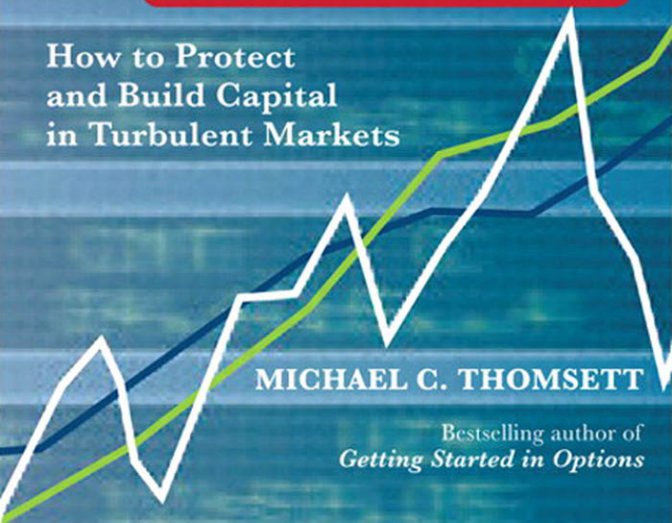
PUT OPTION STRATEGIES FOR Smarter Trading

How to Protect and Build Capital in Turbulent Markets



MICHAEL C. THOMSETT

Bestselling author of
Getting Started in Options

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HOW TO PROTECT AND BUILD CAPITAL IN TURBULENT MARKETS

Michael C. Thomsett

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Michael C. Thomsett is a widely published author with over 70 published books. He is especially known for his options publishing. His books include *Options Trading for the Conservative Investor* and *The Options Trading Body of Knowledge* (FT Press), *Winning with Options* (Amacom Books), *The LEAPS Strategist* (Marketplace Books) and the best-selling *Getting Started in Options* (John Wiley & Sons) which has sold over 250,000 copies and was released in 2009 in its 8th edition.

Thomsett also writes on many stock market investment topics. His *Investment and Securities Dictionary* (hardcover McFarland & Company and paperback Prentice Hall) was named by *Choice Magazine* as an Outstanding Academic Book of the Year. He also wrote *The Mathematics of Investing* (John Wiley & Sons), *The Stock Investor's Pocket Calculator* (Amacom) and *Stock Profits* (FT Press). The author lives near Nashville and writes fulltime. His Web site is www.MichaelThomsett.com.

INTRODUCTION

Surviving in Volatile and Falling Markets

Declining market value in stocks, alarming economic news, chronic housing and credit problems, uncertain oil prices—all these critical conditions that were worse than ever in 2008 and 2009 make the point that you need alternatives to survive in troubling economic times.

There is good news.

The options market is relatively young, but the popularity of options trading has grown exponentially every year since the early 1970s. This has occurred as increasing numbers of investors have realized that options are more than mere speculative tools. They are effective risk hedge instruments, cash generators, and portfolio management tools that virtually anyone can use beneficially. Even if you have very low risk tolerance, conservative options strategies can strengthen your portfolio and reduce market risks while generating current income.

In volatile markets, when you have no idea what stock values are going to be next month or even next week, options are especially valuable. In outright bear markets such as the market that started in 2007 and extended into 2009, put options offer a way to profit from declining stock values. This book is designed to explore a number of put strategies that can be used to provide profits when the markets are falling.

A *put* is an option designed to increase in value when the underlying security's value falls. It is the opposite of a *call*, which is better known as an instrument that tracks a stock's value and rises when the stock's price rises. Traders often overlook put options because so many are naturally optimistic by nature. It is a common pitfall to believe that a stock's value is always going to rise, and many investors treat their purchase price as a starting point from which values can only increase as time goes by. But anyone who was invested in the markets in 2008 and

2009 knows that this belief is flawed and also that it has expensive consequences. Stocks do fall in value. And when they do, it often defies logic. In 2008, rapid declines in stocks once thought to be invincible made the point that markets overreact. By the end of 2008, many stocks were available at bargain prices, but panic and fear were so widespread that few investors were brave enough to put capital into the equity markets.

This is the perfect market for option trading—and for a number of reasons. On a purely speculative approach to markets that have declined, low prices represent values; and when those prices bounce back (as they always do), anyone who got in at the lowest price levels makes handsome profits. However, if you are so concerned about declining stocks that you do not want to invest in shares, options provide attractive alternatives. The same is true when markets peak at the top. Overbought markets invariably correct; so if you don't want to take profits, but you are concerned about declining values over the short term, options can be used to protect stock positions without having to sell shares.

There are so many possible uses for options and specifically for puts that you can take advantage of the potential in any kind of market. Whether prices are depressed or inflated, and whether the mood is bull or bear, puts are effective devices for maximizing profits. In volatile and falling markets, the value of puts is at a maximum. This is true because the mood in the markets is always fearful at such times. When market prices are rising rapidly, euphoria and even unjustified optimism rule, and in these conditions, putting money at risk is easy. But on the opposite side of the spectrum, when prices are low, doom and despair are the ruling emotions; and few people are willing to put money at risk in this environment.

All markets are cyclical, and that is why using puts as portfolio management devices should remain flexible. The most depressing market, whether in stocks, real estate, credit, or housing, is eventually going to come back and improve. When at the worst portion of a cycle, the situation always seems permanent, and investors cannot see their way to a recovery. But recovery does occur, and it always takes the markets by

surprise. By the end of 2008, the P/E ratio of stocks on the S&P 500 had fallen from 26 three months earlier to about 18, a decline of more than 30 percent.[1]

This fall in the overall market's P/E ratio defines the bear market of the time. This ratio, which tracks market sentiment about the future price direction of stocks, is far lower than it was only four years earlier when it peaked above 40; but many people are surprised to learn that the dismal 2008 numbers were higher than historical averages. A few decades ago in the 1970s, S&P 500 P/E fell into single digits and did not rise above 20 until the mid-1980s; so the decline in this important benchmark by the end of 2008 demonstrated that the current market is not as severe or as depressed as it has been in the recent past.

All these historical trends, when viewed in perspective, make the point that even the most volatile current market needs to be analyzed in context. Most market cycles last between two and five years, and the longer the downturn, the more rapid the recovery seems to be. Past cycles have demonstrated this interesting tendency time and again. What this means for investors is that volatility and uncertainty—as troubling as they are—present opportunities as well. And using puts to take advantage of volatility can be quite profitable in several ways:

- Producing short-term profits simply by timing buy and sell decisions based on rapid and volatile price changes;
- Protecting long stock positions by using puts as a form of insurance for paper profits;
- Entering into contingent purchase positions of stock using puts rather than committing funds; and
- Employing a variety of combined strategies to hedge risk while producing short-term profits and leveraged control over stock.

This book explains all the put-based strategies in detail and shows how even a troubled market presents great opportunities to keep you in control. The worst aspect of volatile markets is a sense of not having control over events, and puts can be used to offset this apprehension. You have probably heard that astute traders can earn profits in all types of markets. Puts are among the best devices to accomplish that goal.

[1] Source: BullandBearWise, at www.bullandbearwise.com/SPEarningsChart.asp

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1

THE FLEXIBLE NATURE OF OPTIONS: RISKS FOR ALL LEVELS

Are you investing in companies or in the prices of their stock? A lot of emphasis is placed on the difference between "value" and "growth," but perhaps a more important distinction should be made between what you invest in. If you follow the fundamentals, you are probably investing in the company; if you are a technician, your interest is in the stock and its price movement.

In either case, buying and selling stock are not the only alternatives you have. In fact, the volatility of the market, by itself, makes the case that just using a buy-and-hold strategy is very high risk when markets are volatile. All you need to do is to compare prices of some of the best-known companies between the end of 2007 and 2008 to see what a disastrous market that 12-month period was. This includes 28 out of 30 stocks on the Dow Jones Industrial Average, which all lost value.[1]

When you buy shares of stock, you enter into a rigid contract. You pay money for shares, and those shares either increase or decrease in value. You are entitled to dividends if the company has declared and paid them. And if you own common stock, you have the right to vote on corporate matters put forth by the board of directors. The stock remains in existence for as long as you want to continue owning shares, and you have the right to sell those shares whenever you wish.

[1] In 2008, only two Dow companies—McDonald's and Wal-Mart—gained in value. The other 28 DJIA stocks all fell.

With options, the contract is quite different. An option controls 100 shares of stock but costs much less. However, holding an option grants no voting rights and no dividends (unless you also own the stock). You can close an option position at any time you want on listed options on stock. But perhaps the most important distinction between stock and options is that options have only a finite life. They expire at a specified date in the future. After expiration, the option is worthless. So it has to be closed or exercised before expiration to avoid losing all its value. You exercise a put by selling 100 shares at the fixed strike price, and you exercise a call by buying 100 shares at the fixed strike price.

> **Key Point:** Stock and option terms are quite different, including indefinite versus finite lives, dividends, and voting rights.

Options, in general, contain specific *terms* defining their value and status. These terms include the type of option (put or call), the underlying security, the strike price, and expiration date. Every option's terms are distinct; listed option terms cannot be changed or exchanged other than by closing one option and replacing it with another.

Terms of Options

The terms of each option contract define it and set value (known as premium) for each and every option contract. These terms are described next.

Types of Options

There are two kinds of options: puts and calls. A put grants its owner the right, but not the obligation, to *sell* 100 shares of a specific underlying security, at a fixed strike price, and before the specified expiration date. A seller of a put may be obligated to buy 100 shares at the fixed strike price, which occurs when the market value of stock is lower than the put's strike price.

A call is the opposite. If you buy a call, you have the right, but not the obligation, to *buy* 100 shares of a specific underlying security, at a fixed strike price, and before the specified expiration date. A seller of a call may be obligated to sell 100 shares at the fixed strike price, which occurs when the market value of stock is higher than the call's strike price.

> **Key Point:** Holders of long positions are not obligated to exercise, but their positions give them leveraged control over 100 shares of stock per contract.

The rights and obligations of option buyers and sellers are summarized in Figure 1.1.

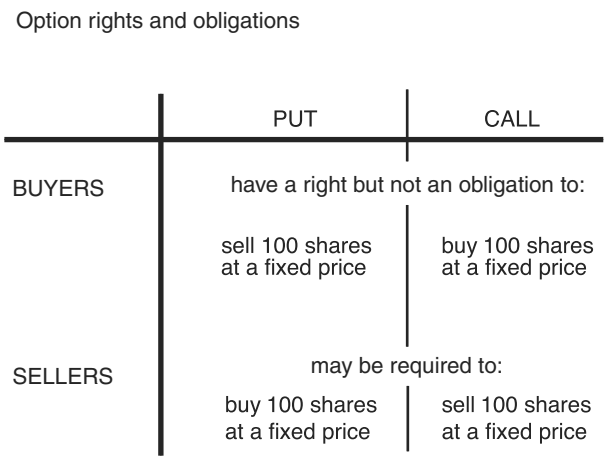

Figure 1.1 Option rights and obligations

Put values rise if the underlying security's share price falls. This occurs because the fixed strike price does not change; so the lower the current price of the stock, the more valuable the right to sell 100 shares at the higher strike price. For a call, the value rises when the underlying security price increases; so the higher the current price of the stock, the more valuable the right to buy 100 shares at the lower strike price.

For example, if you buy a put with a strike price of 35 and the stock's market value falls to $28 per share, you gain a 7-point advantage. You can sell 100 shares of stock at the strike price of $35, or $700 higher

than the current market value of the stock. If you buy a call with a strike price of $40 and the stock's market value rises to $44 per share, your call grants you the right to buy 100 shares at the strike price of $40, or $400 below current market value.

These basic attributes of options form the rationale for all strategies, whether they involve one or more option positions, short or long, and combinations of various kinds (options hedged against stock positions, combinations of call with call, call with put, or put with put in a variety of long or short positions and employing one or many different strike prices.) The strategic possibilities are endless and provide hedging and insurance for many positions and in many different kinds of markets.

Underlying Security

The underlying security may be 100 shares of stock, an index, or a futures position. This book limits examples to options on stock, which are the most popular in the options market and also the most likely kind of underlying security most people will use for option trading. The underlying cannot be changed. Once you open a long or short option position, it is tied to the underlying and will gain or lose value based on the direction the stock moves.

> **Key Point:** Every option position relates to a specific underlying security, and this is not transferable.

The underlying may have a fairly narrow trading range, or it may be quite volatile. The degree of price volatility in the underlying (market risk) also affects option premium values. The greater the volatility, the greater the value of the option. This volatility premium, also called *extrinsic* value, will change as expiration date approaches; but for longer-term options, the volatility of the underlying is a significant portion of total premium value. So the attributes of the underlying are essential for judging the value of options. It is a mistake to determine which options to buy or sell based solely on their current value; the quality of a company on a fundamental basis and the price volatility of its stock (or its technical risk attributes) have to be compared and judged as well to make an informed trade decision.

Strike Price

Strike price is the fixed price at which an option can be exercised. The strike price determines total option value. The proximity between strike and the current value of each share of stock determines whether premium value is growing or shrinking. When a put's strike is higher than the current market value of the underlying stock, it is *in the money*; and when a call's strike is lower than the current market value of the underlying stock, it is also in the money. If the stock's price moves above the put's strike or below the call's strike, the option is *out of the money*. If stock share price and the option's strike price are exactly the same, the option is *at the money*.

> **Key Point:** The proximity between strike price and current market value of the underlying determines the premium values of every option.

These relationships between strike of the option and current value of the underlying security are summarized in Figure 1.2.

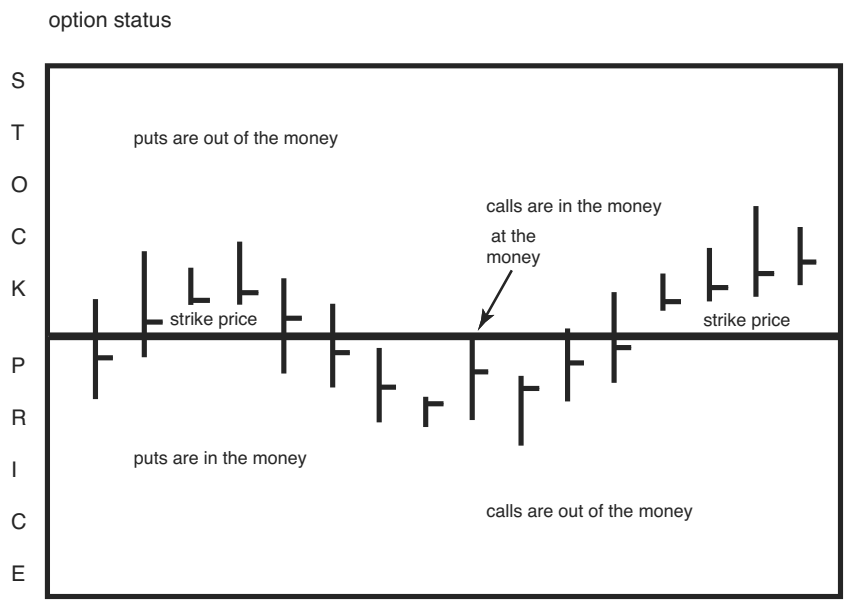

Figure 1.2 Option status

Expiration Date

An option's expiration date is fixed and cannot be changed. It occurs after the third Friday of the expiration month. Standard listed options expire up to eight months out, and the longer-terms option (LEAPS, or Long-term Equity Anticipation Securities) expire up to 30 months away, always in January.

The time to expiration determines how options are valued. The longer the time, the greater the portion of an option's premium known as *time value*. It may be quite high when options have many months to go before they expire, but as expiration nears, the decline in time value accelerates. By expiration day, time value falls to zero.

> **Key Point:** The fact that options expire means value is also finite; unlike stock, every option becomes worthless as soon as the expiration date has passed.

For option buyers, time is a problem. If you buy an option with a long time until expiration date, you will have to pay for that time in higher premium; and if expiration will occur in the near future, premium is lower, but the rapid decline in time value makes it difficult to create a profit. Three-quarters of all options expire worthless, making the point that it is very difficult to beat the odds simply by speculating in long puts or calls.

In comparison, option sellers (those who short option contracts) have an advantage in the nature of time value. Because it declines as expiration approaches, short positions are more likely to be profitable. Short sellers go through a process of sell-hold-buy rather than the traditional long position, which involves the process of buy-hold-sell. So the more decline in an option's premium, the more profitable the short position. Expiration is a benefit to option sellers and a problem for option buyers.

Valuation of Options

Every option has an overall value, known as its premium. But the total premium consists of three specific parts: intrinsic value, time value, and

extrinsic value. The first two are quite easy to understand, but extrinsic value is where all the variations are going to be found. For example, if you look at two stocks with the same market value and with options for the same strike and expiration, you are still going to find differences in those option premiums. The reasons are explained by extrinsic value.

Intrinsic Value

The option's intrinsic value is easy to understand. It is the point value equal to the option's in-the-money level. For example, a 30 put has three points of intrinsic value when the underlying stock is at $27 per share ($30 - $27 = $3). If the stock's value is higher than the put's strike, there is no intrinsic value.

> **Key Point:** Intrinsic value is equal to the number of points between strike price and current market value above (for a call) or below (for a put).

A call has intrinsic value whenever the underlying stock is higher than the call's strike. For example, if the strike is 45 and the current value of the underlying is $51 per share, the call has six points of intrinsic value ($51 - $45 = $6).

Intrinsic value will always track with the underlying stock's price movement. For a put, the intrinsic value increases point-for-point as the stock value falls; and for a call, intrinsic value increases point-for-point as the stock's value rises.

Although intrinsic value is easily defined and understood in the sense that it moves point-for-point with the underlying, the *total* premium does not always change exactly with price changes. The variation occurs because of the nature of extrinsic value (explained later). When you see a stock's price move by three points and the option change by only two or perhaps by four points, the explanation involves an offset between intrinsic and extrinsic value. So although intrinsic value does change predictably, total premium may offset that movement because of price adjustments made in extrinsic value. The risk and volatility of the stock, time to expiration, and changing technical information about the company all have an effect in extrinsic value.

Time Value

Time value is just as easy to track as intrinsic value. The longer the time to expiration, the higher the time value. As expiration approaches, time value declines and the rate of decline accelerates as expiration nears. So there is going to be very little change in time value for a LEAPS option with two years to expiration, and a very rapid deterioration of time value during an option's last two months of life.

Option buyers struggle with time value, because declining premium levels make it difficult if not impossible to build profits in long option positions. For example, if you buy an out-of-the-money put for 3 ($300) and with six months until expiration, you need the underlying to move down by three points in-the-money (below strike) just to break even by expiration; and it has to move even further to make any profit.

> **Key Point:** Like intrinsic value, time value is predictable and specific; it declines as expiration approaches, ending up at zero.

Option sellers benefit from declining time value for the same reasons. For example, if you sell an out-of-the-money put for 3 ($300) and with six months until expiration, you need the underlying to move only by less than three points in the money to make a profit. Because none of the premium is intrinsic, as long as the stock remains at or above the put's strike, it is easy to profit from declining time value at any time before expiration.

Extrinsic Value

Of the three types of premium in an option, extrinsic value is the most interesting and the most complex. It is a reflection of the price volatility (market risk) of the underlying stock. The more volatility, the higher the extrinsic value as a rule. But the longer the time to expiration, the more variation you will find in intrinsic value. It is even possible that increases in intrinsic value will be offset by declines in extrinsic value—due simply to the fact that a lot can happen in an extended period of time.

For example, you buy a put LEAPS with 24 months until expiration. Strike is 25 and the stock currently is at $25 per share (at the money). Total premium is 7 ($700). You believe the stock's market value will decline and create a profit in coming months; you are also aware that the entire premium consists of nonintrinsic value. Over the following month, the underlying declines to $21, a drop of four points in the money. However, the option premium grows only to 9, a change of two points.

> **Key Point:** Extrinsic value is the only form of option value that is uncertain, and that varies based on underlying market risk and volatility.

In this case, two things have occurred. There is little or no change in time value because the time to expiration is so far off. Intrinsic value increased by four points ($25 - $21 = $4); but extrinsic value fell by two points (4 - 2 = 2). This offset is an odd combination of factors. It contains the influence of time and volatility. With 24 months remaining until expiration, the offset between intrinsic and extrinsic value is a way that the market questions whether that particular option should be priced for the entire amount of intrinsic change. While the adjustment is made to intrinsic value, time has a lot to do with this offset; if there was less time remaining in the life of the put, the offset would not be as severe and, in fact, it might not occur at all.

Extrinsic value plays a role in option premium that modifies the effects of both intrinsic and time value. Neither of those portions of the option premium change as part of this price adjustment. Because intrinsic and time value are specific and exact, the change is extrinsic only. Remember, both intrinsic and time value are predictable. Intrinsic value reflects the number of points in the money (so when the option is at the money or out of the money, there is zero intrinsic value). And time value changes on a time-based curve and does not change over time. Time value is affected solely by the proximity of expiration.

Even though these rules are specific, extrinsic value is affected by both the degree of intrinsic change and the time until expiration. This complexity explains why a longer-term in-the-money option premium does not exactly track changes in the underlying; it also explains why even

out-of-the-money options are often quite unresponsive to changes in the underlying. For example, a long-term put that is out-of-the-money might have little or no change in the premium even when the underlying moves closer to the strike price level. The unresponsiveness of the option premium in long-term out-of-the-money status makes sense because you cannot expect more point-for-point changes until (a) expiration is much closer and (b) the option is in the money.

> **Key Point:** Although extrinsic and time value are not the same, the variation in extrinsic value often is affected by the time remaining until expiration.

The variation between degrees of stock price change and option premium change is called *implied volatility* and defines option values when they do occur. An option's premium is almost always worth at least its intrinsic value, and in cases in which it falls below that benchmark, it is going to be very temporary. Because both intrinsic and time value are specific, any bargains in option pricing are going to be found in adjustments to extrinsic value, known as an evolving trend in the option's implied volatility.

Dividends and Puts

Most traders who buy calls know that dividends have a negative impact on premium value. This occurs when the stock goes ex-dividend, the day when the dividend is factored into the share price. However, while this is a negative factor for call buyers, it is a positive one for put buyers.

Since dividends reduce the share value of stock, in-the-money calls are expected to also lose value. But because puts increase in value as stock price falls, an in-the-money put will *increase* in value at ex-dividend date. This reality may affect the timing of many put strategies. Knowing in advance that the put's value will fall because ex-dividend date is looming builds in extra premium appreciation beyond the normal cause and effect of price change in the underlying. The strategy of timing with a dividend in mind is the same for long puts as it is for short

calls; a decline in the stock price is predictable, so the long put will increase in value (beneficial to its owner or buyer) and the short call will decline in value (beneficial to the seller).

> **Key Point:** Whereas dividends are a detriment to call buyers because stock prices fall as a result, they are a benefit to put buyers. The decline in underlying value is offset by an increase in the put's premium value.

Dividends are often overlooked as a factor in both the selection of options and the timing of trades. This is a mistake; dividends represent a significant portion of potential profits on both stock trades and option trades. For example, if you select a stock paying a relatively high dividend (4 percent, for example), ownership of the stock includes an ensured 4 percent annual return. This is even greater if the dividends are reinvested in partial shares, which converts the nominal rate into a compound rate of return.

Dividend income is also significant when considering the relative value and likely outcome of a put strategy that includes ownership of stock. You earn dividends only if you own shares of stock, so this extra consideration applies only when strategies include long stock positions in conjunction with long or short positions. When you compare likely outcome in a number of scenarios, include dividend income in the equation.

For example, you may construct an option strategy combining a long stock position with either long or short puts, or with puts and calls in spread or straddle positions. If you are looking at several different companies as potential candidates for such a strategy, including the dividend income often makes a substantial difference. Assuming that the assumed value of each issue is comparable, a dividend-paying stock is likely to produce a better overall yield than a stock that does not pay a dividend (or one paying a much smaller dividend).

In coming chapters, return calculations include dividend income as a means for comparison. For example, if three different stocks using the same strategy are assumed to produce a range of returns between 7 and

8 percent, a 3 percent dividend on one stock will make it the clear winner in overall income.

Besides augmenting total income from a combined stock and option strategy, dividends create a cushion of downside protection in the stock position. Stocks held for many years grow significantly in value when quarterly dividends are reinvested and when additional income is generated through option strategies. Many of these combined strategies are quite low risk and may produce consistent cash income representing double-digit returns (including dividends), but with little added market risk when compared to simply owning shares of stock.

Comparing Risk Levels

Any option strategy should be analyzed with risk in mind. Any single-option long position contains a specific market risk, based on the fact that most are going to expire worthless or be closed at a net loss. The effects of declining time value make it very difficult to profit from buying options for speculation.

Many additional reasons for buying puts can justify the market risk. For example, protecting paper profits in appreciated stock by buying puts provides a form of insurance. If the stock price does retreat, appreciated put value offsets the decline in value; the put can be closed at a profit to recapture the paper profits lost; or it can even be exercised. This allows you to sell 100 shares of stock for each put owned, at the fixed strike price. So as long as the strike is higher than current market value, this type of long put position hedges the stock position. In a volatile market, this can be a valuable strategic move; it can make long stock positions more acceptable even with high volatility in the market because potential losses are insured against as long as the put position remains open.

> **Key Point:** The many specialized uses of long puts make them more than speculative in nature. They can reduce or eliminate risk in long stock holdings and work as an affordable market risk hedge.

Additional advanced strategies combining long puts with stock, with short puts, or with calls can also make the long put valuable as a source for potential profits or as a means for limiting risk in the overall position. So puts serve as a device for reducing profits in numerous stock and combined option positions.

Risk comparison should also be made between short puts and short calls. Writing naked calls is one of the highest-risk option strategies because, in theory, a stock's market price can rise indefinitely. This means that the true risk of a naked call is unknown. It is defined as the difference between market value of the stock and the short call's strike price, minus the call's premium received when the position was opened:

(current value, 100 shares - strike price, short call) = short call risk

This is "unlimited" because you cannot know how high the current price per share is going to reach. So uncovered calls are high risk. In comparison, a *covered* call is not only low risk; it is exceptionally conservative. By definition, a call is usually covered when you also own 100 shares of the underlying. In the event of exercise, you simply give up the 100 shares of stock at the strike price. So as long as the strike is higher than your original basis in the call, you profit with exercise from three sources: capital gain on the stock, premium on the short call, and dividends. Covered calls produce annualized returns in double digits in many cases because time value decline translates to higher profits for the call seller.

A short call is also "covered" when you own a long call that expires on the same date or later, and at the same strike. If the strike is higher, the risk is limited to the difference between the two strikes. For example, if you sell a May 55 call and buy a May 60 call, upon exercise you would exchange 100 shares at 60 for 100 shares at 55; your risk is limited to five points ($500). So a "covered" call based on short and long positions is usually only a partial reduction of risk. The difference in strikes combined with the net credit or debit normally translates to a net risk, but a relatively small one.

Key Point: A short call can be covered by ownership of 100 shares of stock, or by ownership of a long call expiring at the same date or a later date than the short position.

Short puts also contain risks and cannot be truly covered in the same way as calls. This means that while a short call is covered with 100 shares of long stock, a short put is not as easily made lower risk. However, short puts are not as risky as short calls, a fact often overlooked by those who want to go short on options. A short call may end up in a loss position, but the loss is not indefinite. A stock can fall only to zero, so a lower strike price represents a lower "worst case" risk. In a practical sense, the true risk of a short put is not really zero; it is actually the tangible book value of the stock. For example, if a stock is selling today at $34 per share and tangible book value per share (net worth less intangible assets) is $11 per share, the true maximum risk is $23, before considering the put premium received when the position is opened. If you receive a premium of 4 ($400) when you sell a put, the net tangible risk is 19 points:

($34 - $11) - 4 = 19 ($1,900)

If the entire premium is nonintrinsic (meaning the stock's market value was at or higher than the strike when the put is sold), this maximum risk is quite unlikely. As time moves on and expiration approaches, time value falls and the short put loses value.

Risk is further mitigated by rolling techniques. If the short put does go in the money, exercise can be avoided by closing the position or by rolling it forward. Short call sellers roll forward to a later exercise date, or forward and *up* to a higher strike to avoid exercise; short put positions are rolled forward to a later exercise date, or forward and *down* to a lower strike. Although rolling extends the period of exposure, it can result in an additional credit while avoiding exercise.

Considering the limited risk between strike and tangible book value per share, the decline in time value, and the ability to avoid exercise through rolling, short puts—often considered high-risk strategies—are actually not that high risk. This is especially true when the short put is

combined with other stock and option positions, which are explored in detail in later chapters.

> **Key Point:** Uncovered call risk is unlimited and cannot be known; uncovered put risk is finite because the underlying can fall only so far.

The point to keep in mind about risks and puts is that strategies can be devised and designed to match your risk tolerance quite well. The purpose to any strategy should be understood and carefully articulated. In a volatile market, puts can be used to protect long stock positions, take advantage of exceptionally wild price gyrations, or simply to speculate on a rapidly changing market. For management of your portfolio, short and long puts serve many purposes and, when used appropriately to reduce risks, hedge other positions, or maximize income opportunities, can enhance profits while holding risks to a minimum.

Many stockholders have a sense of helplessness when markets become volatile, especially when the volatility takes market-wide prices to the downside. Widespread apprehension keeps many people out of the markets, awaiting further developments even if that means missing exceptional opportunities. Using puts in place of adding new positions to a depressed portfolio not only makes sense financially, but also enables you to control stock without needing to commit funds, protect paper profits, and create short-term profits even in the most unpredictable markets.

The next chapter examines risk hedge as a basic put strategy and shows how proper use of puts offset (and in many cases entirely remove) risk from other portfolio positions.

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