

Module 1.2 – How to Protect Stocks that have Options

Welcome to the second video in Module 1 – How to Protect your Portfolio in a Falling Market. My name is Christina, and today I will be showing you how to protect the stocks in your portfolio that have options. Before we proceed, you must have a basic understanding of Put Options and Hedging. If you don't, you need to do Module 0 - Option Basics and Module 1.1 – Introduction to Hedging.

Inside this video, I will cover the following points:

1. how can I tell if my stocks have options?
2. how do I decide which option to use for my hedge?
3. how do I purchase put options?

By the end of this video, you will know how to check if your stock has options, how to choose the appropriate option for your hedge and how to purchase put options using CommSec's trading platform.

Without further ado, let's get straight into the first point:

How can I tell if my stocks have options?

Not all stocks listed on the ASX have options. Options are available for most of the large cap stocks such as those in the ASX 50. This video will show you how to protect your stock if it has options.

Don't worry if your stock doesn't have options as we will show you how to protect those in the next video.

To check if your stock has options, we need to go to the ASX website.

(ASX demo 1) On the [ASX homepage](#) click on Prices, Options and then type in the ASX code for the stock you wish to check. If the stock has options, a list options will be displayed.

Let's take a look at BHP. As you can see, BHP is a stock which has options. This is also known as the options chain for BHP.

Next let's take a look at a stock that does not have options. TRS which is the ASX code for The Reject Shop. As you can see from this message, TRS is a stock which does not have options.

This is the easiest way to quickly check if your stock has options or not.

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How do I decide which option to use for my hedge?

Let's say you have just bought BHP shares and based on your analysis, you believe the price of BHP will go up but if it does not, you want to limit your loss to 20%. If you have bought BHP at \$40 per share, then a 20% loss is \$8 which means you would like to be able to sell your shares for at least \$32. As hedges have a cost, you will need to factor in the cost of your put option in determining which put option to buy.

(ASX demo 2) Let's look at the option chains for BHP. Key in the code for BHP and choose "Put options only".

When we look through the chain for BHP we will find that there is an option in December which is at a strike of \$33.00 which costs 83 cents. This option will provide us with about 3 months of protection for our BHP share that will limit our loss to less than 20%. We can always buy a longer dated option to provide a longer period of protection, but it will cost you more.

For this example let's just use the December option, BHPK57. Click on the option code to get more details about the option.

Look at the contract size for the option. Most contract sizes for a standard option is 1,000 securities, however, this could always differ for each stock code.

The number of contracts, strike price and expiry date will all be required when you place the order for the put option with your broker.

Let's quickly recap this taking note that for the purpose of simplicity I am excluding brokerage commission in any calculations.

We purchased BHP stock at \$40.00

We also purchased a Dec 09 put option at a \$33.00 strike for 83 cents

This means that our breakeven point is the share price + the put option premium, giving us \$40.83; and

Our maximum possible loss would be \$7.83 per share which is less than 20% of our investment. This is best illustrated on the following profit and loss diagram.

After 3 months, one of three things would have happened:

1. BHP goes up in price as you have hoped, say to \$44. Your put option would expire worthless and you would have lost what you paid for your hedge but gained \$4 of unrealised capital gain. You may then decide to use some of that profit to buy a higher priced put option to lock in some of your profit.
2. BHP goes down in price, say to \$30. Your \$33 put option will be worth at least \$3.
 - a. If you think the price of BHP will keep going down and you no longer wish to own BHP shares, you can exercise your put options and sell your BHP share at \$33 per share, limiting your loss to less than 20%.

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- b. If you think that BHP is likely to go up again soon, you can sell your \$33 put option for a small profit which will partially compensate for the capital loss in your shares. You can use this “insurance payout” to buy more shares or more protective put options at no extra cost to you.
3. BHP price stays about the same. Your put option would expire worthless and you would have lost what you have paid for your hedge. You have to decide if you still think BHP shares will go up as you thought. If not, you may decide to sell your shares at a small loss and reemploy your capital more productively elsewhere. You could buy more put options but they would have a cost and you need to evaluate if the cost of the hedge is justified.

How do I purchase my Put Options?

Once you have decided which put option to buy, make a note of the option code, strike price, expiration month and the contract size, e.g. BHPK57 is the option code for the \$33 Dec 09 put option with a contract size of 1000.

You will also need to work out how many option contracts you need to buy to properly hedge the shares you own. Each option contract typically covers 1000 shares but that is not always the case. For example, each Telstra option covers 1040 shares. If you own 1200 BHP shares, you would probably buy 1 put option contract. However, this means that 200 of your shares will be unhedged. You could buy 2 option contracts but that would cost more and the additional expense may not be justified.

Once you have the above information. You can call your broker or enter your order on your broker’s online trading platform. Of course you must have already opened your options trading account with your broker. Contact your broker on how to do this.

In closing

Put options are a great way to manage your risk.

They are better than stop losses because you do not have to worry if a stock suddenly gaps down below your stop price.

This can really help you sleep better in a volatile market.

That brings us to the end of this video. I hope that you’ve found it useful and that you have an understanding of how to buy put options to limit your loss or to lock in your profit. I recommend that you watch all of the videos first just to make sure that you get an overview of everything before you take further action.

Inside the next video, I’ll show you step-by-step how to protect your stocks that do not have options.

Thank you for watching this video, I’m your host Christina, and I’ll see you in the next video.