

OptionProfessor.com Alert

August 18th, 2021

# HEDGING STRATEGIES



BY THE OPTION PROFESSOR

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Hedging Strategies  
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Last Week...We told readers in our Weekly Update that the Semiconductors decline could be a "Correction Canary" meaning a precursor to an SPX drop...here we are. In our view; the keys RISKS now 1. GDP & Inflation, Consumer Spending peaking/ slowdown 2. Interest Rates on 10yr treasuries peaked at 1.75% in March 3. P/E Valuations on S&P now 22 X contracts to normalized 18X with inflation 3%+ (example SPX \$200 earnings X 22 = 4400 or X 18 = 3600).

Maybe this is summer doldrums to be followed by big rally after Sept 15 as we close out Q3. Maybe the news on the Delta variant, supply bottlenecks, jobs numbers are about to change in the next months and we resume a big rally.

BUT...why not review the uses and risks of strategies that traders use to protect their account values against declines?

**How Options Are Used To Hedge Upside And Downside Risk:**

Options trading has been considered a high risk investment for the many decades since their inception.

Did you know many investors actually use options to REDUCE risk in their portfolios?

Before we begin; I would like to introduce myself as the person sharing his views and opinions. My name is Jim Kenney and I have been the content provider for OptionProfessor.com for decades. As a graduate of Boston College and having conducted hundreds of option seminars for thousands of investors nationwide; I have seen many investors struggle with the concept of options as a hedge.

Let's start out by understanding the concept of a hedge. If an investor owns a position (long) in their account; the risk is that asset will fall in value and value of the account will decline as a result. In this hypothetical example the investor could benefit from an option strategy that would increase in value during a market decline to offset in part or in total the decline in the underlying position. Conversely; should an investor not own a position in the market, a rise in price would be his opportunity risk in that he may be compelled to buy at higher

prices. In this case an option strategy that would benefit from a rising market could be of value offsetting in part or in whole the risk of higher prices. Many of you have had trading experiences where a hedge could have added real value.

Before we go further; you may have some "let's cut to the chase" type questions right now. They may include "How much do these hedges cost?" and "How much hedge do I get?" and "When do you it? All great questions and some have factual answers while others do not. It's a combo of Art & Science. My opinions are my own and other opinions will vary. Ask your firm & advisor. Here's some scenarios.

SCENARIO #1 - The investor initiates a position in a volatile tech stock. They are concerned about the downside risk as the stock has had huge moves up and down. They believe the stock will have a major advance but want some floor under their equity. They could use a stop loss but the risk of getting stopped out or the stock gapping thru their stop leads them to look for an alternative. There are a number of option tactics that I would consider including married puts and collars. Here's where the art and science comes in. There are questions that I would have to answer before reaching a decision. What is the implied volatility of the options? If the stock has been hugely volatile then the option premiums are going to be big if not the premiums may be fair sometimes even cheap. How much of a hedge do I want? This is where you determine what strike price to choose. How much time to I want to be hedged? This is where you select your expiration dates. Some investors want to hedge specific events (e.g. Fed meetings/earnings announcements/dividend dates/splits/takeovers ect.) while others want to sleep at night with parameters around their positions. Always price out the puts in the far out expiration and compare to the nearby puts; you may find a little bit more money gets you a lot more time. Remember; like many other types of hedges, when your contract expires so does your hedge.

Hypothetical example on Apple. Let's say you take a position of 100 shares (each option contract is based on 100 shares) @ a price of 175. All of these hypothetical example are exclusive of any fees or commissions the total is \$17,500. You decide that for the next 6 weeks you would like to get a hedge for an objective of hedging your position to a 3% draw down for that period. The monthly option expiring in 6 weeks with a strike price of 172.50 can be bought for \$2.50 in this hypothetical example. The strike price of 172.50 minus the premium paid puts your hedge at 170 per share or about 2.8% below your entry level of 175 well with your parameters. There are many things that could happen between now and the expiration date but let's look at 3 outcomes at expiration settlement. Apple has risen to 195. The stock has risen \$20 from your entry but you need to reduce that by the put cost of \$2.50 or \$17.50 gain. Should the

stock decline to \$155 or a decline of \$20 in value. The put gives you the right but not the obligation to sell at \$172.50 minus the cost of \$2.50 or \$170. The difference between \$170 and \$155 is a credit of \$15 per share. In this example you hedged \$15 of the \$ 20 risk. Should the stock trade sideways but stay above \$172.50; you lose the premium but still own the stock.

Sometimes option premiums are very high due to many factors including implied volatility. My feeling on implied volatility is that the options are priced as to what has happened not what is going to happen and therein lies the rub. Options on slow moving stocks tend to be a lot lower than a fast moving stocks as the implication is the same volatility will continue. The problem is slow moving stocks can get news and volume that increases their moves and fast moving stocks can subside or correct.

When option premiums are high and you still want downside hedge you may need to consider a strategy that combines the use of covered call writing with put buying also known as an options collar.

Since this strategy combines 2 strategies simultaneously; there are 2 risks that need to be considered among other things. First off; when you are selling calls against your stock, you are agreeing to sell your stock at a certain price for a certain amount of time and for that you receive the call option premium. Secondly; when you are buying a put, you have the right but not the obligation to sell at a certain price for a certain amount of time and you pay the put premium. Among other things; you limit your upside but you also limit your downside simultaneously.

This hypothetical example will involve buying 100 shares of Boeing after a major advance @ \$440 or \$44,000 again all examples are exclusive of fees and commissions. Again; your objective is to have the ability to participate in some while hedging against a down move for the next 6 months of time.

The options expiring in 6 months are priced at \$25 for the 470 call and \$25 on the 430 put. The collar strategy would be the selling of the 470 call @ \$25 or \$2500 dollars received. This obligates the investor to sell/deliver stock at 470. Simultaneously; the investor buys the 430 put @ \$25 or pays a premium of \$2500 for the right but not the obligation to sell at 430. Essentially; the investor has limited his upside to an additional 30 per share (470) while limiting his downside to \$10 per share (430). Should the stock remain between the strike prices thru expiration; both options may expire worthless and the investor retains the stock. The investor has taken the premium received on the call and

used that premium to buy the put. There are other considerable factors and adjustments.

This is known as collaring the position so that while additional upside after a substantial up move still exists; the put option strike price puts a floor under the position until the options expire. Other factors such as liquidity (bid/ask spreads) and volume (amount of contracts traded) should also be considered. Again no strategy is right for everyone so consult your brokerage firm and adviser.

I will be providing more details on my views and considerations when considering an option strategy. Should you want to receive updates or have question; I invite you to contact me at [optionprofessor@gmail.com](mailto:optionprofessor@gmail.com).

### **- The Option Professor, 8/18/21**

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