

Day Traders, Swing Traders and Options? Perhaps!

Protective Puts Could Prove Gainful When Buying On Break-Outs and Bottom Fishing

By Ron Ianieri

Day and swing traders typically look for stocks with short-term movements. They are not in the business of holding positions overnight let alone a week or two. Options are, therefore, not a popular component of their trading strategies. With new opportunities for profit now available, many firms are allowing their traders to trade options. They soon find that option strategies do not apply to the in and out nature of day trading. Since these traders often look for break-out and go bottom fishing for profitable opportunities, premium paying options can be gainful.

Why is this the case? Bottom fishing and break-outs are associated with volatility. A strategy can provide traders with the necessary protection to carry positions through overnight risk while remaining fully protected. They also benefit from the large potential upswing, which is the original goal of identifying the bottom and the break-out. This strategy is the protective put.

The Protective Put

A put option gives an owner the right, but not the obligation, to sell a certain stock at a certain price by a specified date. The owner pays a premium for this right. The buyer, who receives the premium, is obligated to take delivery of the stock should the owner wish to sell at the strike price by the specified date. A strategically used put option offers protection against substantial loss.

The protective put involves the purchase of put options in combination with the purchase of stock. This strategy is very effective in stocks that normally trade under high volatility, or in stocks that do not trade under high volatility but may be involved in an event driven, volatile situation.

When an investor purchases a stock, they can buy the protective put to provide a proper hedge. The construction of this position is simple. The investor buys the stock and the put at a one-to-one ratio, meaning one put for every 100 shares. One option contract is worth 100 shares, so if a buyer purchases 400 shares of IBM, they need to purchase exactly four puts.

Investors must keep in mind that by purchasing an option, they are paying out money as opposed to collecting money. This means that their position must “outperform” the amount of money that they paid for the put. If a buyer paid \$1.00 for a put and owned stock against it, the stock must increase in price \$1.00 just to break even. The protective put strategy has a time premium working against it, thus the stock needs to move to a greater degree, and more quickly, to offset the cost of the put.

Three potential outcomes exist with stocks. The stock can go up, down or remain stagnant. Only one outcome, the stock going up, can produce a positive return. That occurs only when the stock increases more than the amount the buyer paid for the puts. The other scenarios produce losses. If the stock is stagnant, the investor loses the amount paid for the put. They lose again if the stock goes down, but the loss is limited. This limitation of loss in highly volatile situations makes the protective put so attractive.

How This Strategy Can Work For You

Imagine you buy stock for \$31.00 and buy the 30 strike put for \$1.00. If the stock goes down, the position will produce a loss. If the stock is down to \$30.00 (down \$1.00) at expiration of the option, you have a \$1.00 capital loss. With the stock at \$30.00, the 30 strike puts will be worthless. You incur a \$1.00 loss because that is what you paid for the put. Your total loss will be \$2.00. The protective put strategy, which

allows you to set loss limits, set a cap on your losses.

Let us examine this in detail. We will set the stock price down to \$28.00. Since you purchased the stock at \$31.00, there will be a capital loss of \$3.00. The puts are now in the money with the stock below \$30.00. With the stock at \$28.00, the 30 strike puts are worth \$2.00. You paid \$1.00 for them so you have a \$1.00 profit in the puts. Combine the put profit (\$1.00) with the capital loss (\$3.00) and you have an overall loss of \$2.00. The \$2.00 loss is the maximum you can lose no matter how low the stock goes because the buyer of your put must take the stock at the strike price. The put provides this protection.

It is possible to calculate anticipated maximum loss before every protective put trade by using the following formula:

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

Suppose you pay \$30.00 for your stock and you want no more than a \$3.50 loss on the position. You would choose the \$27.50 strike put that costs \$1.00. Following the formula, you take your stock price (\$30.00) and subtract the put's strike price (\$27.50), which leaves you \$2.50. To this \$2.50 loss, you then add the amount you spent on the option (\$1.00), which gives you a combined maximum loss of \$3.50 for this position. You can set your loss limit by the strike price of the put you buy and the cost of the put. This formula will work every time and there are several scenarios where the protective put strategy deserves consideration.

Picking the "Right" Bottom

A stock in the process of a steep decline is an ideal opportunity to implement a protective put when trying to pick a bottom. 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.

There is a potential for a very big reward if you pick the "right" bottom, but with big potential gain comes an equal potential for loss. Here is a perfect opportunity to employ the protective put strategy. It provides protection against substantial loss and allows room for potential gains if the stock bounces. If you feel that the stock has bottomed out and is starting to consolidate, purchase the stock and put at the same time as insurance against further decline.

If the stock runs back up, its profits 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. If you still like the stock at this time and want to hold on to the long position, you can always start selling calls against it.

Technical Analysis

Another potential opportunity for using the protective put is in combination with Technical Analysis. Technical Analysis is the study of charts, indicators and oscillators. It has proven to be reasonably accurate in forecasting future stock movements. Stocks travel in cycles that form repetitious patterns. These patterns are predictable and detectable by the use of any number of charts, indicators and oscillators.

Although there are many forms and styles of technical analysis, they have several similarities such as the technical "break-out." A break-out is a movement of the stock where its price trades quickly beyond an obvious "technical resistance" or resistance point.

For a bullish break-out, this level is at the very top of its present trading range. Once through that level, the stock has "broken out" of its trading range and will often trade higher and establish an even 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. If the break-out fails, the stock could trade back down to the bottom of the previous trading range. You will incur a large loss because you bought at the upper end of the previous trading range. This “break-out” scenario is an opportunity that has large potential rewards but can on occasion, have a large downside risk.

You can drastically limit your downside exposure by applying a protective put strategy with the stock purchase. For instance, if you were to buy the 65 strike put for \$2.00 and 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 fall. 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. This is a much better risk/reward scenario.

Even the most successful traders struggle to make money consistently. They spend a month building up profits only to lose that money in just one day – sometimes on one stock. Avoiding a handful of these losses could amount to soaring profits. Turning to protective puts when buying on break-outs and bottom fishing is perhaps the key to the professional traders due rewards.

***Ron Ianieri** enjoyed fourteen years of success as a floor trader on the Philadelphia Stock Exchange, including 4 years as the lead market maker in DELL computer options – one of the busiest books in history. He is currently Chief Options Strategist and Co-Founder of The Options University, an educational company that teaches investors how to make consistent profits using options while limiting risk. For more information about The Options University or options trading please visit www.optionsuniversity.com or call 866-561-8227.*