

ROI JULY 30, 2009, 10:10 P.M. ET

Buying Insurance Against Booming Stocks

By **BRETT ARENDS**



Another day, another big gain for the Dow. Markets have risen a long way over the past four months. But if you're feeling nervous about your portfolio, maybe this is a time to consider crash insurance.

Most people don't realize it, but one form of insurance can be bought reasonably cheaply through any broker. So-called "put options," which pay out if a stock, fund or index falls below a certain point, can be purchased against many indices, exchange-traded funds and blue-chip stocks, from [Amazon.com](#) to [Yum Brands](#). If the stocks hold up, you write off the premium, usually a small percentage of the underlying shares' value.

Such derivatives are often considered exotic paper suitable only for high-octane traders. But that's an unfair view.

"There's a large swathe of people who could use these effectively, but they are too afraid of derivatives," says **Gigi Turbow Marx, principal of Old Field Advisors on Long Island.**, and a former Wall Street trader. "But people are asking about it now. Two years ago I couldn't get anybody interested."

How can put options help an ordinary investor? Consider a simple illustration. The [iShares MSCI Emerging Markets Index Fund](#) (EEM) has doubled since last November, rising from \$18 to nearly \$36. [As my colleague Jason Zweig pointed out last week](#), investors are now chasing emerging markets higher with an alarming flood of new money.

If you've been riding that boom, you may be wondering if, or when, to get out. After all, these are volatile markets. What may worry you is not the big risk that you will make only small gains from these levels, but the small risk that you may suffer a very big loss if these shares crater.

Insurance? Instead of selling your fund for \$36 and giving up on any future profits, you can just hand over a few dollars per share for about 18 months' worth of crash insurance.

Some \$30 put options that expire in January 2011 cost about \$4 per share. If the fund falls below \$30 during that period, you pocket the difference. The \$24 options cost \$2. (Note: You also pay taxes on option gains.)

Put options allow you to keep your investment, and profit if it continues to boom. But if your investment collapses, your insurance will cover at least some of your losses.

If you buy \$24 put options, and the fund falls to \$18, you can pocket at least the \$6 difference. But you may collect much more: After all, if the fund falls to \$18 quickly, others will start betting it's going to \$16, or \$14, or even lower. You could sell those \$24 put options for \$8 or \$10 or more.

The key thing about put options is that they give you the right to sell shares at the pre-arranged price, but do not oblige you to do so. That means if the stock goes to zero you can cash in, but if it skyrockets you just throw the option away.

[Russell 2000](#) index of small U.S. stocks has risen from 343 in March to 560. Anyone worrying that the market may go back to new lows might look at the 400 puts, which are good until December 2010 and cost about \$30 a share.

[Bank of America](#) stock has risen from \$3.14 to about \$14. So if you had 100 shares, they'd be worth about \$1,400. Buying a January 2011 put for \$5 puts cost just 39 cents per share, so you could buy some cheap insurance for about \$39. If the bank stock collapsed to zero, those \$5 put options would be worth \$500. That would provide a cushion for your losses on the stock.

Consider this: [Apple](#) has risen from \$78 to \$163 since last winter. The \$100 puts due in January 2011 cost \$6.40. To the nervous, that may prove a far cheaper way of sleeping at night on your big gains than maybe selling your shares altogether. (Intriguingly, the market rates the chance of Apple rising another \$60 or so much higher than it falling: The January 2011 \$230 call options, which give you the right to buy the stock above that level, cost about \$11. It's a high-risk bet for raging bulls.)

Options certainly aren't for everyone and there are plenty of caveats. It is worth doing your homework and talking to an adviser before buying them. Options can be expensive: Over the long term, more money is made selling them than buying them. They are generally sold in lots of 100.

Options can last as little as a month or, in a few cases, up to about two years. It usually makes more sense to buy the longest-lasting options you can, to insure your portfolio as long as possible. Such options are known as "LEAPS" (for "Long-term Equity Anticipation Securities"). So-called "out of the money" put options, which only pay out if the shares fall a long way from today's price, are usually the cheapest insurance option.

Sid Blum, owner of GreatLight Fee Only Advisers in Evanston, Ill., says investors using options need to keep a close eye on tax liabilities. Otherwise they may end up paying

taxes on their gains at higher short-term rates. It's an argument for buying options inside a shelter such as an IRA.

One thing that can hardly be stated often enough is that people on Wall Street really don't know what's going to happen next, even though they say they do. In these circumstances it makes sense to spread your bets, and to look for cheap insurance where you can find it.

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