

Option strategies— buying protective puts



Wealth
Management

Bearish strategies

The buyer of a put option has the right—but not the obligation—to sell the underlying stock at a fixed price (the strike price) for the life of the option. The value of a put option benefits from a decline in the underlying stock price and is the reason many investors use puts to protect their stock positions. In many respects puts, when used in this fashion, can be viewed as insurance policies.

Hedging strategy — Investors looking for ways to reduce their exposure and protect the value of their equity positions may consider purchasing a protective put option, as an alternative to selling shares. The put purchase reduces downside exposure while allowing for continued upside potential. Clients might initiate this prior to an earnings report or if they believe the stock is trending downward.

Strike price choice — The strike price of the put option determines the level at which the investor may choose to exercise and sell his or her shares. Put options with higher strike prices afford greater protection for the underlying stock. These higher strike puts will also have higher

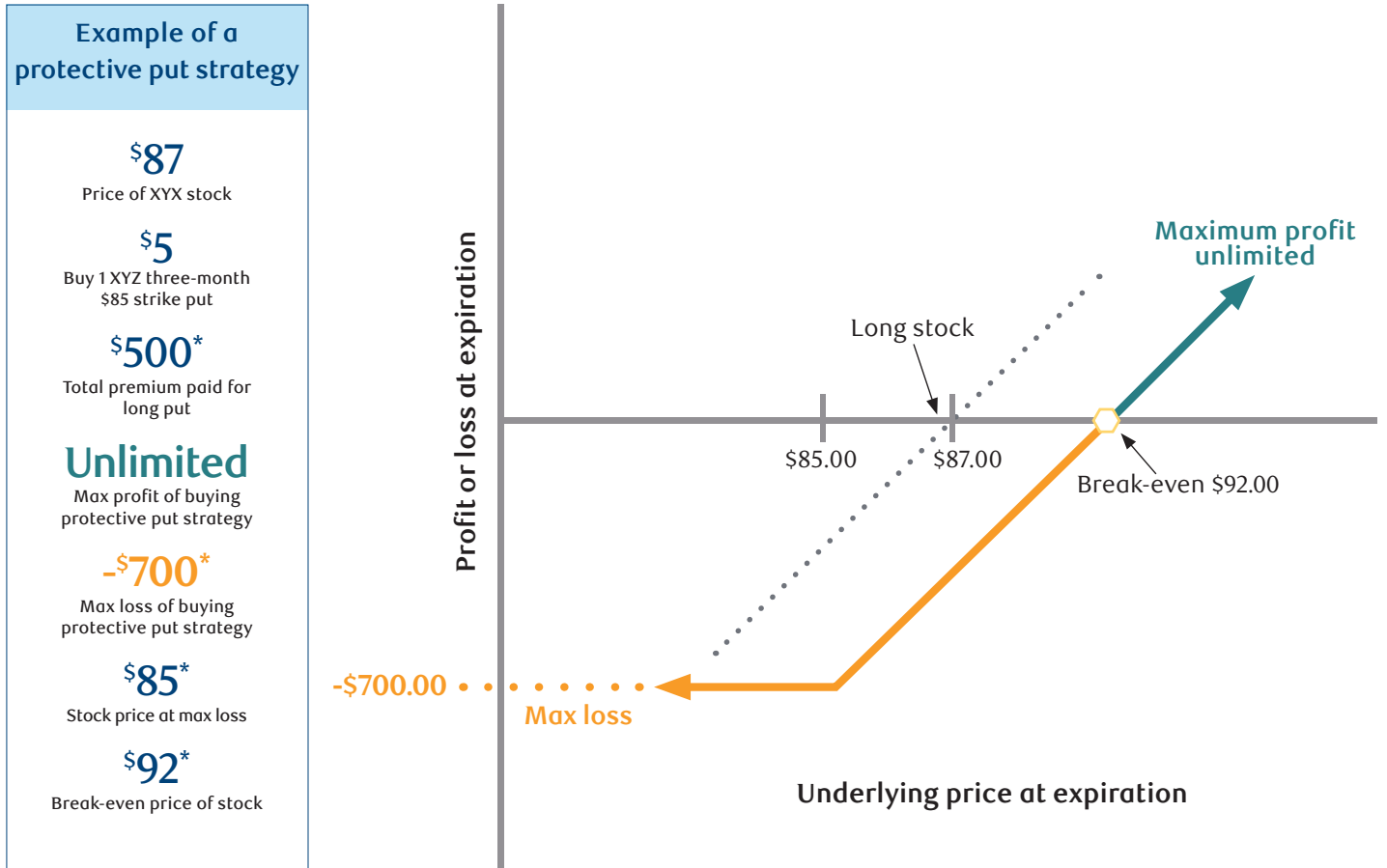
premiums. Like an insurance policy, a put with a strike price that is less than the stock's price can be viewed as having a deductible. Puts offer price protection below the strike price, investors who purchase out-of-the-money puts assume risk of the difference between the stock price and the strike price. Also, like an insurance policy, the further out-of-the-money (higher deductible), the premium price will be lower. The investor must weigh the trade-off of the lower premium and the higher deductible.

Expiration choice — Options have a finite life, making it extremely important for investors to choose an option with an expiration date that more than covers the time frame of perceived risk in their underlying stock position. Note, long puts decrease in value and incur losses when time passes and the stock price remains unchanged.

Volatility — Rising and falling stock prices create volatility, which impacts options prices. When volatility rises, options prices tend to move higher. A protective put position will increase when volatility rises and decrease when volatility falls when all other factors—such as the stock price—remain constant.

Alternative strategy to stop-loss stock order — Some investors prefer to enter stop-loss stock orders to limit their downside risk in their underlying stock. Unfortunately, executed stop-loss orders can sell shares in volatile markets at very poor prices and then that same stock can recover at much higher prices within the same day. A client who owns a protective put helps avoid the sale of shares because they decide when they'll exercise or sell their shares. The long put provides protection in those volatile markets. Clients control the ability to sell their put or keep their protection in place.

Strategy P/L



Reach out to your RBC Wealth Management financial advisor to discuss option strategies, including buying put options, and how these strategies may help you accomplish your overall wealth management goals.

*Commissions not included

This strategy sheet discusses exchange-traded options. It is not to be construed as a recommendation to purchase or sell a security. Before engaging in the purchasing or writing of exchange-traded options, investors should understand the nature and extent of their rights and obligations and be aware of the risks involved, including the risks pertaining to the business and financial condition of the issuer of the underlying stock. Listed options are not suitable for all investors. Prior to buying or selling an exchange traded option, a person must be provided with, and review, a copy of CHARACTERISTICS AND RISKS OF STANDARDIZED OPTIONS. A copy of this document may be obtained from the RBC Wealth Management Business Supervision Group, 250 Nicollet Mall, Minneapolis, MN 55401. Phone: (612) 313-1449. Additional supporting documentation including statistics and other technical data are available upon request.