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Options Strategies
Protective Puts

How to insure your stock portfolio against a market fall with protective puts

Overview

Investors looking to purchase stocks when they are trading at historically low valuations, without the worry of further downside risk, may want to consider the Protective Put strategy.

It is amazing the number of investors who would choose to insure their car but neglect to protect a much larger stock portfolio. This is especially surprising considering the amount of control you have over a car compared to the control you have over the stock market.

For a relatively small cost, protective puts allow investors to lock in a guaranteed sale price on their shares over a pre-determined period in the future. Although a range of different contract timeframes are available, for the sake of simplicity, we'll look at 6 and 12 month protection, similar to the timing of mainstream insurance policies.

There are two main ways that investors can take advantage of protective puts, these are detailed below.

When buying stock

The first way to implement the strategy is when entering the stock for the first time. For example, if an investor was to buy stock XYZ at $20.00, they could simultaneously purchase $20.00 protection for approximately $1.60.

What this means is that for the next 12 months, you have the right to sell your stock at the same price you purchased it for. In other words the largest loss you can incur is the cost of the insurance policy, in this example your total risk on the trade over a 12 month period is limited to just 8%. The cost of insuring stocks can be reduced or even eliminated if dividends are used to pay for the protective put.

If the market falls , clients with a protective put can sell out at their entry price, and re-enter the position at the lower price. This allows investors to increase the number of shares held without having to provide more capital.

Locking in profits

The second way to implement the strategy is when a stock has seen some significant capital gains which you want to lock in, without selling your stock.

Similar to the example above, if an investor had bought a stock at $20.00 and proceeded to see it run to $30.00, they may have the view that short term it is overbought and wish to take out insurance allowing them to sell at the $30.00 level for 6 months. The cost of this could be expected to be around $1.35 or 4.5%. This means that after the 50% run the stock has had, even if the stock were to fall to zero over the next 6 months the investor would still be up 45.5%. Again dividends will reduce costs further through this period.

In both these examples, if the stock were to continue to rally the investor could sell the insurance policy on market for some residual value, and there is no capping of upside and no dividends are at risk.

Want more information?

There are a range of other methods by which to reduce the cost of protection which your adviser can discuss with you if you call today!

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