Using options to protect positions

By Dan Keegan

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FROM THE ARCHIVES

Let's review a trade with a stop order placed 5% below the point of purchase. BIDU is purchased at 145. The stop loss order is triggered as soon as BIDU trades at 137.75 or lower. Twenty-eight days later that happens and BIDU is sold at 137.50 for a loss of $750 per round lot. Instead of a stop order being placed, a BIDU Dec 135 put is purchased for 5.50 along with the purchase of the stock. The time value of the put has eroded over the 28-day period so that its premium has remained at 5.50. If the drop in BIDU occurred earlier, the put would have retained more of its value. Once again, time value rises and falls constantly so the 5.50 example probably would be a higher or lower number. If BIDU rises 5% to 152.25 over a 28-day period of time, the stop order strategy results in a profit of $725 per round lot. The Dec 135 put probably would be priced around 1.00, reducing the overall profit to $275 per transaction.

Let's say BIDU descends below 137.75 14 days after the stock is purchased. BIDU reverses course after bottoming out at 136 and heads up to 152.25 14 days later. The stop order loses $750 while the options order nets $275. Because we are looking at a longer term scenario, what would happen if there is a gap opening where the stock doesn't move 5% but rather 30%? BIDU opens at 101.50. The stop order allows the long position to be liquidated for a 43.50 loss on the opening. The Dec 135 put probably would be worth about 34.00. That would result in a net loss of $1,500 per transaction vs. $4,350 per transaction.

Other than using a stop order or an out-of-the-money option for risk control, there is a third alternative. The BIDU Dec 135 call can be purchased for 16.00 and the BIDU Dec 155 call can be sold for 5.50 for a net price of 10.50. The maximum loss on this position would be $1,050 per transaction regardless of how far down the stock travels. If BIDU heads up to 152.50 in 28 days, the spread probably would widen to about 13.00 for a profit of $2,500 per transaction. If BIDU rose to that price over a 47-day period of time, the spread would widen to 17.50 for a profit of $7,000 per transaction. The Dec 155 calls act as a stop against further profits should BIDU travel north of 155, however.

Changes in the price level of time value are not a problem using this spread strategy. The 6.00 of time value embedded in the 16.00 premium for the long 135 calls is counteracted by the 5.50 in time value in the short 155 calls. Another added benefit to using the spread strategy is the low cost ($1,050) to establish the position. Purchasing 100 shares would cost $14,500, half that amount if purchased on margin. If the underlying contract was a futures contract, similar leverage to options might be achieved; but if the trade went against you, you would need to shovel more money into the account.

If the underlying instrument (stock, future or ETF) is traded back and forth frequently on an intraday basis, using stop orders might be the best way to go. The biggest drawback would be

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Symbol	Last	Change (%)
Emini	2050.75	−2.50 (−0.12%)
Euro	1.09750	+0.00410 (+0.37%)
Gold	1077.8	+7.8 (+0.73%)
Oil	38.12	+0.26 (+0.69%)
Gas	2.042	+0.057 (+2.87%)
Corn	364'4	−1'0 (−0.27%)

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when the stop order is triggered and then the underlying instrument immediately reverses course. The options strategy works best in that case, as well as when the trade goes against you.

If it's a long-term position being traded, it seems clear that some type of options strategy works best, especially in the case of a large overnight move against you. The purchase of a call against a short position or put against a long position as an insurance policy has the problem of time decay that is inherent in options. That can be eliminated by using the outright spread strategy, which has the drawback of capping profits. All of these strategies have their pluses and minuses, but using none at all is the biggest minus of all.

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