

Options: Protection in Uncertain Times

Securities that allow investors to buy and sell shares at a later date can help lessen portfolio risk

BusinessWeek By Ben Levisohn April 7, 2008

Up markets are easy. Simply buy and hold and watch your portfolios grow. Down markets, though, can be more complicated, as many investors try to assess how their holdings will weather the storm. The current climate is especially tough to predict, with so many unknowns about housing and financial companies' exposure to bad loans and how long the U.S. economy will struggle. That's why the stock markets have been so volatile, with multiple -percentage-point gains in the major indexes one day, followed by large losses the next.

Savvy investors have a weapon to stay in the market and lessen the blow if stocks trend lower: options. These securities give the holder a right to buy or sell at a later date, and can be used as a hedge to lower overall portfolio risk.

Options have a reputation for being risky, speculative investments, and in some cases it's well deserved. Anyone who sells uncovered calls or puts, meaning selling someone else the right to buy or sell a stock without owning the stock beforehand, deserves punishment. But even the least risky strategies aren't for everyone. Options lose value over time and with falling volatility, cost more to trade than stocks, and often have wider spreads.

Stay in the Game

Most investors will do fine by simply keeping their portfolio balanced and riding out the storm. If your portfolio is keeping you awake at night, maybe it's time to cut back on the number of stocks or funds you own in favor of less risky investments. Other types of hedges, including bear funds (BusinessWeek.com, 4/2/08) and short exchange-traded funds (ETFs), may provide adequate protection in case of a market meltdown.

However, used wisely and selectively, options can act as a form of insurance on your portfolio, protecting you and your money from the sudden, violent swings. "During times of panic, they can prevent you from doing something stupid," says financial advisor Stephen Shueh.

How stupid? Investors often make the mistake of getting spooked out of the market. Right now the Standard & Poor's 500-stock index is stuck in a range between the mid-1200s and mid-1300s. Earnings season is beginning, and how companies perform could determine which way the market goes. Technical analysis indicates that if the S&P breaks above 1370, the market may head higher, but if shares trade below 1250, the market could be headed for a fall. If you sell stocks now, and the market falls, you'll feel like a genius. If the market rises, you'll feel like a chump.

The Put Option

One way to avoid making what is, at best, an educated guess, is the use of options to hedge against the S&P 500. A put option on SPDRs, an ETF that tracks the index, could act as an easy form of insurance. For example, earnings season will be over by mid-May, so you could buy an SPDR put with a strike price of 125 (equivalent to an S&P 500 of 1250) and a May expiration. If you have a \$1 million portfolio, it would take around 8,000 shares to fully insure it. That will set you back nearly \$8,000 and if the market rises, that money's gone. But if the S&P plummets to 1150, you'll make around \$80,000, enough to cover the 8% drop in the value of your portfolio. Ultimately, the put has insured your portfolio against the drop, all for under \$10,000.

You may worry more about a single stock than your entire portfolio. Let's suppose you now own 1,000 shares of Lehman Brothers (LEH), a stock that's seen plenty of volatility in recent days. It currently trades at over 40 a share, but tumbled to as low as 20.85 just a few weeks ago. You're pretty sure the worst is over, but with the way stocks are trading, you never can tell. If you sell your position outright and Lehman shares rally, you'll miss out. You could use a stop loss order,

but then you risk selling your stock on a sudden down move—like the one that drove Lehman shares down into the 20s—and taking an enormous loss, only to watch it retrace. Or you could buy a Lehman put option with a strike price of 40.

Why a put? If, for some reason, shares of Lehman dropped again and this time stayed down for the count, you'd be able to sell your shares at 40, even if the stock were trading at 20. But if the shares rise, you're still holding your position and you've only lost the premium you paid for the option.

Unfortunately, that premium isn't necessarily cheap. "One of the interesting things the increased volatility does is it makes option premiums more expensive," says Bud Haslett, director of option analytics at Miller Tabak & Co. How expensive? The price will also be determined by the length of time until expiration. An option to sell Lehman shares at 40 with an expiration date of Apr. 18 will set you back \$1,550, not including commissions; the same put with an expiration date of May 17 will cost you almost twice as much for nearly three times as many days. Either way, you're not looking at pocket change.

Covered Calls

But the same volatility that drives up the price for put buyers makes selling covered calls—giving someone the right to buy your shares at a preselected price in exchange for a premium—more attractive. For instance, you may think that Lehman shares will go up in the long run, but experience some weakness through the end of the year. Rather than buying a put, you could write a covered call with a strike price of 45 that expires in October. At current market conditions, that will earn you nearly \$7,000, or around 16% of the stock's current value. You've effectively protected yourself if shares of Lehman should fall to 37.

However, if the stock runs up, your shares will most likely be called away—sold to the buyer of the call for 45. However, with the premium included, it's as if you sold your shares at 51.85.

"Here's a way to hedge your position and earn an attractive return on your investment," says Mike Schwartz, chief options strategist at Oppenheimer (OPY).