

Hedge with Options

By Gigi Turbow Marx, MBA

How many times have you heard the mantra that stocks outperform all other assets in the long term? Unfortunately, many retiree wannabes are finding out the hard way that the long term can be *really* long.

The most important reason to hedge is that waiting for the long term isn't always an option. Investment success comes from careful risk management, which means minimizing losses, not from being a genius stock picker. Broad diversification among asset classes should be your first line of risk management defense (see Strategy #40). But hedging provides you with a Plan B, and having a back-up plan is definitely the best plan in uncertain times! The strategy explains how to use options to hedge.

Know the Options Basics

Options are a *derivative* product. Very simply, that means their value is derived from something else. If you buy or sell options on an asset such as a stock or exchange-traded fund (defined as the *underlying* asset), the price of the option is going to move with that stock or index in a fairly well-defined relationship. That relationship allows you to use options to track price changes in the underlying asset for a fraction of the cost.

Understand how options work

Here are some useful options-related terms you should be familiar with:

- ✓ **Premium:** The premium is the price of the option.
- ✓ **Strike (exercise) price:** This is price at which you agree to buy or sell the underlying asset if the option is exercised.
- ✓ **Expiration:** The date on which the option ceases to exist; all rights and obligations conferred by the option contract terminate when the option expires.
- ✓ **Contract size:** One contract is equal to 100 shares of the underlying asset.

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Any options contract gives rights to the buyer and commits the seller to obligations. Options also come in two varieties, calls and puts, depending on whether the buyer wants the right to purchase or sell the underlying asset. Table 28-1 shows how these rights and obligations break down.

<i>Buyer or Seller of the Option</i>	<i>Calls</i>	<i>Puts</i>
Option holder (buyer)	By buying a call option, the holder purchases the right to buy the underlying asset at the strike price.	By buying a put option, the holder purchases the right to sell the underlying asset at the strike price.
Option writer (seller)	By selling a call option, the writer commits to selling the underlying asset at the strike price.	By selling a put option, the writer commits to buying the underlying asset at the strike price.



Perhaps the single most important concept for you to master about options is the following one: Options have a limited life.

Unlike your core portfolio holdings, options expire, and when they do, they no longer have value and no longer exist. That may actually be your goal. If it's not, you can liquidate an option position or roll it over to another strike price or another time period. The important point is that you must do it *before* the expiration. This underscores the point that hedging requires an economic point of view and active oversight.

Look at how you can use options to hedge

You can use options for the following reasons:

- ✓ To protect your portfolio
- ✓ To generate additional income
- ✓ For speculation/leverage

A 2008 Charles Schwab study of options trading found that, contrary to popular perception, only one in four traders surveyed indicated market speculation was their leading reason to trade options. Three-quarters of the respondents used options with the goal of generating income or hedging for risk management.

Okay, but how do you actually use this stuff? In this limited space, I can barely scratch the surface of useful ways to apply options, but the following example may give you some ideas. Consider the unpleasant situation in which one of your ETFs has fallen 20 percent over the past year. In theory, you know that you should try to buy more to reduce your average cost and rebalance your holdings. In reality, you have little cash and even less stomach for further losses.

If you have only \$5,000, you could use the whole amount to buy 50 shares of your now-\$100 stock today. Alternatively, you could purchase call options — the right to buy that stock — for less money and buy yourself some time to see whether the situation worsens or improves before you commit to buying more stock.

Say you already own 400 shares. You decide to buy four call contracts at a \$95 strike price to reduce your cost basis more effectively. You see that you can buy options that expire in four months for a premium cost of \$7 a share, costing a total of \$2,800 ($\7 per share \times 100 shares per contract \times 4 contracts).

If your analysis is correct and the stock recovers to \$105, you've locked in the right to buy up to 400 shares at a cost of the strike price (\$95) plus the premium (\$7), or \$102 per share in total — \$3 less than market price.

But what if you really want to add only 50 shares to your position? By selling 350 shares in the stock market at \$105 and exercising your contracts to buy 400 shares, you'll get your 50 shares. You'll also get a \$1,050 gain on the stock you don't want to keep ($\$3 \times 350$)! That's a gain you can use to replenish your cash account or to repair another investment. (And *that's* why they call them *options*, Virginia!)

What if your analysis is wrong and the stock keeps dropping? Again, the value of your options will move in tandem with the underlying asset — that is, down. But you've limited the potential loss on your investment strategy because you can't lose more than the (\$2,800) premium you paid, and you've still got some cash left to consider a new strategy.

Do Your Homework

Options trading is a game of strategy similar to competitive chess or sports. It's versatile but complex, so make sure you do your homework and research the risks and returns of any strategy you want to pursue.

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Start with the Options Industry Council (OIC) Web site (www.888options.com): The council is comprised of all the U.S. options exchanges plus the Options Clearing Corporation. It has a vested interest in protecting the good reputation of its market, and that means it has a vested interest in protecting you, the investor.



You've probably seen those car ads where they warn "Professional driver on a closed track: Do not attempt." If you're an aspiring do-it-yourselfer, use the Options Industry Council's (OIC's) version of a closed track (www.888options.com) — they offer a virtual trading tool that allows you to practice with electronic money before you put real money at risk!

One visit to the OIC Web site should convince you that you don't need to pay lots of money for an options newsletter. The resources available through the OIC are comprehensive, approved by regulated compliance departments, and free of charge.



Newsletter vendors, whether covering options or any other investment, aren't regulated. They can consequently make all sorts of ungrounded claims about potential investment returns without fear of scrutiny or sanctions. Until you know enough to evaluate which newsletters are reputable, stick with the OIC for education and a registered investment advisor or SEC-regulated broker dealer for implementation.

Take Your First Steps

You may be shocked to discover that you can't just decide that you'd like to try a little options trading one day and go place an order. You first have to apply to your brokerage firm for trading authorization. There are multiple levels of authorization, and you have to graduate through the ranks. Demonstrate financial capacity and reasonable care at conservative strategies, and they'll approve you for more complex strategies. Believe me — they're doing you a favor because they've seen the roadkill. Here are some other important rules of the road for novices:

- ✓ **Start with the asset or market you understand best.** Options trading is complex, so make sure you're familiar with the underlying assets.
- ✓ **Start small.** Just because you have \$5,000 doesn't mean you should spend it all in one place! Options provide a lot of leverage for a wee bit of cash, but it works in both directions — gains *and* losses.