

- If the contract is not approved and shares plummet to $65, the investor can exercise and sell stock at $75 or sell put back to market and reassess

Protective Put Example #1

Stock JETX is trading at $81.00

- Investor is bullish/cautious and long from $80
- Investor wants to limit downside risk

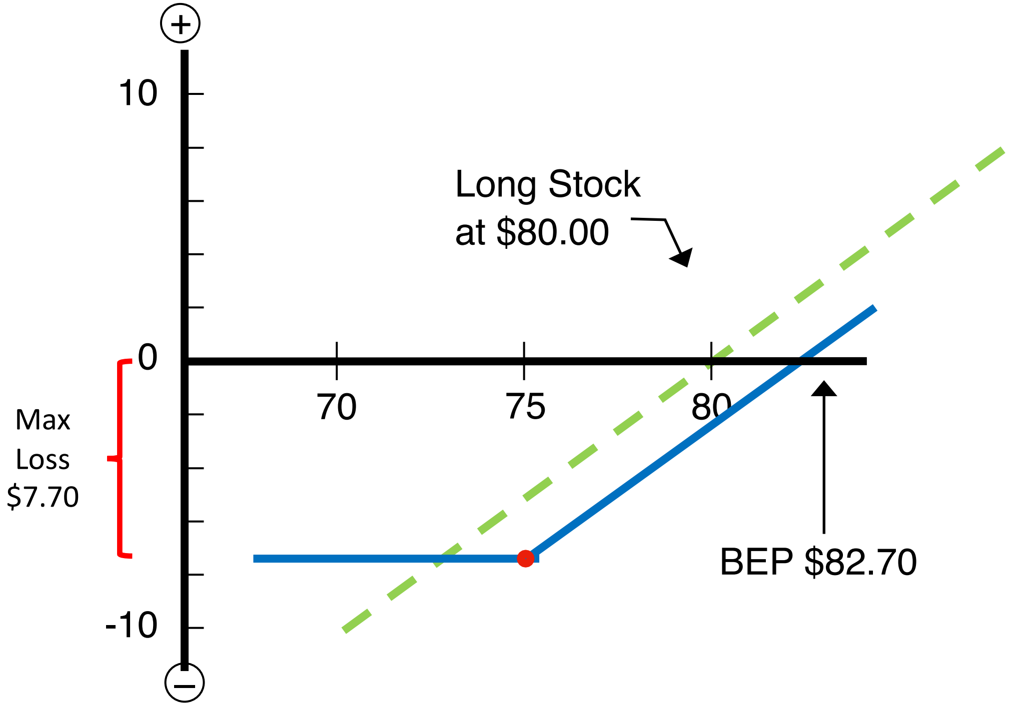
Investor buys a two-month, 75.00 strike put at $2.70 ($270)

- Premium represents roughly 3.4% of investment

Stock price at Expiration	Long 75 Put P/L at Expiration	Long $80.00 Stock Value	Total Profit/(Loss)
$90.00	($2.70)	$10.00	$7.30
$80.00	($2.70)	$0.00	($2.70)
$75.00	($2.70)	($5.00)	($7.70)
$70.00	$2.30	($10.00)	($7.70)
$65.00	$7.30	($15.00)	($7.70)

Protective Put Example

Long Stock at $80
Buy 75.00 strike put at $2.70



Break-even at Expiration:
Initial Share Price + Put Premium
$80.00 + $2.70 = $82.70

Maximum Loss:
Initial Share Price + Put Premium – Strike Price
$80.00 + $2.70 – 75 = $7.70

Protective Put Example #2

- Investor has a $100,000 portfolio, largely reflecting a broad-based index or ETF
- Cautious on the market for the next 90 days & looking to limit downside risk beyond a 10% correction
- Looking to buy puts in a corresponding ETF whose performance closely resembles the index

Protective Put Example #2

Calculations/Inputs:

Portfolio value:	$100,000
Desired Protection:	10% downside ($90,000)
Underlying Index/ETF:	$250
10% Out-of-money put:	225 (250 – 10% = 225)
Price of 90-day 225 put:	$3.00 ($300 per contract)

Protective Put Example #2

Calculations/Inputs:

$$\frac{\textbf{Portfolio \$\$\$ to hedge}}{\textbf{Notional Value of Strike Price}} \quad \textbf{or} \quad \frac{\textbf{\$90,000}}{\textbf{225 x 100}} = \textbf{4 puts}$$

- Investor purchases 4 90-day 225 puts to hedge $90,000 worth of risk
- $1,200 premium ($3.00/contract x 4 puts x $100) is the cost of insurance
- Can also buy fewer puts to hedge less of the position
- Assumes 1-to-1 correlation between portfolio and hedge

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Protective Put Example #2

At Expiration:

Long 4 90-day 225 puts for $1,200:

Index/ ETF	% Gain	Expected Portfolio $ Gain/Loss	Hedging Cost	225 Put Value	Total	Expected Portfolio % Gain/Loss
300.00	+20%	$20,000	$1,200	$0	$18,800	18.80%
275.00	+10%	$10,000	$1,200	$0	$8,800	8.80%
250.00	+0%	$0	$1,200	$0	$1,200	-1.20%
225.00	**-10%**	**-$10,000**	**$1,200**	**$0**	**$11,200**	**-11.20%**
200.00	-20%	-$20,000	$1,200	$10,000	$11,200	-11.20%
175.00	-30%	-$30,000	$1,200	$20,000	$11,200	-11.20%

Put protection kicks in

Not including commissions


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Stock Repair Strategy

What is it?

- Ratio spread using calls to lower the breakeven point of a losing long stock position

Who might benefit?

- Investors that are willing to forego potential long-term profits and/or investors unwilling to commit more funds to an already losing position

What else might an investor do?

- Hold and hope
- Buy additional shares at lower prices to reduce overall breakeven

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Stock Repair Strategy

Scenario: Investor is long 100 shares of a stock from $65. Due to recent market declines, the shares are currently trading $57 and the investor is looking to recoup some of his/her losses.

Possible remedies:

- Investor can 'stay the course' and hope that the stock rallies
- Investor can purchase an additional 100 shares at $57, thus reducing the overall breakeven point to $61/share. This would require him/her to invest an additional $5,700 into an already losing position
- Investor can execute a Call Front Spread with little or no additional funds

Strike	Delta	Bid	Ask
57.00	53	.92	.98
59.00	37	.60	.66
61.00	26	.47	.50

Call Front Spread Setup

- Long 100 shares from $65
- Buy 1 57 call for $.96
  Sell 2 61 calls for $.48
- Front Spread: Even money

Call Front Spread Example (Stock Repair)

Long 100 shares from $65 Long 1 57 call and short 2 61 calls for even money

Share Price @ Expiration	Long Stock P/L	Value of Long 57 Call	Value of 2 Short 61 calls	Net Profit/Loss
$63.00	($2.00)	$6.00	($4.00)	-0-
$61.00	($4.00)	$4.00	-0-	-0-
$59.00	($6.00)	$2.00	-0-	($4.00)
$57.00	($8.00)	-0-	-0-	($8.00)
$55.00	($10.00)	-0-	-0-	($10.00)

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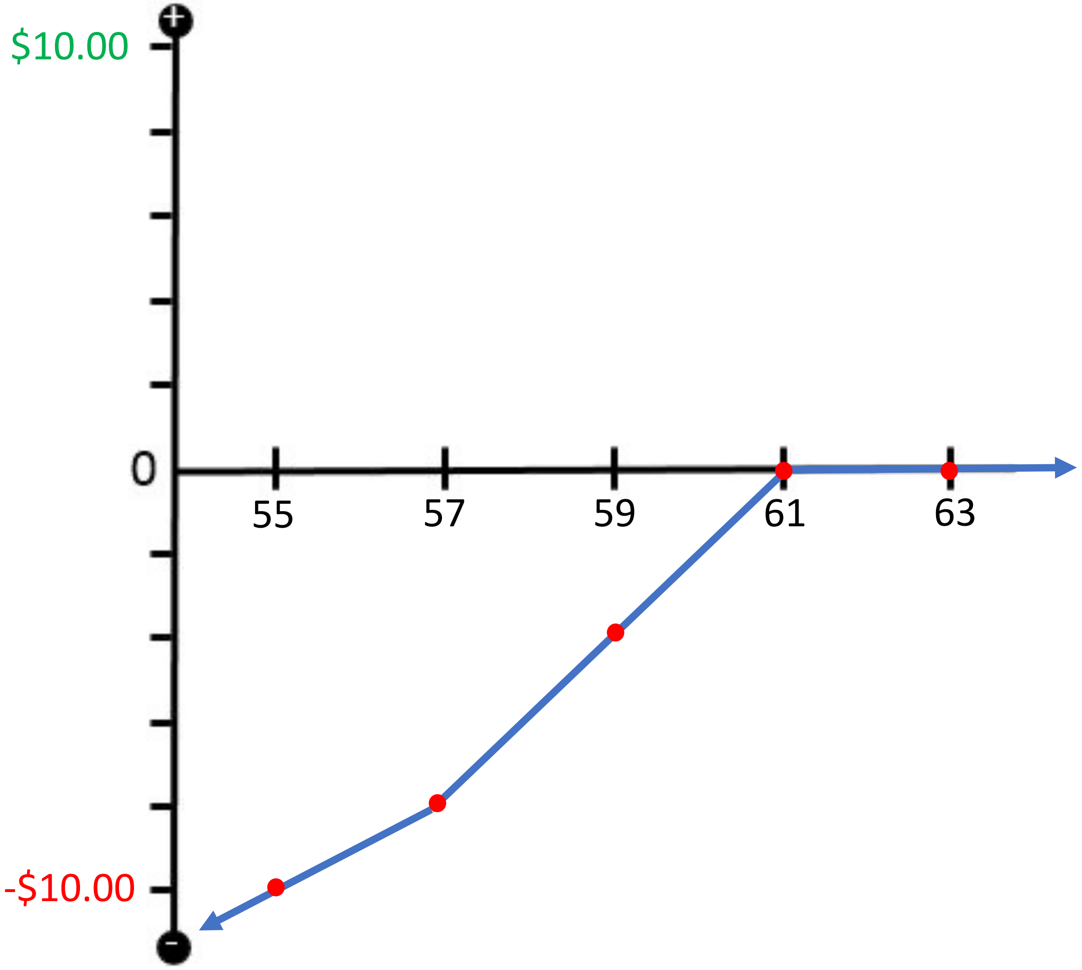
Call Front Spread Example (Stock Repair)



Long 100 shares from $65

Long 1 57 call & short 2 61 calls

EVEN MONEY

Maximum Loss: **Substantial (same as long stock position)**

Maximum Gain: **Breakeven**

Breakeven: **$61—Down from $65 of original long stock position**

For More Information

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