Option Trading Series – eBook 6 of 8

BUYING PUTS TO OPEN

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About the author

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Emmanuel has over twenty-five years experience in financial markets, including equities, CFDs, options and futures. Emmanuel started his career with Société Générale in Paris, then with Citibank, Jefferies, Brown Brothers Harriman in London in equities, options and fixed-income trading before joining Internaxx Bank (now Swissquote Bank Europe) in Luxembourg.

Emmanuel is a member of the Client Services team of Swissquote Bank Europe, where he works closely with clients and team members to service the advanced trading needs of our most active clients.

Now, let's get introduced to the world of puts.

We established previously that buying calls is a bullish strategy, while selling calls is bearish.

A put gives its buyer the possibility to SELL the underlying security at the strike price, until its expiration. The buyer of a put will therefore profit from a fall in value of the underlying security from the moment he bought the put, since he'll be able to either exercise it and sell the shares at the (higher) strike price, or else simply "sell to close" the put at a higher price.

Buying put options can have two main purposes:

- either speculating that a security will lose value.

  In this case, you do not own the underlying shares, but feel that the security is due for a fall. Maybe the stock price has gone up a lot lately, and you think a correction will happen soon; or you have studied the company's fundamentals and you think the price is too high. Buying puts will make you profit from a fall in the share price.

- or protecting an existing position against a possible short-term loss: a "protective put".

  Here, you already own the underlying shares, and of course you're hoping they will rise in value in the long-term; but you want to protect yourself against a possible short-term correction, without selling the position. In this case, buying a protective put will make sense. Think of it as an insurance, designed to protect the value of your assets for a limited time.

Irrespective of whether you buy a speculative or a protective put, you will need to pay the premium upfront for the privilege of benefiting from a possible fall in price. If the price does not fall between the purchase of your put and its expiration, the put will expire worthless, and your premium will be lost.

When you buy puts, the higher the strike price, the higher the price (premium) of your option. Therefore, if you want to reduce your cost when buying puts, you can look at a slightly lower strike price. The trade-off is that you will receive less if you exercise them.

Exercising puts vs selling to close

Let's take a scenario where you own 100 shares of company A, but want to protect your stock position against a possible price fall in the next two months, because it rose up a lot lately and you would like to "lock in" this recent gain. So you buy a put – let's say 'at the money', which means the strike price is very close to the stock price.

A few weeks later, you are celebrating your intuition, since the stock has just lost 20%! And you decide to cash in on your put.

You have two possibilities, which will be roughly as profitable, with one notable difference:

1. Exercise the put

You call Swissquote Client Services, and ask them to exercise your put in company A (the Swissquote system does not have an online exercise function).

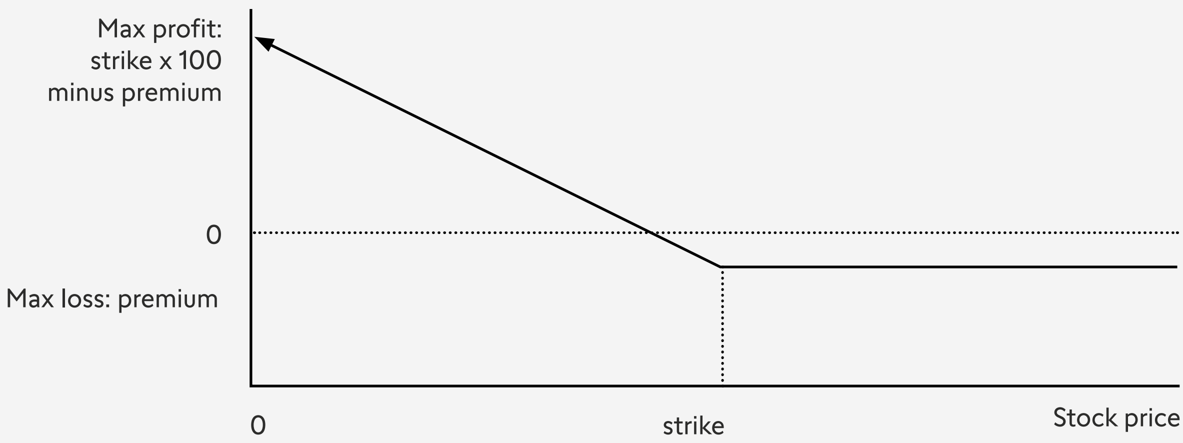
Shortly afterwards, when you log into your account, you will see that your 100 shares were sold at the strike price for you. The put option has also disappeared.

2. Sell the put to close

You log into your account, and sell your put at market best.

Because the put price is inversely related to stock A's price, you will sell the put at a profit. The difference here is that you still hold your shares; their loss in value was compensated by your put's gain. Your insurance has paid off.

Selling puts to open: P&L Chart



Here is our generic profit and loss chart for a long put.

One line summary

A long put lets you profit from a fall in price of the underlying security until expiration.

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