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The Protective Put Strategy

As a reminder, a put gives an owner the right but not the obligation to sell a certain stock, at a specific price, by a specified date.

For this opportunity, the buyer pays a premium. The seller, who receives the premium, is obligated to take delivery of the stock should the buyer wish to sell the stock at the strike price by the specified date. A strategically used put offers maximum protection against substantial loss.

The Protective Put, also referred to as a "married put," "puts and stock" or "bullets," is an ideal strategy for an investor who wants full hedging coverage for their position.

Whereas the Covered Call Strategy will cover an investor down only as far as the premium he receives, the protective put strategy will protect the investor from the breakeven point down to zero.

This strategy's philosophy is different from the covered call (buy-write) strategy in two major ways.

The covered call is a premium selling strategy, while the protective put is a premium purchasing strategy; and the covered call is most effective in a less volatile situation while the protective put is more effective in high volatility situations.

When an investor purchases a stock, he can either sell the call (buy-write) or buy the put (protective put) to provide a proper hedge. The construction of the protective put position is actually quite simple. You buy the stock and you buy the put on a one to one ratio meaning one put for every one hundred shares.

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Remember, one option contract is worth 100 shares. So, if we have 400 shares of IBM then you would need to purchase exactly four puts.

Number of Shares Owned	Put Contracts to Buy
100	1
300	3
1700	17
9200	92
14500	145
267000	2670

From a premium standpoint, we must keep in mind that by purchasing an option, we are paying out money as opposed to collecting money. This means that our position must "outperform" the amount of money that we put out which is the opposite side of what we did in the covered call strategy.

If we were to pay $1.00 for a put and we owned stock against it, we would need to have the stock increase in price $1.00 just for us to break even. Unlike the covered call, the protective put strategy has the premiums working against it, thus the stock needs to move more to offset the cost of the put.

This is why long option strategies need more volatility than short option strategies. Earlier we talked about the covered call strategy needing to be done over a decent period of time (a year or so) in order to take advantage of the odds.

We stated that selling options and collecting the premium was the right thing to do 75% – 82% of the time. If this is true, then buying an option and paying out premiums is only going to be right 18% – 25% of the time.

Those are not good odds. So, you should try to stay away from employing this strategy over a long period of time to avoid having the odds fall against you. However, employing a protective put can be extremely effective in the proper situation.

Let's take a look at the risks and rewards of the protective put strategy over three different scenarios.

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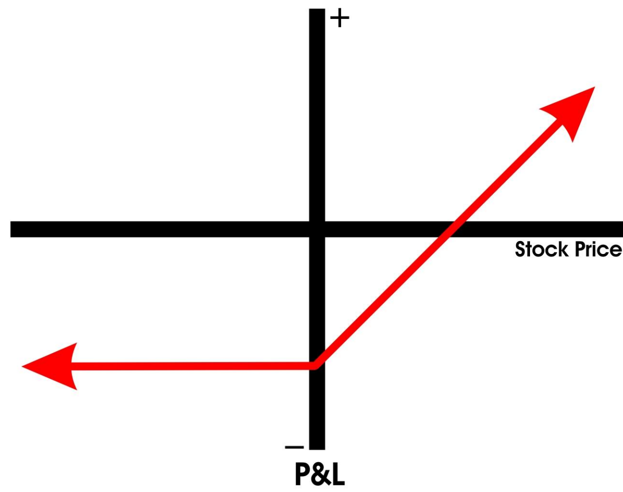
Protective Put Strategy P&L Chart



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