Volume 36, Number 7

THE VALUE LINE
Daily Options Survey
On Line at the Opening Bell, Every Trading Day

Pages 1-2 **The Weekly Option Strategist** February 16, 2004

Hedging Stocks with "Married" or "Protective" Puts

In This Issue:

For nearly two years now, we have been ranking so-called "married" (or "protective") puts (as well as uncovered options and covered calls). These "married" puts consist of a long position in the stock and a long (i.e. purchased) put on that stock to protect it.

We rank "married" puts based on a combination of the common stock rank (1 being the best) and the pricing of the put (the more under-priced the better). In this report, we review the dynamics of this type of hedge.

Buy Protective Puts

Buying a put to protect a stock that you own is the most easily understood example of option buying as insurance. If the stock goes down, the put will compensate for at least some of the losses. But what exactly are you insuring against? The simplistic answer is that you are insuring against losing money. But that is not the whole story. If losses were all you were worried about, you would simply sell your stock.

What you are really insuring yourself against when you buy a protective put is making the wrong investment decision. Wrong decision #1: you do not want to have sold your stock if it then keeps on rising. Wrong decision #2: you do not want to continue holding the stock as it takes a swan dive. After the fact, if you had protected with the put, you can be right either way (either the stock went up and you did not sell it, or the stock went down and you covered your losses.)

You can even tailor your put hedge to suit your expectations and your perception of risk, as we will show in the following three examples.

On Wednesday February 9, 2004, the Yahoo common was trading at around $45.00 per share, with the at-the-money July $45 strike offered at (i.e. asking price) $4.60, the in-the-money $55 offered at $11.35 and the out-of-the-money $35 put trading at $1.25.

Graph 1 on page 3 and the data directly below it, show the different outcomes from (1) 100 shares unhedged, (2) 100 shares hedged with the at-the-money put, (3) an out-of-the-money put and (4) an in-the-money put. Notice that with the in-the-money put, you suffer the lowest loss if the stock drops sharply, but you also have the lowest gain if the stock rises.

Buying Full Insurance

Which of these put options offers the maximum insurance? The instinctive answer is the in-the-money put because it protects the downside more than the other puts. But is this really the maximum insurance? After all, if you just wanted to protect against a loss, your best choice would be to sell the stock and hold cash. But then, of course, you would have given up the chance for any further gains in the stock.

Really, when you think about it, buying the at-the-money $45 strike put at $4.60 is the maximum insurance. Why? Because if you are uncertain about the direction of the stock, and do not want to be wrong if the stock makes a big move <u>in either direction</u>, then the at-the-money strike put is the insurance you want to buy.

With the at-the-money put, if the stock rises $10 by the July expiration, to $65, the investor will have participated in all of the $1,000 gain in a 100-share stock position, but will be out the $460 paid to purchase the put. Alternatively, if the stock declines $10 to $35, all the investor will lose is the $460 premium, since coverage of the put will kick in as soon as the stock goes below $45. *A simple rule of thumb: if you expect a lot of volatility, but are uncertain about the direction, then buy the at-the-money put.*

Deductible Insurance with an Out-of-the-Money Put

Suppose you were more bullish than bearish on the stock, but wanted to cover yourself should the stock unexpectedly decline sharply. In this case, you may want to cover your exposure by buying deductible insurance in the form of the out-of-the-money put. Looking again at Graph 1, notice that if you buy the out-of-the-money $35 strike put at $1.25 ($125 for one option), your protection at expiration starts at this lower strike price. However, if the stock rises instead of declines, your gains will be a lot better than if you hedged by buying the at-the-money put.

When you hedge with an out-of-the-money put, you are essentially buying deductible insurance. The most you can lose on 100 shares covered with the $35 put in this example is $1,125, i.e. your $1,000 "deductible" (represented by the distance between the common and the strike prices) and the $245 you paid for the put. Even if the stock were to go to $25, the most you can lose on this position is $1,125.

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The Value Line Daily Options Survey (ISSN 1087-3945) is published semi monthly on the second and fourth Mondays of each month by Value Line Publishing Inc., 220 East 42nd Street, New York, NY 10017-5891. Subscription Rate: One year in the U.S. and U.S. possessions: $399. Foreign rates upon request. Periodicals postage paid at New York, NY and additional mailing offices. POSTMASTER: Send address changes to Value Line Daily Options Survey, 220 East 42nd Street, New York, NY 10017-5891.

In-the-Money: Another Type of Deductible

Buying the in-the-money put is also another form of deductible insurance, even though most people don't see it that way. Remember that with the $55 strike put, $10 of the premium is actually tangible value and only $1.35 is time premium.

Here you are essentially selling off your stock, but insuring yourself against the wrong decision by retaining the right to some upside potential if the stock makes a really large upward move. At all prices below $55, you are out the option's time premium of $135, since gains and losses on the stock and the option will offset each other. Above $55, you will start to reap profits. (Note this move is really quite similar in its outcome to selling the stock and then buying the $55 strike call, which makes money only if the stock moves above the strike price.)

Looking for Puts for Hedging

Since May 2001, we have been ranking puts for "married" or "protective" put buying as well as for "naked" put buying. (We recommend the latter as bearish positions.) If you want to see our top 200 picks for married put buying, you can select them at our *Interactive Options* page online. These are usually highly ranked stocks (rank 1 or 2) with inexpensive puts (i.e. puts that are "undervalued"). If you are looking for the best puts on a particular stock, simply enter the stock's ticker code and then look for the ones that either have the best married put rank or those that are the least expensive (i.e. have the lowest number in the *under/over valuation* column).

Other Reports on Hedging

Subscribers may also want to look at the following in our *Options Reports* archive on hedging their stocks.

· *Hedging with Collars:* You can greatly reduce the cost of your put hedges by selling off some of your insurance when you hedge with what is known as a collar. You can even sell your insurance in such a way that you actually take in time premium (Ot031103.Pdf).

Hedging with a Bear Spread: You can also hedge your stock with a bear put spread or a bear call spread. These spreads can offer you the opportunity of taking advantage of overpriced insurance in making your hedges more efficient (OT031103.Pdf).

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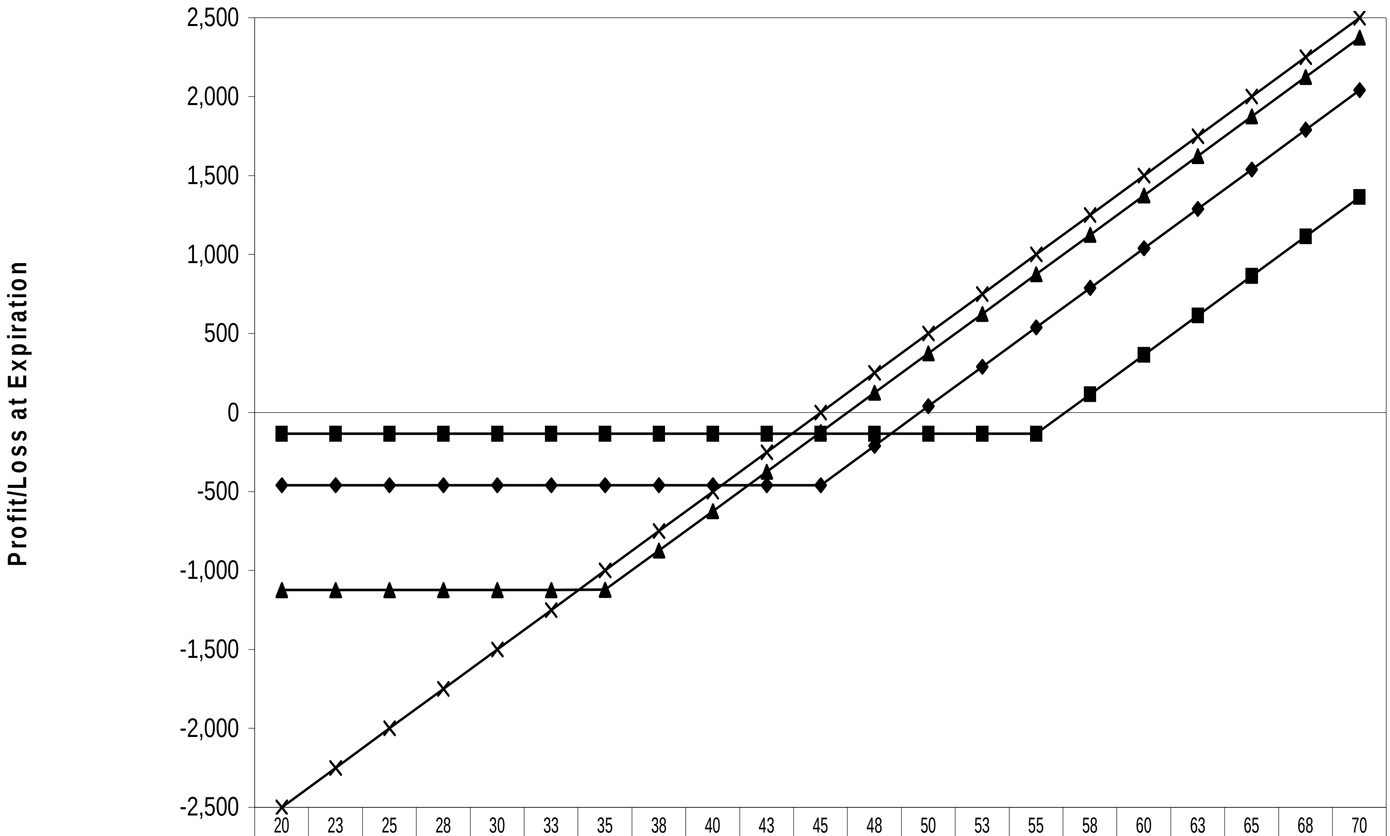
Graph 1 - 100 Shares of Yahoo Hedged with Puts
Stock Price = $45



	20	23	25	28	30	33	35	38	40	43	45	48	50	53	55	58	60	63	65	68	70
Unhedged Stock	-2,500	-2,250	-2,000	-1,750	-1,500	-1,250	-1,000	-750	-500	-250	0	250	500	750	1,000	1,250	1,500	1,750	2,000	2,250	2,500
At-the-Money $45 Put	-460	-460	-460	-460	-460	-460	-460	-460	-460	-460	-460	-210	40	290	540	790	1,040	1,290	1,540	1,790	2,040
In-the-Money $55 Put	-135	-135	-135	-135	-135	-135	-135	-135	-135	-135	-135	-135	-135	-135	-135	115	365	615	865	1,115	1,365
Out-of-the-Money $35 Put	-1,125	-1,125	-1,125	-1,125	-1,125	-1,125	-1,122	-875	-625	-375	-125	125	375	625	875	1,125	1,375	1,625	1,875	2,125	2,375

Stock Price

Market Review - Week Ending 02/10/04

Market Indexes	Close	% Change	Volatility Indexes*	% Change
Dow Jones Industrial	10,709.40	1.94%		
Nasdaq 100	1,507.57	1.05%	23.32	-11.33%
S&P 500	1154.74	1.65%	15.46	-10.84%

Performance Tables

Common Ranks	% Change	Count	Percent
Rank 1	2.87%	8414	8.20%
Rank 2	3.13%	21518	20.97%
Rank 3	2.59%	55090	53.68%
Rank 4	2.28%	13411	13.07%
Rank 5	2.85%	4186	4.08%
Call Buyer's Ranks			
Rank 1	18.14%	3866	7.57%
Rank 2	20.22%	9453	18.51%
Rank 3	16.04%	37762	73.93%
Call Writer's Ranks			
Rank 5	-10.56%	2099	6.18%
Rank 4	-10.66%	5490	16.16%
Rank 3	-12.42%	26384	77.66%
Covered Call Ranks			
Rank 1	0.51%	2373	6.98%
Rank 2	0.66%	5640	16.60%
Rank 3	0.56%	16572	48.78%
Rank 4	0.68%	6324	18.61%
Rank 5	0.55%	3064	9.02%
Put Buying Ranks			
Rank 1	-10.32%	5131	9.95%
Rank 2	-11.28%	9343	18.12%
Rank 3	-11.68%	37090	71.93%
Put Writer's Ranks			
Rank 5	8.07%	2214	6.15%
Rank 4	8.93%	5566	15.47%
Rank 3	9.33%	28191	78.37%
Married Put Ranks			
Rank 1	0.93%	3960	7.68%
Rank 2	0.95%	9838	19.08%
Rank 3	1.02%	24018	46.58%
Rank 4	1.19%	8066	15.64%
Rank 5	1.53%	5682	11.02%

* - VIX for the S&P 100 and VXN for the Nasdaq 100