

## **“Put” Away Your Risk: Using Put Options as Portfolio Insurance**

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It's always instructive to reflect back and consider what could have been done differently, especially during bear markets when investors tend to lose money. We advise that you don't waste energy second-guessing when or whether you should have sold stocks. It's likely that none of us will have any better recognition of the next market top than we did in March 2000. But we do have a different suggestion: *portfolio insurance*. Consider that we insure our homes, autos, businesses and even our lives. Now there is a technique that can be used to insure our investments.

We should clarify that portfolio insurance is a technique and not a product. The common form of portfolio insurance can be achieved by buying “Put” options. Put options are a derivative of the underlying stock (or index). They are just the opposite of “Call” options (See *Fiscal Fitness* July 2000 edition: “Taking Cover”). As an example, let's say Pat bought 5000 shares of NEWIPO.com ten months ago @ \$10/share and the stock is now worth \$75/share. Pat doesn't want to sell any shares until he's held them a year to capitalize on long-term capital gain rates. Yet, he worries that the shares are grossly overvalued. What can he do? Buy put options at a strike price that insures him against further downside.

Warning: Only the most adventuresome will want to read the following contents in brackets. [The option **Strike Price** is the price at which you can “put” (sell) the stock to someone else. The **Expiration Date** is the date at which the option contract expires. The **Option Premium** is the amount paid for the option contract. Also, one **Contract** covers 100 shares of the underlying stock. Let's revisit our example: Pat wants to buy 50 contracts to cover his shares (50x100=5000 shares) at the strike price of 70. The expiration date is May 2002 (6 months from now). He is paying \$2 per contract for a total of \$10,000. In buying the puts, Pat has *insured* his holdings of NEWIPO.com against losses below \$70/share for the next 6 months. If the stock falls below the \$70 level, at any time, he has the right to *put* the shares (to the seller of the put contracts) at \$70/share. If the stock doesn't fall below that level, Pat has maintained the value of his shares and considers the \$10,000 to be akin to an insurance premium. Incidentally, expired put options are considered a capital loss in the year of expiration].

It's not as important that you understand the mechanics of Puts as understanding what they can do. That is, insure against losses. The following may be good candidates for this strategy:

- ♣ Investors with large blocks of stocks that aren't ready to diversify their holdings.
- ♣ Investors with appreciated stock waiting for a more favorable time to sell and incur capital gains
- ♣ Nervous investors or those concerned about future market conditions

The cost of the “insurance” is usually 2-3% of the portfolio, depending on the strike price and expiration date. However, this may be a bargain if you're concerned more with downside than upside. Those who are *Fiscally Fit* will always consider when buying puts can be a useful hedging strategy. Talk to us on how Puts can work for you.