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Options Strategies
Selling Puts

How to generate an income or buy stocks below the current market price with selling puts

Selling Put options (Puts) is often used as a way to generate an ongoing income to supplement any type of portfolio. This strategy guide provides the general risks and rewards when selling Puts.

Given the nature of the strategy, it is recommended that investors use an ASX accredited derivatives adviser when implementing this strategy.

How it works

The seller of a Put is making a commitment to buy a stock at a certain price (known as the 'strike price') over a specified period of time (known as the 'option expiry day'). The strategy is commonly used in two ways. The first is to buy stock below the current market value should it reach a pre-determined price and the second is to take a bullish to neutral view on the market, in other words investors can profit from a view that a stock will stay flat or increase in value.

Here is an example

XYZ is currently trading at $34.50 at the start of January. You feel that the stock will present great value should it fall to $31.

By selling 10 Puts with a strike price of $31 and a January expiry, you are making a commitment to buy 1000 shares of XYZ at $31 should it close below this strike price on the January expiry day*. For making this commitment the options market will pay you approximately $550**.

If XYZ does not close below the chosen strike price of $31 at the chosen expiry date, then you will keep the premium with no further obligation. If it is trading below $31 at expiry you will be required to buy XYZ at $31. (With a lower effective entry price with the premium received)

You can choose to repeat this exercise at various strike prices for an ongoing income.

Avoiding unwanted exercise

Early exercise is when the buyer of the option chooses to assign (i.e. sell the stock to you) at the chosen strike price before the expiry date.

It is for this reason that investors will need to ensure they have enough cash available to buy the stock should it reach the chosen strike price. However, while it is important to keep this in mind when entering a position, there are a number of techniques available to avoid early exercise.

The most common is to sell European style options rather than American style options. Both of these styles are available for most stocks in the ASX top 50.

Another way is to roll the sold Put once it is "in the money" which involves buying back your sold Put and then selling another Put for another month further out.

Speak to your PhillipCapital adviser for more information on either of these strategies.

A sold Put does not need to be held to expiry, either, for every day the put is kept open (all else being equal) the time value component of the option decays in value, until finally expiring worthless on the expiry date. This notion is called time decay and works in favour of the seller.

* Options Expiry is generally on the last Thursday of the month, an in-depth calendar of options expiry dates can be viewed here: http://www.asx.com.au/ products/futures-options-expiry-calendars.htm

** Please note that the premium received will vary depending on a number of factors , while the example above uses a real life premium, it is important to speak to your adviser about the various factors that affect this amount.

Understanding the risks

The seller of a Put option should be aware that they may be early exercised at anytime, this only applies to American style options and means that you could be required to take up the stock before the expiry date should the buyer of the option choose to exercise the Put. This will usually only occur if the chosen stock is trading below the nominated strike price.

If the seller of the Put is required to take up the stock at the nominated strike price, they can choose to sell the stock at any time on the market in which case they will be liable for the difference between the market price and the strike price.

To ensure that the seller of the Put is able to cover this potential shortfall, they need to ensure that they have adequate funds available to cover their margin requirements.

These margins are held by the ASX Clear while the sold Put position is open. The seller of a Put can meet margin requirements by either using cash or by lodging existing shares with ASX Clear as security. If cash is used to meet margins, investors will continue to receive interest on the funds held at the cash rate. Investors who lodge shares will still receive all dividends and franking credits.

Lodging existing shares with the ASX Clear is an efficient way to generate additional returns from the market without having to put new money to work. When doing this it is recommended to use European style options to avoid early exercise.

We can do the hard work

The multitude of different scenarios and situations cannot be covered in detail through this strategy guide, so we suggest that investors use an ASX accredited derivatives adviser when implementing this strategy. We have specialist advisers who provide this and various other options strategies for their clients.

Want more information?

To enquire about options strategies that could potentially generate a monthly income for you, speak to one of our ASX accredited derivatives advisers today.

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