# PURCHASING PUT OPTIONS

**Owners of concentrated positions who want to protect their stock from downside risk may want to consider purchasing protective put options.**

### What is a put option?

A *put option* provides the shareholder the right to sell 100 shares of stock to the seller of the put option at a specified price until a specified date. The specified price is known as the strike price, and the specified date is the *expiration date*.

The purchaser can exercise the put option regardless of the price of the underlying security. If the price of the security falls below the strike price, the owner of the put option can sell his or her shares to the put option seller at the higher strike price. The put option seller must deliver the amount of cash equivalent to the strike price per share to the put option owner (each option represents 100 shares).

Essentially, the put option provides the shareholder with insurance against a drop in the share price below the strike price over a certain period of time.

### What is the benefit of purchasing a put option?

- A put option provides absolute protection against a decline in share price below the strike price.
- The maximum amount the purchaser can lose is the amount paid for the put option.

### What are the downsides associated with purchasing a put option?

- The purchaser must pay for the option with cash out-of-pocket.
- The longer the time remaining until the expiration date—and the closer the strike price is to the current share value—the more expensive the put option. Total protection of the share price for any extended period of time can be expensive.
- Because put options expire at some point, the shareholder must repurchase more options if he or she is looking to continue to protect share value.

### An example of using put options to protect a concentrated position

In the following example, a put option acts as a short-term insurance policy to help protect against a decline in stock price.

Mr. Smith owns a large position in ABC, a publicly traded company, which is currently trading at $40 per share. Mr. Smith has been buying shares in ABC for many years and has an average cost basis of $20 per share. Due to continued increases in the cost of materials, Mr. Smith feels that ABC's earnings could be negatively impacted in the next quarterly report and place downside pressure on the stock price. Rather than sell the shares, Mr. Smith would like to protect his position for the next three months until after the next earnings report.

On October 15, Mr. Smith purchases January put options with a strike price of $40 at a price of $2 per contract. At any point prior to expiration, which is the third Friday of January, if the price of ABC is below $40, Mr. Smith has the option to "put" his shares to the seller of the put option at a price of $40, regardless of the current trading price. If ABC is $30 per share on the third Friday of January, Mr. Smith can sell his shares at a price of $40 by exercising his put options. If ABC is trading above $40 per share at expiration, the options will expire worthless, and Mr. Smith will continue to retain ownership of his shares.

### Considerations

Purchasing put options as a price protection strategy can be very effective; however, the costs associated with these purchases may make the strategy prohibitively expensive and uneconomical. Holders of concentrated positions seeking price protection should explore and consider other strategies that incur fewer and less expensive out-of-pocket costs.

Please note that options are not suitable for all investors. Typically, commissions are charged for options transactions. Please contact your financial advisor for a copy of the Options Disclosure Document (ODD).

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