The complete and useful guide to selling puts

Learn when it’s best to utilize short put strategies, how to build, evaluate and manage these strategies.
Disclosures

- Options’ trading entails significant risk and is not appropriate for all investors. Certain complex options strategies carry additional risk. Before trading options, please read Characteristics and Risks of Standardized Options, and call 800-544-5115 to be approved for options trading. Supporting documentation for any claims, if applicable, will be furnished upon request.

- Examples in this presentation do not include transaction costs (commissions, margin interest, fees) or tax implications, but they should be considered prior to entering into any transactions.

- The information in this presentation, including examples using actual securities and price data, is strictly for illustrative and educational purposes only and is not to be construed as an endorsement or recommendation.
Goal of this webinar:
To educate traders on when they can utilize short put strategies. Also to show how to build, evaluate, and manage these trades.

What we will cover:

➢ Explanation of the strategy
➢ Different reasons for selling puts
➢ Ways to generate put selling opportunities
➢ Choosing the appropriate strike and expiration to match your outlook and objective
➢ Evaluating the risks of the strategy
➢ Discuss different ways to manage the strategy
Short Put Strategy

Outlook:
Bullish/Neutral

Construction:
Selling a put (cash-covered or naked) in return for premium

Max Gain:
Premium received

Max Loss:
Substantial (but limited to the strike price)

Breakeven @ expiration:
Strike price – Premium received

Trader’s View:
➢ Short puts have the same profit/loss profile as a covered call strategy. Therefore, the short put can be used as a covered call alternative potentially reducing commissions while simplifying position management.

A full explanation of this strategy is available using the Option Strategy Guide in Fidelity’s Learning Center.
Goals of the strategy

Why do traders sell puts?

➢ Generate income
  • Take in premium on a bullish neutral outlook
  • Generate returns in a sideways market

➢ Take advantage of relatively high implied volatility (IV)
  • If you are expecting a decrease in IV, the value of puts will be reduced making them less expensive to buy to close

➢ Allows for higher probability trades when compared with other bullish strategies, such as a long call

➢ Alternative to using a limit order to buy the underlying

Trader’s View:

➢ The short put allows the trader to take advantage of high volatility in a way that is easily quantifiable.
Short put vs. Buy limit order

Short puts may be used as an alternative to placing buy limit orders.

Example:

YHOO current market price = 49.70

Trader wants to own 100 shares of YHOO if price goes down to $49

Option 1: Place a buy limit order

Buy 100 shares of YHOO @ 49

Cost basis = 49
(if order is filled @ 49)

Option 2: Sell a $49 strike put

SPO - YHOO150130P49 @ 1.68

Cost basis = 47.32
(if the put is assigned)

*If you are not assigned on the short put, you still get to keep the premium!
Risk Management

The Greek exposure of a short put might be the reason a trader chooses this strategy over another bullish strategy, such as a long call.

**Delta** (+)  Bullish directional bias: 32 long share exposure

**Gamma** (-)  Accelerated losses, decelerated gains

**Theta** (+)  Profit $4.45 with each passing day

**Vega** (-)  Profit $12.58 with each 1% decrease in IV

*Profit/Loss calculator in ATP: Simulated a short GLD Feb 20 121 Put, GLD trading @ 124.31*
Implied Volatility

Short puts allow the trader to capitalize when anticipating a decrease in implied volatility (IV).

**Short GLD Feb 121 Put**

➤ Vega = -12.57

➤ Strategy **gains $12.57** with a 1% decrease in IV

➤ Strategy **loses $12.57** with a 1% increase in IV
Which Fidelity tools and resources can you use to find put selling opportunities?

➢ To find potential bullish positions
  • Equity Summary Score / Analyst options
  • Stock Screeners (Preset or custom)
  • Trade Central’s technical analysis report
  • Recognia event and pattern recognition

➢ To find underlying products with relatively high implied volatility (IV)
  • Market Scanner
  • Strategy Ideas tool
  • ATP Filter
Idea Generation

➢ Strategy Ideas tool – Cash Covered Puts

<table>
<thead>
<tr>
<th>Stock Symbol</th>
<th>Stock Price</th>
<th>Expiry 1</th>
<th>Low Strike Price</th>
<th>Put Bid</th>
<th>Yield to Strike (YTS)</th>
<th>Annualized YTS</th>
<th>Put IV</th>
<th>HV30</th>
<th>Action</th>
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</thead>
<tbody>
<tr>
<td>ESI</td>
<td>7.97</td>
<td>03/20/2015</td>
<td>6.00</td>
<td>0.56</td>
<td>9.30%</td>
<td>64.05%</td>
<td>123.18</td>
<td>72.80</td>
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<tr>
<td>WAC</td>
<td>15.47</td>
<td>03/20/2015</td>
<td>13.00</td>
<td>1.20</td>
<td>9.20%</td>
<td>63.36%</td>
<td>103.62</td>
<td>51.25</td>
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<tr>
<td>OCN</td>
<td>7.41</td>
<td>03/20/2015</td>
<td>5.00</td>
<td>0.45</td>
<td>9.00%</td>
<td>61.98%</td>
<td>144.70</td>
<td>171.06</td>
<td>Action</td>
</tr>
<tr>
<td>JDST</td>
<td>9.03</td>
<td>03/20/2015</td>
<td>5.05</td>
<td>0.45</td>
<td>8.90%</td>
<td>61.29%</td>
<td>175.10</td>
<td>207.95</td>
<td>Action</td>
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<tr>
<td>W</td>
<td>20.21</td>
<td>03/20/2015</td>
<td>17.50</td>
<td>1.25</td>
<td>7.10%</td>
<td>48.90%</td>
<td>82.63</td>
<td>62.80</td>
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<tr>
<td>HLSS</td>
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<td>02/20/2015</td>
<td>10.00</td>
<td>0.70</td>
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<td>157.50</td>
<td>90.12</td>
<td>Action</td>
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<td>SGY</td>
<td>14.44</td>
<td>03/20/2015</td>
<td>12.00</td>
<td>0.30</td>
<td>6.70%</td>
<td>46.14%</td>
<td>82.80</td>
<td>89.64</td>
<td>Action</td>
</tr>
</tbody>
</table>

Looks for high yields on OTM puts by comparing Yield to Strike (YTS)
Bid/Strike price = .56/6 = .093 = 9.30% YTS
**Strike Selection**

Consider tradeoffs when choosing strikes:

<table>
<thead>
<tr>
<th>Strike</th>
<th>Premium received</th>
<th>Break-even</th>
<th>Probability of assignment</th>
</tr>
</thead>
<tbody>
<tr>
<td>ITM $16 Put</td>
<td>$1.58</td>
<td>$14.42</td>
<td>61%</td>
</tr>
<tr>
<td>ATM $15 Put</td>
<td>$.97</td>
<td>$14.03</td>
<td>46%</td>
</tr>
<tr>
<td>OTM $14 Put</td>
<td>$.54</td>
<td>$13.46</td>
<td>31%</td>
</tr>
</tbody>
</table>

**Trader’s View:**

- Selling an ITM put is a strategy which may be used in an attempt to acquire the stock at a discount. Be careful though – if the price goes up, you could miss out on the opportunity.
## Strike Selection

Consider your goals and objective for the trade:

<table>
<thead>
<tr>
<th>Common Use</th>
<th>In-the-Money (ITM)</th>
<th>At-the-Money (ATM)</th>
<th>Out-of-the Money (OTM)</th>
</tr>
</thead>
<tbody>
<tr>
<td>An alternative to placing a buy limit order</td>
<td>ATM options have the most time value</td>
<td>Income generation Premium selling</td>
<td></td>
</tr>
<tr>
<td>Probability</td>
<td>Highest probability of being assigned</td>
<td>Probability of being assigned ≈ 50%</td>
<td>Lowest probability of being assigned</td>
</tr>
<tr>
<td>Premium/Risk</td>
<td>Highest premium received</td>
<td>Offers the most exposure to time decay (highest Theta)</td>
<td>Lowest premium received</td>
</tr>
<tr>
<td>Highest gamma risk</td>
<td></td>
<td>Highest gamma risk</td>
<td></td>
</tr>
<tr>
<td>Position Management</td>
<td>More Aggressive (More bullish)</td>
<td>Balance exposure to small price moves by ≈ 50%</td>
<td>More conservative (Less bullish)</td>
</tr>
</tbody>
</table>
Strike Selection

Additional forms of analysis may cause a trader to be more aggressive or passive in their strike selection...looking at key support levels is one example.
Expiration Selection

Time decay typically accelerates as expiration comes closer, meaning shorter term options have the highest time decay.
Rolling shorter term contracts* vs. selling one long term contract

Over a 4 month period....

Write an ≈ 30 day option 4 times?
$2.50 \times 4 = $10

Write an ≈ 120 day option 1 time?
$4.85 \times 1 = $4.85

All things equal, due to accelerating time decay, rolling shorter term options offers a higher potential annualized ROR

Trader’s View:
➢ Rolling shorter term contracts gives you potentially higher annualized returns, where longer term contracts gives you income certainty.

*Please note commissions will be charged for each trade.
Capital Requirements

Return on Capital (ROC) =

\[
\text{Premium received} / (\text{Capital requirement} - \text{Premium received})
\]

Cash covered puts

- Capital req = Exercisable value

Example: Selling a cash covered GPRO put

- GPRO150220P47 @ 2.40

- Capital requirement = 4460

- ROC = 240/4460 = aprox 5%

Naked puts

- Capital req = Margin requirements detailed in FAQs on Trading page on Fidelity.com

Example: Selling a naked GPRO put

- GPRO150220P47 @ 2.40

- Capital/margin requirement = 935

- ROC = 240/935 = 26%
Position Management

A trader has 3 ways they can manage any strategy:

Option 1: Leave the strategy alone
- **Makes Sense When:** I would put the same trade on today

Option 2: Close the strategy
- **Makes Sense When:** The strategy no longer aligns with the outlook

Option 3: Adjust the strategy
- **Makes Sense When:** The existing strategy can be altered to better align with the outlook

Trader’s View:
- Be honest with yourself when re-evaluating an existing trade and manage accordingly. Don’t fall into the trap of making adjustments without considering the end objective of the trade.
Position Management

Exit strategy:

- Upside: If stock is above strike price, you can potentially keep the full premium.
  - Trader receives max gain if put is held to expiration - No commission charged
  - Establish a predetermined profit target to close trade
    - Less profit potential but the trade off is a higher probability of profit
- Downside: Potential for substantial loss if stock falls.
  - Have predefined risk levels in place should this happen (i.e., percentage of loss you are willing to accept, falls below major support level or change in trend)

Potential adjustments:

- Let stock be assigned, potentially sell covered calls against it
- Roll the option out (new outlook on stock should match strategy)
- Define risk from the beginning by creating a spread
Key Takeaways

➢ Selling puts is a popular strategy used to generate income on an underlying product that a trader has a neutral to bullish outlook and a bearish volatility outlook

➢ Selling a put can be used instead of placing a buy limit order when a trader is looking to establish a long stock position at a specified price. The benefit is that the premium can potentially reduce the cost basis of the long shares if assigned. However, like a buy limit order getting the long shares of stock is not guaranteed.

➢ Fidelity has tools and resources to help you generate ideas for this strategy whether your objective is to generate income, establish bullish directional exposure, take advantage of decreasing implied volatility or to get long shares of the underlying.

➢ Tradeoffs should be considered during the strike selection process. Consider the potential rate of return vs. the risks being taken (probability of assignment, probability of profit, etc.)

➢ Proper risk management is being able to look at a strategy and determine if it makes sense today and going forward – ignore the past
Put Selling

Resources used in this presentation:

➢ ATP option chain
➢ ATP option analytic tools,
  ➢ Option Statistics
  ➢ Probability Calculator
  ➢ Profit/Loss Calculator
➢ Option Strategy Guide (Fidelity Learning Center)

Additional Resources:

➢ Fidelity.com Learning Center
➢ Option Strategy Guide (Fidelity Learning Center)
➢ Recorded webinars from Fidelity
Put Selling

This concludes today’s presentation.

Thank you for attending.

To Register, please visit the Fidelity.com Learning Center
https://www.fidelity.com/learning-center

For more info: How to start trading options

For additional support, please contact a Fidelity representative at (877) 907-4429.