

Module 1.3 – How to Protect Stocks that do not have Options

Welcome to the third and final video in Module 1 – How to Protect your Portfolio in a Falling Market. My name is Christina and in the previous video, I showed you how to protect your stocks if they had options. However, the majority of the stocks listed on the ASX do not have options, so today I will be showing you how to protect the stocks in your portfolio that do not have options.

Inside this video, I will cover the following points:

1. What types of risks can I mitigate for stocks that do not have options?
2. How do I protect my stocks against market risk?
3. How do I protect my stocks against sector risk?

What types of risks can I mitigate?

In the first video in this module, we identified some of the major risks for stock investments, which are:

1. Market risk – risk that affects the whole stock market
2. Sector risk – risk that affects all the stocks in a particular sector
3. Company specific risk- risk that is specific to a particular stock

For stocks that do not have options, we can still mitigate market and sector risk using options.

To mitigate company-specific risk, you can set a stop loss to sell the stock if the stock falls below a certain price to minimize your loss.

How do I protect my stocks from market risk?

There are two ways to mitigate market risk using options:

1. The first way is to use index options.

XJO is the ASX code for the ASX200 index which is a broad market index. We can buy put options on XJO to hedge the stocks in our portfolio that do not have options. Index options are structured a little differently from stock or equity options. We will go through an example later in this video.

2. The second way is to use options on Exchange Traded Funds (ETFs).

STW is an ETF that tracks the ASX200. ETF options are structured in the same way as equity options and we have already shown you have to buy equity options

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in the previous video. If you are not comfortable with using Index options, you can buy put options on STW instead.

Let's walk through an **Example** using XJO.

Assume that it is October and you have a share portfolio worth \$100,000 which approximately tracks the ASX200 index.

XJO is currently at 4701 and you believe that there may be a downturn in the market over the next three months.

We look three months out to December for a strike that is close to the XJO Index value of 4701. We find a December 4700 put option costing 100 points. The December 4700 put option gives you the right to "sell" the Index at a level of 4700 anytime before its expiry in December.

XJO Index options are priced at \$10 per point

The December 4700 XJO Index put option has a face value of \$47,000 (4,700 points x \$10)

The cost of one option contract is \$1000 (100 points x \$10 per point).

To protect your \$100,000 portfolio you need to buy two contracts (based on $\$100,000 / \$47,000 = 2.13$).

Each contract costs 100 points so your total cost is \$2000

Let's take this further by looking at an example where the index drops by 10%

Let's assume a similar 10% decrease in your \$100,000 portfolio, which would leave us with \$90,000

Our PUT Options would have increased in value. In this example, we started with a strike value of 4700 points so a 10% increase times the 2 contracts we purchased will see a 940 point increase. At \$10 per point, the options would be worth \$9400.

If we subtract the cost of purchasing the 2 option contracts at \$2000

We have a portfolio value of \$97,400.

Without hedging, our portfolio value would be \$90,000 which represents a 10% decrease in value.

By using hedging we would have a portfolio value of \$97,400 representing a 2.6% decrease in value. In real life, your portfolio may or may not track the XJO as we have assumed in this example. To work out a more accurate hedge, we need to beta weight your portfolio against XJO, but that is beyond the scope of today's lesson.

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How do I protect stocks against sector risk?

Ideally, you should be able to protect stocks against sector risk by buying put options on sector indexes or ETFs. Unfortunately, unlike the US markets where there are plenty of sector based ETFs, there is currently only one sector based ETF listed on the ASX (Listed Properties). ETFs are becoming more popular in Australia and new ETFs are constantly being added on the ASX. Check the ASX website for updates (URL: http://www.asx.com.au/products/etfs_etcs/types/australian_etfs.htm)

The biggest sectors on the ASX are Resources and Finance. If you own a resource stock and global commodity prices are falling, you could buy put options on a large resource company like BHP or RIO as a way of hedging your resource stocks.

In closing

Even though it's not as easy to properly hedge your stocks that do not have options, you can still achieve some downside protection using index options and options on related stocks and ETFs.

That brings us to the end of this video and the end of Module 1. I hope that you've found it useful and that you have an understanding of how to hedge your stock portfolio against adverse price movements.

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