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Equity Options
Strategy

MONTRÉAL EXCHANGE

Cash-Secured Put

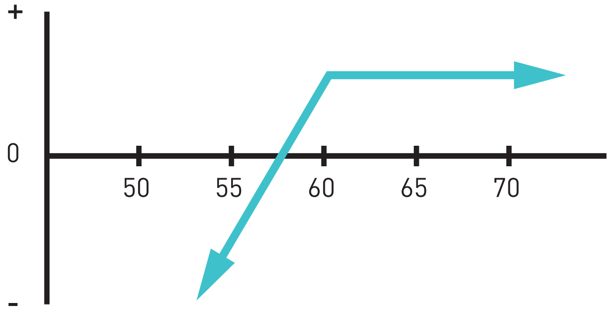
Description

The cash-secured put involves writing an at-the-money or out-of-the-money put option and simultaneously setting aside enough cash to buy the stock. The goal is to be assigned and acquire the stock below today's market price. Whether or not the put is assigned, all outcomes are presumably acceptable. The premium income will help the net results in any event.

The investor is bullish on the underlying stock and hopes for a temporary downturn in its price. If the stock drops below the strike, the put may be assigned. That would allow the put writer to buy the stock at the strike price. The effective purchase would be even lower: strike price less the premium received.

There are two principal risks. First, the stock might not only dip but plummet well below the strike price. The investor must be comfortable with the strike price as an acceptable long-term acquisition price, no matter how low the market goes.

Cash-Secured Put
Net Position



Example

Short 1 XYZ 60 put
Long $6,000 T-Bill

MAXIMUN GAIN
Premium received

MAXIMUN LOSS
Strike price - premium received (substantial)

Second, by waiting for a price dip, the investor risks missing out on a stock that keeps climbing upward. The choices then include repeating the short put strategy (possibly at a higher strike price), or closing out and buying the stock outright, or simply accepting that this winner 'got away.'

Outlook

Looking for a short-term dip in stock price, followed by a longer-term appreciation.

Summary

The cash-secured put involves writing a put option and simultaneously setting aside the cash to buy the stock if assigned. If things go as hoped, it allows an investor to buy the stock at a price below its current market value.

The investor must be prepared for the possibility that the put won't be assigned. In that case, the investor simply keeps the premium received for selling the put option.

Motivation

This is primarily a stock acquisition strategy for a price-sensitive investor. Unlike a naked put writer whose only goal is to collect premium income, a cash-secured put writer actually wants to acquire the underlying stock via assignment. The strike price, less the premium received, represents a desirable purchase price.

However, the put assignment is not guaranteed. Should the stock price remain above the strike during the life of the option, the investor will miss out on the stock purchase. The consolation would be pocketing the premium received for the put.

If the investor is intent on acquiring the stock and is less concerned about price, there are other strategy choices worth considering.

Variations

A cash-secured put is a variation on the naked put strategy. The main difference is that the cash-secured put writer has set aside the funds for buying the stock in the event it is assigned and views assignment as a positive outcome.

In contrast, the naked put writer hopes that the put will keep losing value so the position won't be assigned and can be closed out early at a profit. This investor would have to liquidate other assets quickly, or borrow cash, to be able to honor an assignment notice.

Max Loss

The maximum loss is limited but substantial. The worst that can happen is for the stock to become worthless. In that case, the investor would be obligated to buy stock at the strike price. The loss would be reduced by the premium received for selling the put option.

Notice, however, that the maximum loss is lower than would have occurred, had the investor simply purchased the stock outright rather than via selling a put option.

Max Gain

The maximum gain from the put option itself is limited. However, the optimal outcome is not readily apparent in the expiration profit/loss payoff diagram, because it does not address developments after expiration.

The best scenario would be for the stock to dip slightly below the strike price at the put option's expiration, trigger assignment and then rally immediately afterwards to record heights. The put assignment would have allowed our investor to buy the stock at the strike price just in time to participate in the following rally.

From a strictly short-term perspective, the maximum possible gain occurs if the stock stays above the strike, causing the put option to expire worthless. The investor would keep the T-Bill cash originally set aside in case of assignment and simply pocket the premium from the sale of the option. While that is a benign outcome, it obviously doesn't reflect the fact that the investor would rather be participating in the stock's upward movement.

Profit/Loss

In a short-term sense, the potential profit (from the put option itself) is very limited, while the potential losses are substantial. The premium earned is comparatively small compensation for accepting the large downside risk of a stock owner. If the stock falls to zero, the put writer is obligated to buy a worthless stock at the strike price.

Still, this short-term view gives an incomplete picture of the risks and rewards. It is perhaps more appropriate to compare this strategy to buying the stock outright, since the goal of stock ownership is the same.

The cash-secured put does somewhat better if assignment occurs. The put writer gets a better purchase price than the original stock price. The 'discount' consists of the original out-of-the-money amount, if any, plus the premium received. Both investors face the risk of the stock's falling to zero, but the put writer's premium income reduces the loss at every level. And if the stock rallies back, the put writer's gains are better by the amount of the premium.

The outright stock buyer is better off than the put writer if the put is not assigned and the stock keeps rallying. Granted, the put writer keeps the T-Bill interest and the put premium. However, the stock has gotten even further away from the original target price and would now cost more to get into the portfolio.

Breakeven

Since the object of this strategy is to acquire stock, the investor would break even if it is possible to sell the stock at the same effective price they paid for it.

Breakeven = strike price – premium

Volatility

Whereas an increase in implied volatility would be considered an unqualified negative for a naked put writer, the effect could be described as neutral to slightly negative for the cash-secured put writer, all other things being equal.

If it now appears likelier that the put will be assigned, greater volatility is a neutral or perhaps even encouraging development.

However, greater implied volatility is clearly a negative in the sense that it can raise the put's market value and thereby the cost of closing out the position. Remember, implied volatility is a measure of anticipated movement in either direction, up or down. Say, the investor is now convinced the stock will rally instead, and decides to purchase the stock outright before it goes any higher. Unless the investor is prepared to buy even more stock if assigned, the short put must be closed out, and its cost is now higher.

Time Decay

The passage of time will have a positive impact on this strategy, all other things being equal. As expiration approaches, the option tends to move toward its intrinsic value, which for out-of-money puts is zero. If the original forecast and goals still apply, the investor keeps the premium and is free to either buy the stock outright or write a new put.

Assignment Risk

Slight. Since the goal of this strategy is to acquire stock, assignment is not a problem. However, early exercise would require the investor to convert the interest-bearing asset to cash in order to pay for the stock.

Also, if assignment happened during a particularly severe downturn and the put writer has second thoughts about owning the stock at the strike price, the delay between assignment and notification means that the stock could fall further before the investor can act to limit losses. This is one reason why all option writers have reason to monitor the underlying stock very closely.

And be aware, a situation where a stock is involved in a restructuring or capitalization event, such as a merger, takeover, spin-off or special dividend, could completely upset typical expectations regarding early exercise of options on the stock.

Expiration Risk

None. Since the goal of this strategy is to acquire stock, the investor should welcome an assignment at the option's expiration.

Comments

Investors are told repeatedly to be wary of short option strategies, and quite rightly so. Without question, they entail tremendous risk, far greater than the limited premium income. They are definitely not suitable for all investors and situations.

However, here is a short option strategy with a risk profile that is identical to the covered call. Though far from risk-free, covered call writing is considered a perfectly legitimate strategy for many equity investors.

The key here is the cash-secured put investor's intent to acquire the underlying stock regardless of the near-term lows it might hit. So as long as the put writer is comfortable with assignment and the downside risks of the stock, this strategy isn't inherently more dangerous than a covered call. Of course the risk is large if the stock is falls to zero. However, that risk applies to all stock owners and covered call writers, too.

Related Position

Comparable Position: **Covered Call**

Opposite Position: N/A