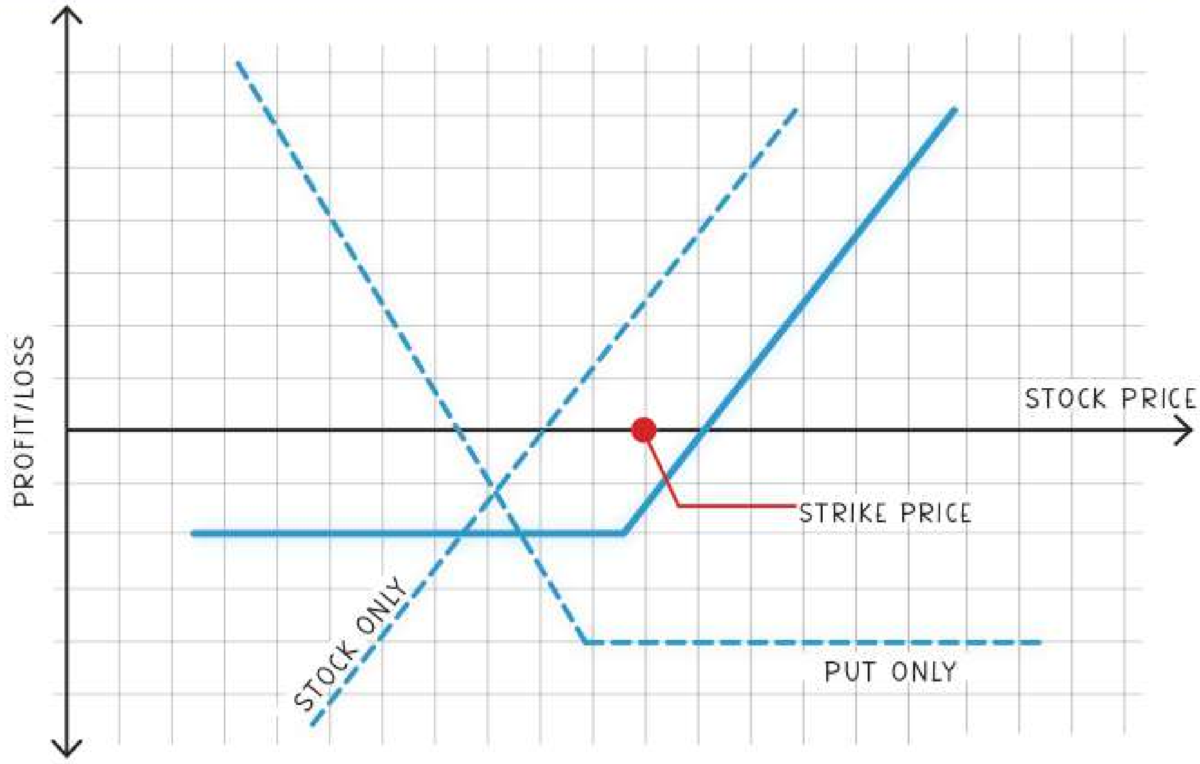
10.2 PROTECTIVE PUT STRATEGY

Explainer Video

> PROTECTIVE PUT STRATEGY IS A RISK MANAGEMENT STRATEGY THAT USES A PUT OPTION TO INSURE A POSITION IN ANY STOCK OR INDEX. IT LIMITS THE DOWNSIDE THAT A POSITION MAY HAVE WHILE KEEPING THE UPSIDE INTACT. HOWEVER, PROTECTIVE PUT COMES AT A COST I.E. PREMIUM.

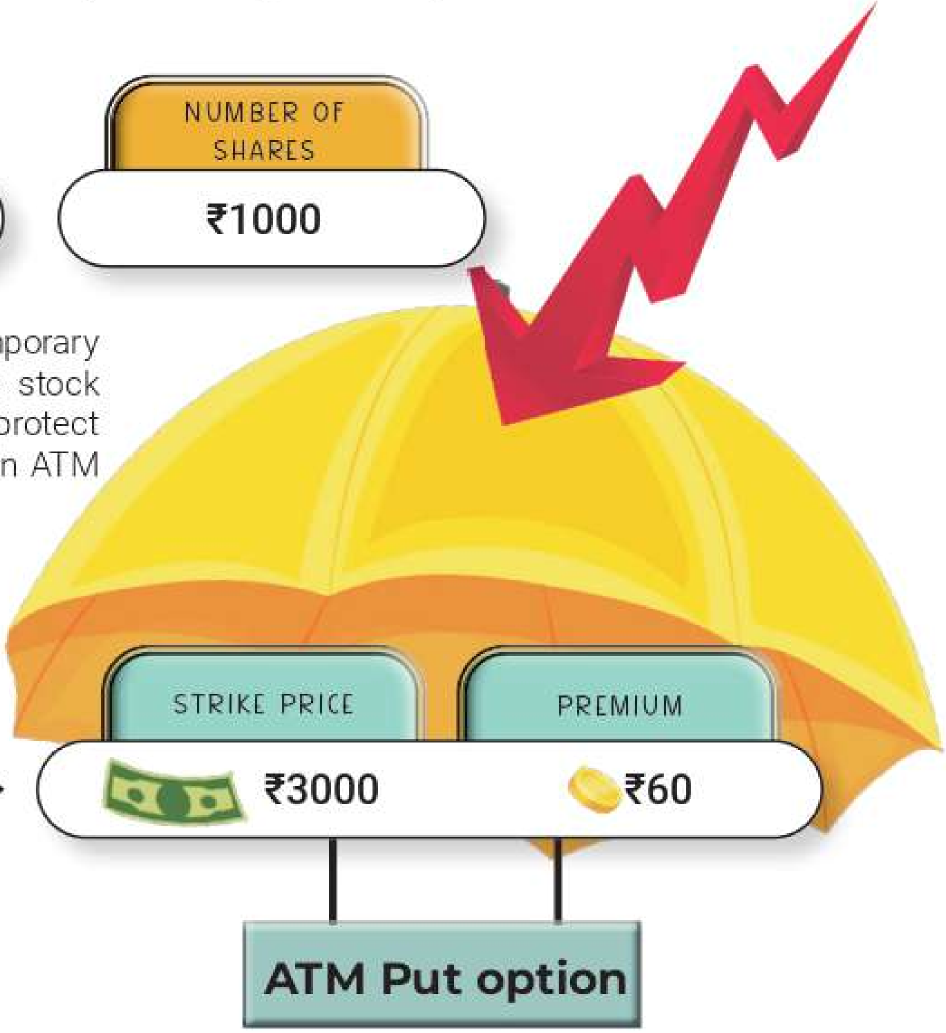


The protective put strategy is also called ***Married put or Synthetic call***. The name synthetic call is used for this type of strategy because it behaves like a call option only, but since it is not a straightforward call but a combination of assets that have risk-reward like a call would, it is called a synthetic call.

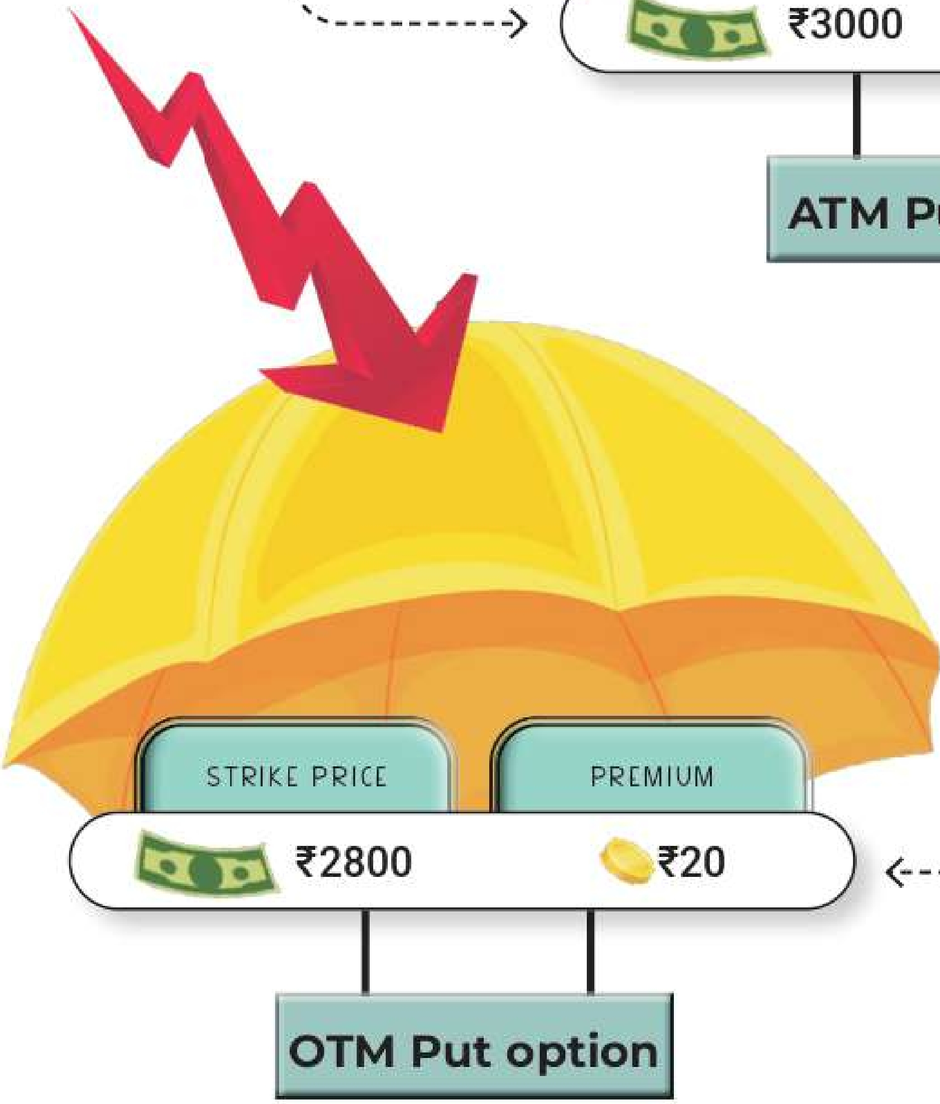
Let's understand what a protective put is through an example.
Suppose we own shares at

CURRENT MARKET PRICE	NUMBER OF SHARES
₹3000	₹1000

And we are expecting a temporary downturn in the price of the stock because of some reason. To protect ourselves from this, we buy an ATM put option at



Alternatively, we may buy an OTM put at



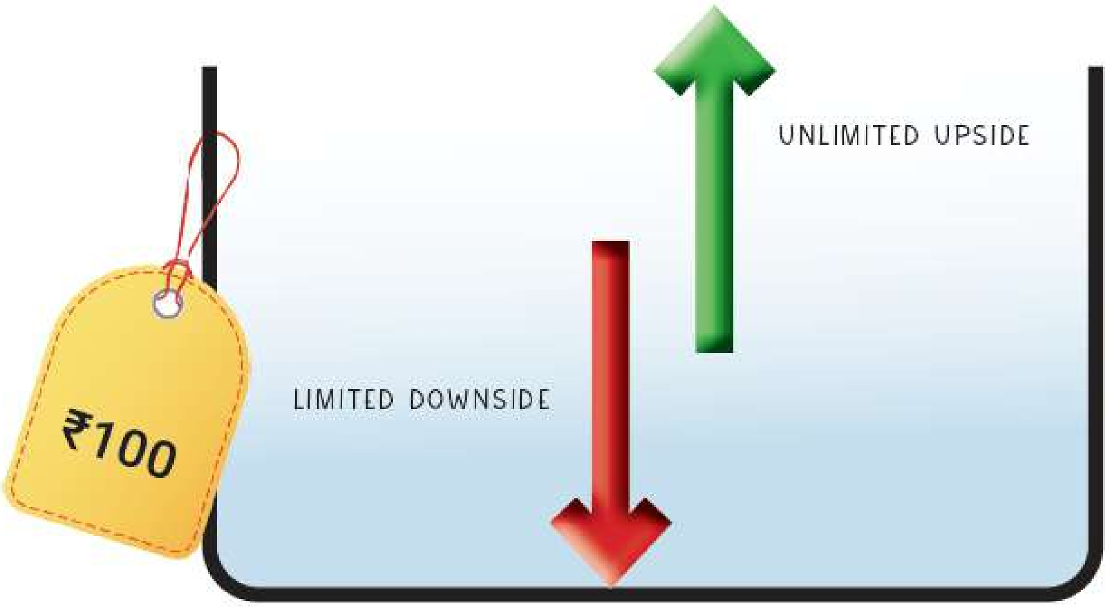
Let's say we buy the ATM put. Then, the premium amount (₹60) is the cost of protective put that we will be paying.
Assuming,

MARKET PRICE ON EXPIRY	NET PROFIT/ LOSS	EXPLANATION
₹2900	**Profit/Loss =** Profit/Loss on Shares + Profit / Loss on Option = (2900-3000) + (3000-2900-60) = -₹100 + ₹40 = **(₹60)**	So, we can see that despite the stock price going down by ₹100, our losses are only at ₹60. This is where Protective Put protects us from the downside.
₹3200	**Net Profit** = ₹3200– ₹3000 – ₹60 = **₹140**	We see that when the price did not actually go down, we enjoy the upside of stock position. However, ₹60 paid as premiums will reduce our profitability. This is the cost of Protective Puts that we have to incur.
₹2000	**Profit/Loss =** Profit/Loss on Shares + Profit / Loss on Option = (2000-3000) + (3000-2000-60) = -₹1000 +₹940 = **(₹60)**	We can see that despite the stock price going down by 33%, our losses were still capped at ₹60.

By applying this strategy, we have in a way insured ourselves from the expected loss for a specific period of time. We can again and again enter into such protective put strategy whenever we have reasonable believe that the stock may go down. However, this is a very expensive protection and it eats into our investment results. So, if we have protective put very frequently, it will generate below-par results on the entire position. It is only to be used when there is significant reason to be bearish.

Large companies and banks generally have large blocks of shares of single company.

In case of expected turbulence in the market, it is not possible to sell so many shares at once. In such a scenario, the protective put strategy comes in handy to insure the shareholder against any downside while enjoying the profits. And if the price of the share does not fall, the premium will be the limited loss for the shareholder.



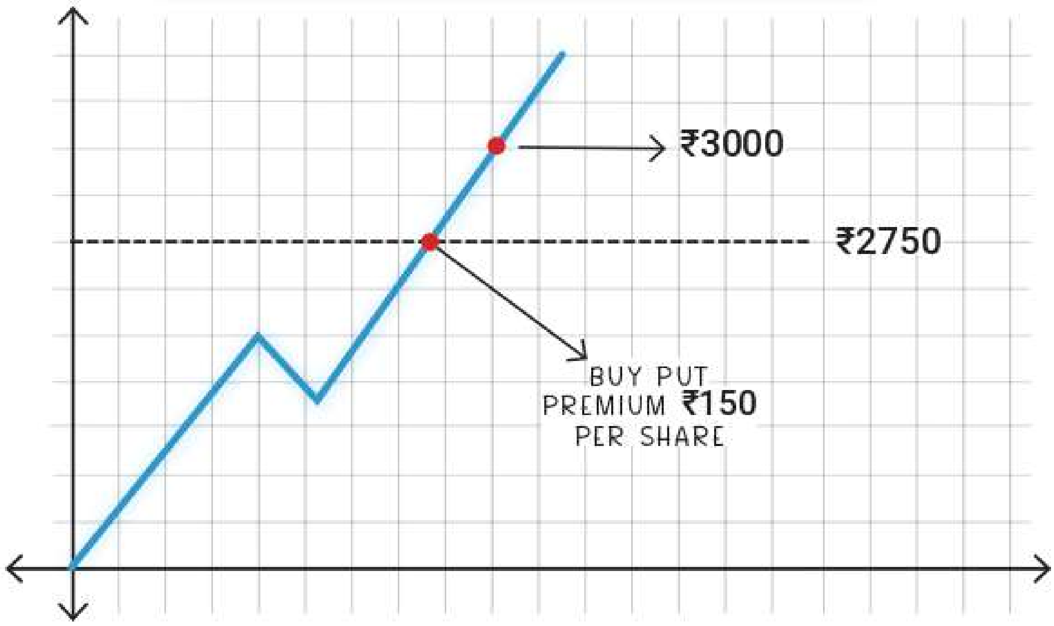
Essentially, the downside stays limited. The upside potential stays unlimited. And the cost is the premium paid. These features are like that of a call option and therefore, the name synthetic call. This protects our long-term portfolio. We can use it for trading purposes as well.

WE MAY BE LONG ON FUTURES + LONG ON PUT OPTIONS, THIS WOULD GIVE US UNLIMITED PROFIT POTENTIAL FOR A PARTICULAR PERIOD OF TIME TOO.

ASIAN PAINTS

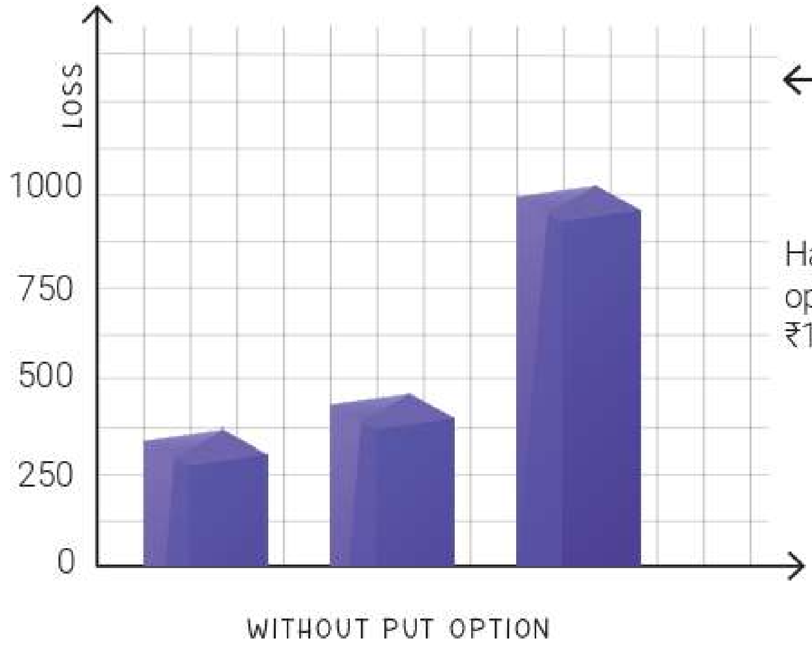
Let us look at another example here,
A man buys 100 shares of Asian Paints at ₹3000 with the expectation that the price will increase. Therefore, he hedges his position by buying a put option at

STRIKE PRICE	PREMIUM
₹2750	₹150



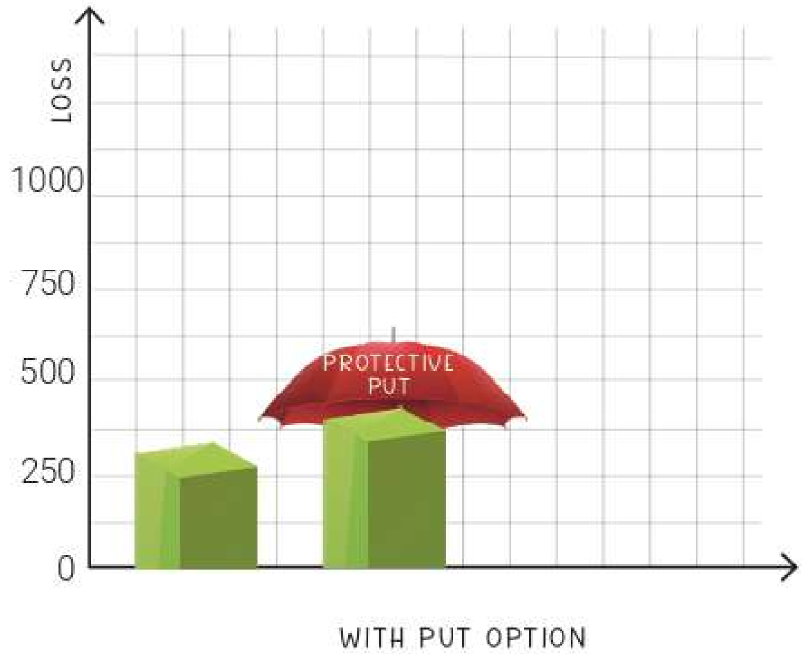
Let's assume 2 scenarios,

CURRENT MARKET PRICE (CMP)	NET PROFIT/ LOSS	EXPLANATION
₹4000	**Net Profit =** ₹4000 – ₹3000– ₹150 **= ₹850**	Since, the price rises by ₹1000, the Net profit is ₹850 per share.
₹2000	**Profit =**Strike–CMP–Premium = ₹2750 – ₹2000 – ₹150 **= ₹600** **Net Loss =** ₹3000 – ₹2000– ₹600 **= ₹400**	Since, the price has declined, the put option will protect from losses. The net loss is capped at ₹400 per unit here.



Had he not bought the put option, he would have had ₹1000 loss per share.

But with protective put strategy, his losses came down to (₹400) per share. This is the maximum loss that the trader can incur as losses are limited in a protective put.



A protective put strategy might look very appealing in the sense that you will always be protected. However, this strategy is very costly and therefore, it can be looked at as a temporary hedge only. The monthly cost of this strategy can lower the overall profits significantly. Having a put option at all times for your position will make the position loss-making rather profitable.

One must use protective put only when there is a large position and you want to insure yourself against a temporary fall in the asset price. From a trading point of view, use the same when you expect the asset price to go up but want to protect the downside as well.