

## Key Point in Protective Put Strategy

Key Point - The protective put strategy, when used correctly, will allow investors to take advantage of some opportunities that could provide large potential gains without being exposed to the severe risks that normally accompany such risky opportunities. With the proper protection in place, the investor can profit from aggressive upside moves in the stock while having a fixed, limited loss.

As stated before, this strategy is not going to work all the time. However, there are some especially favorable opportunities for implementing the protective put strategy.

One is the case of a stock in the process of a steep decline. Quite often, stocks experience bad news or break down through a technical support level and trade down to seek a new, lower trading range.

Everyone wants to find the bottom to buy and go long, catching the technical rebound, or to start accumulating the stock at lower levels for the longer term.

Although this scenario sounds good, these types of trades are risky. The risk is in identifying the true bottom. A stock that is in a freefall or rapid decline might give a false indication of a bottom which could lead to substantial losses. The protective put will provide protection against this kind of substantial loss.

A stock that goes through a freefall finally "exhausts" or works through the sellers. The stock proceeds down to lower levels where sellers are no longer interested in selling the stock.

At this level, the stock consolidates and buyers move in. Because the sellers are now done (exhausted) the pressure is lifted from the stock and it proceeds up as buyers out-number sellers.

There are models that are used to calculate where this bottom may lie, commonly referred to as "exhaustion models." The problem is that the stock, on the way down, may stop and give the appearance of exhaustion but then continue further down. If you had bought at the false appearance of exhaustion, you could be looking at a big loss.

There is a potential for a very big reward if you pick the "right" bottom.



However, with the big potential gain comes the big potential loss that is common in these types of risk/reward scenarios. Here is a perfect opportunity to employ the protective put strategy!

Remember, the protective put allows for a large potential upside with a limited, fixed downside risk. If you feel that the stock has bottomed out and is starting to consolidate, you purchase the stock and purchase the put.

If you are right, and the stock runs back up, the stock profit will well exceed the price paid for the put. Once the stock trades back up, consolidates, and develops its new trading range, the need for the protective put is over. At this time, if you still like the stock and want to hold on to the long position, you could always start selling calls against it.

Use the formula for maximum loss discussed earlier. Calculate the loss in the stock and the amount you paid for the put and add them together for your maximum loss in this position. The protective put has limited your loss.

$$\text{Maximum Loss} = (\text{Stock Price} - \text{Strike Price}) - \text{Option Price}$$

This protection will save you enough money when you pick a false (wrong) bottom that you may, if you like, try to pick the bottom again at a lower point. The exhaustion scenario, as described here, is a perfect opportunity to apply the protective put strategy.

As seen with the exhaustion example, the protective put strategy is best used in situations where the stock has a potential for an aggressive upside move and the chance of a big downside move.

Another potential opportunity for using the protective put is in combination with Technical Analysis. Technical Analysis is the study of charts, indicators oscillators, etc. Charting has proven to be more than reasonably accurate in forecasting future stock movements.

Stocks travel in cycles that can and do form repetitious patterns. These patterns are predictable and detectable by the use of any number of charts, indicators and oscillators.

Although there are many, many forms and styles of technical analysis, they all have several similarities. The one we want to focus on is the technical "break-out." A break-out is described as a movement of the stock where its price trades quickly through and beyond an obvious "technical resistance" or resistance point.



For a bullish breakout, this level is at the very top of its present trading range. Once through that level, the stock is considered to have "broken out" of its trading range and will now often trade higher, and establish a new higher trading range.

The "break-out" is normally a rapid, large upward movement that usually offers an outstanding potential return if identified properly and acted upon in a timely fashion. However, if the break-out fails, the stock could trade back down to the bottom of the previous trading range.

If this were to happen, you would have incurred a large loss because you would have bought at the upper end of the previous trading range. As you can see the "break-out" scenario is an opportunity that has large potential rewards but can on occasion, have a large downside risk.

Therefore, this is an excellent scenario for application of the [protective put strategy](#).

For example, XYZ is presently at the top of a trading range with the upper end of the range being \$66.00 and the bottom end of the range being \$58.00. When the chart, indicator, or oscillator you are using identifies the break-out of the stock (when it trades through \$66.00), you would buy the stock immediately.

The risk of the stock not following through with its breakout is not large but it does happen. The stock could trade back down to \$58.00 which is the bottom of the trading range. If you had bought the stock naked above \$66.00, you would realize a minimum \$8.00 loss.

However, if you were to apply a protective put strategy with the stock purchase, you can drastically limit your downside exposure. For instance, say you were to buy the 65 strike put for \$2.00. If the stock trades up to \$75.00, you would make \$9.00 if done naked but only make \$7.00 if done with the protective put.

This difference is the cost of the put. This \$2.00 investment is more than worth it should the stock go down. If the break-out turns out to be a "false" break-out and the stock reverses and trades down, your 65 put will allow you to sell your stock out at \$65.00 minus the \$2.00 you paid for the put. This limits your loss to \$3.00 instead of a potential \$8.00 loss. This is a much better risk/reward scenario.

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