PUTS AND CALLS FOR THE CONSERVATIVE INVESTOR
Common Sense Strategies

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Conservative investors can enhance their earnings or reduce their risk by the careful buying and/or selling of puts and calls. Puts and calls are options to sell or buy an underlying security at a given price, the strike price, on or before a given date, the expiration date. When you buy a put or a call (you are the buyer or owner or holder of the option), you have the right but not the obligation to buy or sell the underlying security. When you sell (you are the seller or writer of the option) a put or call, you have the obligation to deliver the underlying security if the option is exercised.

Puts and calls are traded on several exchanges. Sophisticated traders with fast access to the markets and advanced tools to identify arbitrage opportunities use puts and calls combined with risk-free investments and/or other investments in order to make short-term financial gains. The strategies discussed here are not aimed at such financial professionals. Rather, they are meant for conservative long-term investors.

What characterizes conservative long-term investors? Generally, they seek growth in their portfolios through buying stocks representing good businesses—companies that are well managed, have a good future, generate cash, have reasonable amounts of debt, and whose stocks are listed, liquid, and marketable—and do this buying when the share price is undervalued or reasonable valued. They tend to hold stocks for three to ten years or even longer. They are optimists who are long-term bullish on the economy in general and certain industries and stocks in particular. And with discipline, focus, patience, and a modicum of luck they usually become rich over time.

Investors such as this may fine tune their portfolios with the discrete use of options for purposes of generating additional portfolio income, protecting and/or hedging and/or leveraging existing long positions, and specifying a target date for buying or selling a stock.

If you buy a put or call, you may or may not choose to exercise it depending upon whether doing so would be profitable or not. If it is profitable to do so, then you exercise the option and take your profit. If it would not be profitable to exercise the option, merely let it lapse; you will forfeit the premium you paid for the option, but you will not be risking the capital necessary to have bought the underlying stock.

The buyer/owner/holder of a call (referred to as being long on a call) has the right to buy a security at the strike price on or before the expiration date for which the buyer will pay a premium to the seller. The seller/writer of a call (referred to as being short on a call) is obliged to deliver the underlying security if the call is exercised. If the call writer does
not have the stock to deliver, he will have to purchase it on the open market to provide timely delivery.

The buyer of a put (long on a put) has the right to sell a security at the strike price on or before the expiration date for which right the buyer will pay a premium to the seller. The seller of a put (short on a put) is obliged to buy the stock at the strike price from the put owner if the put is indeed exercised.

Note carefully that the buyer of an option--a call or a put--has a choice as to whether to exercise the option or let it expire. In contrast note the obligations of the seller:
1. The seller of a call has the obligation to deliver the underlying security if the call owner exercises the option. If he is long on the security he must merely deliver the security to the call owner. If he is short on the security he must buy it in the market in order to deliver it.
2. The seller of a put has the obligation to buy from the owner the underlying security at the exercise price if put owner exercises the put.

As a seller of options, an investor must be keenly aware of his obligations the ramifications of which are discussed below.

Some significant facts about puts and calls:

- Generally, puts and calls that are openly traded on exchanges have standardized contract terms. For such options, one put or one call is equal to 100 shares of the underlying security. (There are other “customized” option contracts but we won’t get into that in this paper.)
- Options are bought from and sold to a clearinghouse that guarantees payments or delivery. There is no reneging.
- The price actually paid for or received from an option is at or between the bid and asked price of the option depending upon the valuation at the moment of the transaction. The valuation of the option may change very quickly reflecting a change in the valuation of the underlying security.
- The value of the option bought or sold is stated on the investor’s brokerage account as a long or short position. No money changes hands until the option is exercised or expired.
- Commissions for options trades at on-line discount brokers are as low as $8 plus a small charge (<$1 per contract). Full service brokers charge higher, of course.
- All brokers will require cash or stocks to be used as collateral (margin) to allow you to buy or sell options. If the price of the underlying security goes against your position and if there is not enough collateral (cash or securities) in your account to cover your obligation, your broker may require you put up more margin. This is known as a “margin call,” and if more margin is not forthcoming, your broker may sell out your position to ensure adequate coverage of your obligation.
- The expiration date for most options is between one to nine months and falls on the third Friday of a given month.
• Longer-term options called LEAPS expire after a year or two on the third Friday in January of a given year.
• Few options are actually exercised. Some are traded or rolled over, but most expire unexercised.

In the examples given below, individual stocks are presented. But the same logic and transactions can be utilized with exchange-traded funds with the exception that index funds options sometimes may not be exercised before their expiration date. Also, note that all computations of profits and losses do not include transaction fees or taxes.

When to Buy a Call

Buying calls is a bullish strategy. Generally, as a long-term investor, when considering buying a call select one with an expiration date well into the future, at least a year or two. But be aware that the premiums received from or paid for long term options on a given stock are relatively more expensive than those with an earlier expiration date. Calls expiring in just one or two months are cheaper but they are less predictable, just as the markets are for such a short term. However since the long-term trend for the stock market (but not necessarily any individual stock) is and always has been up, your chances for a profitable transaction are enhanced when you buy a call expiring later rather than sooner. Here are some scenarios.

1. You Don’t Have Enough Cash. You are bullish on a stock but don’t have enough cash to take a meaningful position. So, buy some calls.

For example, you like Sage Corp. currently selling at $25.73. You see it selling for well above that price in the next year or so and you’d like to buy 1,000 shares but you don’t have $25,730 in ready cash. However, the twenty-four month calls with an exercise price of $25 can be bought for $6.40. So, you buy 10 calls that cost you $6,400. There are three possible results of this transaction:

a) If at (or before) the expiration date the underlying stock is selling for more than $31.40, you might exercise the option thereby purchasing the shares. Your cost for the stock is the $25 exercise price plus the $6.40 call price for a total of $31.40. That’s your break-even point. Anything above that is profit. So, exercise the call, received the tendered shares, and immediately sell them. Or, if you are still bullish in the stock, exercise the call and hold the stock.

b) If at expiration should the stock be selling for anything between $25 and $31.40, exercise the option and limit your loss in the cost of the call.

c) If at expiration the stock is selling for less than $25, you allow the calls to expire, and your loss is the cost of the calls, $6,400.
2. **You Bought the Stock but You Want More of It.** You’re really bullish on the stock and can buy 1,000 shares long but you want to enhance your profit potential. So, buy the 1,000 shares long and buy 10 calls. In essence, you have leveraged your position in the stock. In the Sage Corp. case above, you have a downside risk of the cost of the long position, $25,730, but a limited risk of the call position, $6,400. So consider these as two separate transactions, each with its own risk and reward potential.

3. **You Want to Increase Your Long Position but You Don’t Want to Double Down.** You are long-term bullish on a stock but see some significant short-term downside risk and you don’t want to place too much money in jeopardy. So, go long in the stock and if it still gets lower buy some calls.

For example, you’ve been following Chelsea Corp. for some time but it has always been too pricey. It recently sold at $49 per share, 50 times trailing earnings. After many years of growth, the company missed its numbers one quarter and the price plummeted to a more reasonable $22. You think Chelsea’s fundamentals are good and its recent earnings stumble is a blip, so you bought 500 shares at $22. Then after trading around that price for a few months the stock went down again, this time to $18. If it looked good at $22, it looks even better at $18. You could double down and buy another 500 shares at $18, thus lowering your average cost per share to $20, but you may be wrong about the stock. You’ve already committed $11,000 to your long position and you don’t want to jeopardize any more funds than you need to. It may take some time for the stock to recover to where you think it should be priced, but unfortunately there are no really long LEAPS on the market in so you buy five calls with a strike price of $15 expiring in six months for $3.10 per share. Your break-even point on the calls is $18.10. You have committed $1,550 giving you the option to buy another 500 shares.

   a) If at expiration date the stock goes up to $20, you have a paper loss of $1,000 your long shares but if you exercise your calls you made $950 ($20 price - $18.10 cost = $1.90 profit X 500 shares = $950. So your net loss if you were to sell your long shares is $50 ($1,000 loss on long shares - $950 profit on calls.

   b) If at expiration date the stock goes to above $20, you’ll be making more money the exercised calls and losing less on the long position

   c) If at expiration the stock stays at $18 or goes lower, you’ll have a paper loss on the long position and will exercise the calls if the price is above $15 so as to recoup some of the premium you paid for them.

   d) If at expiration date the stock is selling for less than $15, your long position will have a paper loss and you will not exercise the call thus forfeiting the premium paid.

The advantage to buying calls rather than doubling down is that you have risked less capital in the transaction.
The scenario described above—buying the stock after a significant price drop (okay by itself) and then buying calls at an even lower price—could be characterized as “throwing good money after bad.” This might indeed be the case, that’s why rather than risking a lot of capital on another long position at the lowered price, you buy calls. The key to the decision here is to have done due diligence before you take the initial long position and re-do the analysis after the subsequent price drop. In other words, this is not a bet, but rather an investment based upon logic and reasoning. If the stock does not rebound in a reasonable period (a few years) thus enabling you to profit from the calls and the long position, then in retrospect it was throwing good money after bad. But if your reasoning and logic resulting in having bought the calls was sound, then you have nothing to be regretful about. Sometimes things just don’t work out.

When to Sell a Call

Selling calls is a bearish strategy or a way to hedge a position. Also, it is a way to impose a “sell discipline” on yourself. Here are some scenarios.

1. You Want to Realign Your Holdings. You are long in a stock and are bearish or neutral about its six-month outlook, but bullish on its long-term outlook. You have a good long-term profit in the stock but you want to lighten up a bit as you rebalance your portfolio. So, you sell some calls.

For example, you have 6,000 shares of Haley Corp. presently selling at $37.65. You sell 10 six-months calls with an exercise price of $30. Your premium is $8.30 per share for a total of $8,300. Several things can happen.

   a) If the stock is down to $30 per share or below at the expiration date, the call will not be exercised and you pocket the premium, $8,300, while you wait for better times for your long position.

   b) If at the expiration date the stock closes between $30 (the strike price) and $38.30 (the strike price plus the premium), the call will be exercised and you will deliver 1,000 shares to the holder of the call but keep the premium you received. In essence, you have sold 1,000 shares for $38.30. When you sell the calls using the share price when you sold the call of $37.65, you have made a profit of $0.65 per share, or $650. And your remaining long 5,000 shares have increased in value.

   c) If at the expiration date the stock price is over $38.30, the call will be exercised and you will deliver the stock to the call holder. This is the sell discipline mentioned above. For the 1,000 shares represented by the ten calls you were perfectly willing to sell them at $38.30. You have lightened your position in the stock which was your goal. You will have foregone the profit of the 1,000 shares tendered (although you profited on the receipt of the premium) but your remaining 5,000 shares have participated in the stock’s price rise. That’s the hedge.
2. **You Want to Get Paid for Waiting.** [This is similar to the realignment of your portfolio in #1 above, but the rationale is somewhat different.] You are long in a stock and are neutral about its short-term prospects. It pays a 3% dividend, and has a beta of .8. The stock provides ballast to your portfolio and has some decent upside long-term potential. Also, it is in an industry that is not overly represented in your portfolio. You don’t see the stock moving much up or down in the next few months, and if you were to sell some of it, that would be fine since you have some profit in it. So, sell some calls for half your shares.

For example, you are long 1,600 shares in Farbank Corp. The stock is presently selling for $36.71. Seven-month calls with an exercise price of $35 are selling for $2.10. So, sell eight calls, half your position. What can happen?

a) If at expiration the stock is higher than $35, the calls will be exercised and you will tender 800 shares taking your profit on them and pocket the $1,680 premium received from the sale of the calls. You also keep any dividends received during the call period.

b) If at expiration date the stock is lower than $35, the calls will not be exercised so you pocket the premium received and still have the shares. You keep any dividends received during the call period.

It should be noted that the selling of calls discussed above assumes a long position in the underlying stock of the call. This is a “covered call.” If the call you sold is indeed exercised by its owner you have merely to deliver the stock that you already have.

In contrast are “naked calls,” calls sold without a long position in the underlying stock. This is a very risky transaction and is not recommended for conservative investors. If you sell 10 naked calls on Haley Corp with a strike price of $30 for a premium of $8.30 and the calls are exercised when the stock price is $60, you have to deliver 1,000 shares of stock you don’t have, which means you have to buy it on the open market. Thus, you’d buy at $60 and sell at $38.30 (the exercise price plus the premium). This is not a good strategy for making money. Suppose the stock price when the call is exercised is $100, or $200, or $500. The sky’s the limit. You could find yourself in big trouble.

Selling naked calls is selling someone an option to buy something you don’t already own. A related transaction is “short selling.” Through your broker, you borrow shares and sell them with the expectation that they will be selling for a lower price later on, at which time you will buy them in the market and return the shares to the person from whom they were borrowed. You’ve sold high and bought low, a good way to make money. But suppose the stock price doesn’t go lower than your selling price, rather it goes higher, much higher. You must buy those shares to replace the borrowed ones. And suppose there is a reluctance by shareholders to sell their shares (a situation known as a “short squeeze”), and the price gets bid up to the stratosphere. What do you do then? You have to buy the shares on the open market and make good delivery on them. This is a very risky business and is not recommended as a strategy for conservative investors.
Selling short or selling naked calls is not a conservative investment. Rather, it’s a high-risk investment and is best left to professional traders. If as a conservative investor you buy a stock long for say $1,000, the worst thing that can happen is you lose your investment, all $1,000. Your liability is limited (this is known as a bounded risk). However, if you sell a stock short you can lose your shirt if the stock price rises significantly (this is known as an unbounded risk). Theoretically there is no limit to your liability because there is no limit to how high a stock price can go and you are obliged to tender those shares.

If you sell a put, your liability can be extensive being limited only by the possible worthlessness of the underlying security. For example if you sell 10 naked puts with an exercise price of $40 and receive a premium of $2.50 and the shares become worthless, at expiration the put owner can buy and tender to you those worthless shares and you have to buy them for $40,000. Your loss is the entire $40,000 offset in part by the $2,500 you received as a premium. This is dangerous stuff!

The phrase *caveat emptor*, let the buyer beware, is a good rule to follow when purchasing a house, a hammer, or a Hyundai. But with options it’s the seller who needs to beware. The option owner’s losses are limited to the forfeiture of the premium paid for the option purchased. He can choose not to exercise the option and merely loses the premium he paid. On the other hand, it is the seller of the option who has great risks because once the option is sold the matter is out of his hands. It is the option owner who is controlling the game and if things go her way—the price of the underlying security of a call goes way up (an unbounded risk since there is no limit to how high the price of the underlying stock can go) or the price of the underlying security of a put goes way down (a bounded risk since the price of the underlying stock can not go lower than zero)—she can reap great profits while the seller experiences great losses.

**When to Buy a Put**

Buying a put is a bearish strategy and you are basically a bullish investor. Yet there may be a time or two when buying a put might make sense. Here are two scenarios.

1. **You Want to Sell Your Stock, but Not Right Now.** You are long on the stock and have a profit but you have a neutral or bearish long-term outlook on it. Its better days are behind it. You could sell it now but you already have large capital gains and you want to postpone the sale to the next calendar year. Buy some puts that expire next year. This is called a “postponing put.”

   For example, you bought 800 shares of Donnar Corp. six years ago at $35 per share. The current price is $73. You are neutral or bearish on the stock. You want to sell it but it is now October and for tax purposes you want to wait until next year to take your profit. So, you buy eight puts at $2.10 with a strike price of $70 expiring in January of next year. Your cost is $1,680. What can happen?
a) If at the expiration date the stock price is higher than $70, you sell your 800 long shares in the market, take your profit on the sale and forfeit the premium paid for the put. If the selling price is over $72.10 you make money on the transaction. The higher the price the more you make.

b) If at the expiration date the stock price is down, exercise your put at $70 and tender the long shares at lower market price.

c) If at the expiration date the stock price is still at $73.77, sell the 800 shares in the market and forfeit the premium paid for the put.

2. You Bought a Stock But You Want some Insurance on It. You are long-term bullish on a stock but fear a near-term price decline. So, buy some puts for insurance. This is known as a “protective put.”

For example, you like Tagalet Corp that is presently selling for $57.75. You buy 600 shares long for $34,650. And simultaneously you buy six puts expiring in 15 months with a strike price of $45 for $1.20, a total cost of $620. What can happen?

a) If at the expiration date the stock price is higher than $45 and you are still bullish on the stock you can keep your long position, 600 shares. The put itself is worthless and you are out the $620 you paid for the put. Consider that $620 as term insurance that has lapsed; it was there when you needed it and now you don’t.

b) If at the expiration date the stock price is below $45, buy the stock at the lower market price and exercise your put at $45. If you buy the stock at less than $43.80, you make money. The lower the price at the expiration date, the more money you make.

When to Sell a Put

Selling a put is a bullish strategy. If you are a conservative investor and you are bullish on a stock you can either buy the stock long or buy calls on the stock or do both, although each strategy is different and each has a different profit potential. And of course, if you are bearish on the stock, you wouldn’t want own it in the first place. However, if you don’t have the cash to buy the stock outright or buy calls on the stock, you could accomplish your goal by selling a put. But note the nuances of such a transaction.

If you are long on the stock and sell a put, the most you can profit from the transaction is to keep the premium in the event that the stock price goes up and the put is not exercised. But if the price goes down the put will be exercised. You have risked having to buy the stock from the put owner at a high price relative to the current selling price and this can put a considerable amount of capital at risk for a relatively paltry premium.

For example, you are bullish on Orelco Corp stock currently selling at $17.80 and have a long position of 1,000 shares worth $17,800. You sell 10 six-month puts with a strike price of $20 at $2.58 and receive a total premium of $2,580. The stock tanks to $5.00.
The put is exercised and you have to pay the owner $20,000 for the 1,000 shares you are obligated to buy.

Your total long position is now 2,000 shares currently priced at $5 totaling $10,000. Your cost is $17,800 for the original long position and $20,000 for the exercised put totaling $37,800 for a position now worth $10,000. You have incurred a loss of $17,800 while having gained $2,580 from the premium received for a net loss of $15,220. Was it worth the risk for the premium received? Probably not, although you do now have 2,000 shares of a stock on which you are bullish so perhaps better times lie ahead. But you paid $20,000 for half of those shares.

On the other hand, if in addition to your long position of $1,000 shares you had bought 10 six-month calls with a strike price of 20 for $0.80 paying a premium of $800, and the stock had tanked to $5, your long position would now be worth $5,000 resulting in a loss of $12,800 increased by $800 for the premium paid for a total loss of $13,600. You still have the long position of 1,000 shares.

In both cases losses were incurred, but with the long-stock/short-put strategy you lost $1,620 more than on the long-stock/long-call strategy. So as illustrated, selling puts is not a good strategy for conservative investors.

In the examples presented above, you’ll note that the strategy of selling puts and calls employ short-term expiration dates. That’s because you are selling the options to gain from the premium received from the sale, and the sooner the options expire, the sooner you’ll have your money. As well, the value of the option sold lessens as it approaches its expiration date. This is called “time decay.” Correspondingly, the strategy of buying puts and calls employ longer-term options, or LEAPS (except in the case of a long put to allow a postponed sale of a long stock position for tax purposes). As the holder of an option, you want as much time as possible to decide whether or not to exercise it. Unlike the sellers of these options, time is on your side and the more you have of it, the better.

The author is indebted to Dr. Isabel Tkatch of Georgia State University and Mr. John Beach for their review of an earlier draft of this paper and their helpful comments. Any errors of omission or commission are mine. E.M.W. March 15, 2007

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