TRANSCRIPT

Bearish strategies and hedging

Presenters: Colin Songer and Edward Modla

Colin Songer: Let me bring on the real star of the show, Ed, so he can introduce himself, and we'll dive right in.

Edward Modla: Colin, thank you very much for that kind introduction, and as Colin said, I'm here to talk about bearish strategies. And as a tangent to that, along with that downside look, we'll look at hedging as well, which would incorporate sort of maybe being long stock and using options to hedge throughout the day here -- really covering the market and managing your portfolio from different angles. How do you develop your market opinion? That risk-on versus risk-off perspective, and when you are risk-on, what do you do? Where do you want your money to be? Of course, you can buy yourself shares there, but using options can often be beneficial. Talked about some bullet strategies earlier; now we're going to look at the other side. My background -- started on the trading floor in the late '90s, spent a number of years in the open outcry environment on the trading floors at the CBOE and Amex options exchanges. Spent some time in Chicago and New York, but going on seven years now with OCC and our investor education team, just teaching options. That's all we do. We speak to a variety of market participants, ranging from the retail investor to the money manager and the institutional investor. Really looking forward to this discussion with Colin today.

First, our disclaimers. Options are considered a complex investment tool and need to be well understood before you use them in a live account. And the strategies we're going to look at today, starting with the long put, but from a couple of different perspectives -- and this is where we're going to utilize that speculating, being bearish, along with protecting a position or a portfolio. And the collar is where we'll finish up this session here today -- a little bit more complex strategy with several moving parts, so we'll take our time picking apart and dissecting what that strategy is all about. Something I always like to point out, said it in the earlier session: we see these strategies -- you know, long put, protective put, collar, we talked about covered calls earlier today -- there's a lot of different names for options strategies. You have straddles and strangles, butterflies, condors. And one of the benefits of those titles is that they have classic definitions. So we can all get on the same page. We know what we're talking about when we say "collar." Those who understand the strategy know what it is. But in a live account, with real money on the line, often investors are taking their knowledge of that strategy as it's defined in its classic form and then tweaking it and changing it and doing something different. So it's no longer a collar, or it's no longer a covered call as it's defined. It's something different. Something unique to you. It may not have a name at all. It's just something that you've developed because in that particular position or at that moment in the market, you've decided that you want to do something that fits your perspective and your market outlook a little bit better. Now, when it comes to the collar, because there's moving pieces there, we'll get into those variations and those tweaks that you can do with the collar to make it a little bit more tailored to your experience.

First long put -- and as I said, we're going to look at long put from a few different perspectives, but starting with that speculative nature, here you are bearish. You think the stock is moving lower; most investors I speak with are not shorting stock in their account, so when they're bearish or they're concerned, they're just pulling money out, and they're increasing their cash position versus the amount of capital they have allocated to the market. Options open up another door, and here we have speculating with a long put to potentially profit from a downside move in a particular stock.

Let’s look at the basics of puts and we’ll understand what the put seller is doing as well. The equity put buyer is paying the put premium, the option premium, up front -- that’s a cash outlay or an immediate cash debit -- and now has purchased the right to sell underlying shares of stock. The option will identify what the strike price is, or what price can they sell the shares at, and there will also be an expiration date on the option as well. The investor chooses those details. There’s a number of different choices for strike prices, a number of different expiration dates. You, as the put buyer, choose which one you would prefer. And of course, the higher and higher price you have the right to sell at, it’s gonna cost you more. The longer time you own these rights, that’s also gonna cost you more. So you weigh that cost versus where you think the stock is going, how long you would like to own the option, and you pick the right option for you.

If you’re speculating, which is what we’re focused on here today, you are bearish on the underlying -- the share price moving lower will have a positive influence on the value of a put option if you have the right to sell at a particular strike. Now, I chose my words carefully there. I said “has a positive influence,” because it doesn’t necessarily mean the option price is going to go higher. If the share price goes down, the option price will be influenced higher, but you have those others factors that we won’t get too deep into today, but we will at least glance over the concepts of time decay or changes in volatility, which both affect option premium levels -- that will at least have an awareness that options are slowly decaying. Gradually and gradually, a natural time decay from one passing day to the next. And changes in implied volatility -- investors who are new to options seem confused; they don't understand -- when volatility levels change, what does that mean? What do I need to understand? At its most simple level, all that it means is there's a change in the force between buyers and sellers. If more buyers come into the market, that will drive prices higher, and that will drive volatility levels higher. If there's more sellers in the market -- and I'm specific to the options market when I say this -- more sellers in the market, option prices come down and volatility levels come down right along with it. That's what changing implied volatility means. So if you're buying your hope is more buyers follow you -- you certainly don't want an influx of sellers to follow your purchase of an option. If shares are already owned, then this is buying protection, and we will get to that a little bit later. Buying puts for that downside gain, but in this circumstance it's more or less protecting a position that you have in your account, whether it be a new one or a position that you have a profitable position in.

The other side of this trade, the put seller, is motivated by receiving the premium that you're paying. You're buying this option, you're paying premium up front; the seller wants that premium, and that's their motivation to take in the premium as a cash credit -- that's an immediate credit to their account, it's theirs to keep, and they accept the obligation to buy shares of stock at the strike price, and they are under that obligation until the expiration date.

So we're going to look at the put buyer -- sort of that downside look. You know, if you're speculating, if you're protecting a position, what exactly are you trying to do, and how does it work? Let's walk through an example. It's the easiest way to look at these things, the long put. There's just one piece to it, buying put option -- that's it. An investor here has a bearish outlook on the share price, but can they capitalize on the move lower without shorting stock? So most investors are not taking on short stock positions in their accounts, so they're more or less sitting out those circumstances. When they think the share price goes down, they sit and wait, and maybe they wait until the shares have corrected enough, so they feel comfortable going to long stock, because they are what we would say are long-only investors. There's nothing wrong with being long-only. There's long-only funds, there's long-only money managers. But here another door has opened if you're the type of investor that does on occasion form a bearish outlook and would like to capitalize on that.

A few things you can consider -- there's certainly more than this, but we're going to look at a few of them here. Buying a put option, you own the right to sell shares. That's a fixed price, the strike price. You choose which strike price you're most comfortable with, and it might -- I use that word "might" -- gain value if the share price declines. The word "might" is in there for those reasons I explained earlier. You have time decay, you have changes in volatility levels and a changing stock price -- all of those variables are influencing the option. But if the share price does move down large enough, you've got a very good chance to see your option trade for a higher price than where you purchased it. And there you have -- your other considerations: timing, magnitude of move, if you were tuned into session two we talk about being long a call here -- it's long a put. Not the easiest thing to do consistently. It's tough to have a high batting average of success when you're buying options. You have to have the timing right, the direction right, and the magnitude of the move right in order to be profitable, but that's why buying options generally is coming at a lower cost and a lower risk. Because the odds are somewhat against you that you can be profitable here more often than not, you pay a little bit less, and when you do hit a big move, if you're fortunate enough to get that, the returns can be somewhat substantial as a percentage.

And also, a bearish outlook using options could be a spread; we're adding a little bit of a complexity here. In addition to buying a put, you are now going to simultaneously sell a lower-priced -- and that would be a lower strike put option -- to reduce your overall costs. We're buying one option, we're selling another, we're buying the more expensive, higher striked put, gives us the right to sell shares at that level. At the same time, go to a lower strike, sell that option for the purpose of bringing in premium and reducing cost, and remember what that means. So now we have the right to sell shares, but we also have the obligation to buy them back at that short strike that we sold. So selling and buying -- those two pieces there maximize our profit potential. Limited profit potential -- we can calculate that number; differences between the strikes. But in exchange for that, maximum potential gain -- instead of having all the downside potential, we have traded that off to reduce our costs.

And then Colin, we talked about this earlier. You know, outright versus spread, the level of comfort, the level of complexity -- you know, how do you view the comfort level of investors when it comes to adding these layers, like, particularly here with vertical spreads?

Colin Songer: What I've noticed is that, especially when someone's beginning out, they get really intimidated by spreads, right? You have that additional leg, and there're more complexity with -- there's more moving parts, right? You already mentioned, just in a single leg, how many moving parts there are in that pricing. We're at another leg, so this is even more moving parts. Interestingly enough, it was always stated to me, well, what does the spread do? It spreads off the risks, right? And that's what I was talking about these different price components: it's reducing the exposures to those. So there are some advantages, but it also, it caps the amount that you can make on that as well. So there are push-pulls that go along with it, but I would say the majority of traders are really intimidated by the spread. They have some comfort level with buying a put. Not as comfortable as buying a call, interestingly enough, but buying a put, that single leg, they have a familiarity with it compared to something like a spread, where they have that complexity that just goes really in-depth.

Edward Modla: Yeah, and the other thing I'd say is, you know, be familiar with sort of exercise and assignment, and when you're buying a put option, speculating, undoubtedly your intention is to sell the put option for a gain, or sell the put option when you feel it's the right time. You have no intention of exercising the put and shorting stock. When you have a put spread on, it could be different -- you have the right to sell stock, you have the obligation to buy it back if that put spread ends up what we say is "in the money" -- if the stock does move below both of those strikes, now you've got a choice. Do you just allow that exercise and assignment activity to occur? If the stock is relatively close to one of those strikes, you have some things to be concerned about there. So spreading just -- does also add that exercise and assignment complexity. When you're buying a put -- we're going to show up an example of buying put, that's what we're really focused on here today -- you don't really have that as much, because you're in control when you own the option, you have no intention to exercise, you're going to track the value of this put, hopefully see it increase, and then sell it for a profit.

On a P&L chart, one thing I want to point out with all of the P&L graphs that we look at here today: they're drawn with the expectation that we've reached expiration. And these stock prices that you see, hypothetical stock prices of maybe 190, 200, 210, that allows us to precisely calculate -- what is this option going to be worth at various stock levels and expiration?

Because of this unknown time value, because of unknown volatility levels, a week before expiration or two weeks before, we don't know what an option's worth. So you can't draw these precise, clean profit and loss graphs. That's why they're done at expiration in our example. Stock's trading $200, and we're going to look to buy the 200 strike put instead of shorting stock, but we do want to capitalize on some downside. And we're just going 11 days till expiration, so maybe there's an event on the calendar, or maybe the stock is really sitting here at this 200-strong support level, and we're thinking, hey, if this thing breaks support, it's really going to crash hard. And if it does break support, it's gonna happen within a week. So here you take a chance and you buy a put option; you pay four dollars for the option, which is traded on a per-share basis -- this premium is quoted and traded on a per-share basis. Options deliver 100 shares. This is a $400 cost. And if the stock at expiration is at or above the strike price, then the right to sell shares at 200 isn't worth anything. We lose $400. That's a 100% loss, keep that in mind, 100% loss. But we maximize the potential loss at 400, and if the stock were to drop by expiration, we need to pay ourselves back four dollars to break even. That's that 196 level and then beyond.

The timing, the magnitude, and the direction. You can see it here as well. The stock is at 200, and using our example, 11 days from now, we break even if the stock is at 196. So we need to be right on direction, but also the magnitude of that move -- and it needs to happen relatively soon. This is what I said earlier: it's not easy to have a high batting average when you're buying options, being profitable. But if you do, if it does break support and all of a sudden it's trading 190, 188, 185, you've got an option that could potentially be worth two or three or four times what you paid for it and have a nice gain. Just not easy to do consistently on a basis when you're doing long calls or long puts.

So I think what we want to do now is look at finding bearish ideas. We talked about this -- you know, Colin was looking at this earlier in the first session: finding ideas. How do you get your bullish ideas? Well, same thing from the bearish side. If you want to take that side of the market, looking for bearish ideas is something you will need to do. Options don't trade themselves, so, you know, let's take a look at a demo and we'll look at some things to the downside that investors might want to consider.

Colin Songer: I've found it really interesting when we talk about two things that you really touched on, right? The timing of it, and how we can identify those points. You can use charts to create those outlooks. Ed, you'd mentioned that right at the beginning, right? We create these outlooks to trade off of, right? And this is the tool we can use to help us with that. Help us with our timing. And I'm going to tell everyone -- I'm going to share what I also use it for: when to get out when I'm wrong, right? I actually ask me that question -- "Where am I wrong on this trade?" And I have to answer it before I get into the trade. That way I don't lose everything. So here is a snapshot of a chart, which you can get right here on the top button here, under "Charts." I've already got a few charts in here that you can utilize as defaults, and what it'll bring up is basically a chart -- you have different time frames you can choose -- and Ed mentioned about that support levels. We can find it on our own. There is no such thing as "this is the universal support level." That doesn't exist, right? It's us looking for particular areas. Technicians are going to look for things like what's known as a minor low, which are these dips, right? And what we're looking for is when it breaks these levels. Other mentions are things like moving averages. What do you say for that minor average? A 50-day simple moving average that you hear all over on TV? Well, let's go ahead and add that in.

So as you can see here, I can go in, I can either put the acronym or write it all the way out, add it in. As you can see here, it adds it to the top. Now, I already had the 200-day moving average, that's that -- usually deemed the longer-term trend. But I can go in here, click on it, modify. Guess what? I want the 50. Let me change that period. Period is telling you how many times or how many frequencies -- each bar is shown here daily. This is saying 50 days' worth of data that it's given us an average of.

And boom. I put it on my chart. Now I can use this to help me out with the timing and the reason why I'm in this trade. So in these areas where I'm seeing it break, maybe that's where I start saying, well, maybe this thing is reversing. Maybe I want to use that as a way to enter in from these speculative trades, and if it goes back above -- oh, I was wrong. All right, let me close it out and get whatever value I can. I don't have to go to expiration. I can close those out.

But it had also stated one other thing, right, when it breaks support. When you -- 'cause most investors are long, right? Or some of those investors are long. Where would I want to protect? If it gets down here, now I'm a little nervous. I don't necessarily want to sell out of my possessions, but I want to know if it breaks from here and it starts going down fast, I have something to protect myself. And that's something that we'll be talking down the line. You can use some of these technical levels. Whether it's a support level that you're drawing yourself, or you can use some of these moving averages to help you find these levels. Whatever way or approach that you would like to use, because there are different methods. As we've stated throughout, there is no one best method. There's the method that works for you, and that you're comfortable with. You've got to find that, and that's where it'll make you much more comfortable.

So with that being said, I'll hand it back over to Ed to jump right back into it.

Edward Modla: Sure. Yeah, that was great, Colin. That 50-day really shows you those support levels. They just jump out at you. And of course, you can use those as your entry points to go long. But, you know, in our example, we thought, well, maybe you thought that support level was weak, and you were going to take down side, but that becomes crystal clear there looking on the charts at how you can determine where those levels are and whether or not you want to take action. So we just walked through long put there as a speculative trade. It's a profit on the downside. But let's take that same concept, but instead of using it to profit that way, we're going to protect from either a stock or a portfolio position against those downside moves. So we're going to use the gains of the long put to offset potential losses in other positions that we're actually bullish on. So let's take a look at a few of those.

An investor here has enjoyed gains on a stock position or a portfolio -- we're going to look at both. And they want to protect gains while still participating in the upside. They want their long position. They don't want to get rid of it; it's going well. They're still bullish. But they don't want to see things turn around. And I'm going to speak about market psychology a few times as we go through this example of -- seeing a very good trade turn negative is one of the most destructive psyche events, psychological events, that a market-participant investor can deal with. And when you do have a nice gain, it's real easy to just sit there and watch it get worse and worse and worse and always want that best, best level. Using options can help with some of that discipline, to get out when you need to and don't let that big green profitable trade turn into a negative one.

So how can you participate? We're going to look at both of these. The protective put strategy. Owning shares and continuing to own them for further upside gain, but then paying for a long put not to profit but to purchase the right to sell shares at the strike price of the put, which would effectively be selling the shares that you own. It protects from a share price decline below that level, and you're paying for it. That is an up-front cost. You can also use the same strategy, the protective put, on a portfolio, a basket of stocks, where instead of buying a put option on a stock, you are buying a put option on an ETF or an index that is going to give you the same right to sell shares or to get out of a position at a level or profit -- I should say profit -- off of a downside move on your put option that offsets loss in your portfolio. And here, Colin, one of the common questions is about, you know, how do I know what that should be? You just select an ETF, an index. Well, how do I know what that is, and how do you make that determination? We try to get one that is consistent and will resemble closely the portfolio that you have, but it can be a bit elusive. It can confuse people. You know, how do you feel about that question of investors being puzzled, not knowing which ETF should they be using here?

Colin Songer: Yeah, that is such a common question, right? Because it is. And sometimes people look for that definitive answer, and the real answer is, well, there really is no answer. (laughter) But there is a method that can help you find one that's close enough, right? And that's -- you'll hear this thrown out there about correlation and finding a correlation of your portfolio and the performance of ETFs. All we're trying to say is -- and I've told people in the past this -- watch the performance of your portfolio. Take a look at a few benchmarks, right? Some benchmark indices. See which one does it closely resemble? Is it going to be the exact match? Probably not. But it should be relatively close. And if you notice that it seems to be marrying one of those, ah, now you're on to something. Now, let's say that index is either too pricey, right, because price, let's be honest, is important, right? Maybe it's too pricey and you don't want to spend that much, or maybe it's overexposure. Maybe I don't need that much exposure to that particular index. Well, now I can look for an index, an ETF that mimics that particular index. Now I'm cooking with gasoline. Now I'm going down the right path. I can use something like that as a vehicle to give me a proxy to protect my portfolio, because it mimics that performance. That's what we're looking for. And it's not going to be perfect.

Another method that people have used in the past is, "Let me take a look at my portfolio -- what's in it? What is it comprised of? All right? Which benchmark closely resembles that composition?" There are going to be some that, yeah, they have very similar ones. Maybe not all of them, but there are a lot of them in that same area. You can use that to help find and choose the vehicle or proxy that's best for you.

The most common that's out there that is known is usually based off of the S&P. That doesn't mean it's right for you, right? You've got to find what's right or what best fits your performance of your portfolio. Find that benchmark, right? Because that's not the answer for everyone. You want to find what's right for your portfolio.

Edward Modla: Yeah, we're going to look at that in the demo here in just a few minutes, but you're right, you know, a good starting point -- look at what you've got in your portfolio. And of course, as Colin was saying, a watch list to see -- how is my portfolio performing today, and which of these indicators, which of these ETFs, somewhat resemble that? And looking through history and doing your best, but you're not going to get it right. Colin said it a few times, exactly correct: you're not going to have that perfect one--to-one correlation, but if you're looking for a way to mostly protect your portfolio against a downside move, then ETF that closely but not perfectly resembles the performance of your basket of stocks -- you just have to do some homework and research and go through the process.

Let's look at protective put on a stock, and then I want to walk through quickly the method for calculating a quantity of puts when you're doing this

ETF option on a portfolio. And then we'll look at some interactive demo examples.

Here we have long stock at 120, and this investor is interested in protecting against a downside move, a significant downside move. Now, as we draw this, certainly this investor may have owned shares much lower than 120; they may have owned shares for many months, many years, and now all of a sudden they don't want to get back all those gains. It's a very common situation for an investor to want to implement the protective put. But here let's just say they've owned shares, they've bought stock at 120, they thought the shares were gonna rally, it hasn't happened yet. They still are bullish, they still think there's massive upside potential, they don't want to limit that. But all of a sudden, the length of time you have to wait here is starting to give them a little bit of pause, and so they go out and protect against a huge downside move, buying the 100 strike put, going out six months with a volatility level of 25% -- would give you about a $2 option premium -- $200 cost. That's up front. You're going to pay that. So now your cost is no longer 120; it's 122. And that becomes your break-even point. You need the stock to rally by $2 to reach your break-even point in our example. You've got plenty of time for that to happen. You have upside potential to gain, run parallel to long stock, although you'll underperform long stock, of course -- you paid a little more. Where there's protection, the benefit here is to the downside. If there was something bad that happened to shares that really sold off in a significant way, you've maximized how much this position could lose. And I just want to spend a minute comparing a couple of things: investors will sometimes say, "Well, why wouldn't I just put in a stop loss here at 100? I don't have to pay for that. Stop loss doesn't cost me anything, and it doesn't expire. You know, if the order expires, I just reenter the order, so technically it doesn't expire and I'm not paying for it -- why buy the put option, pay for it, and have an expiration date?"

Well, certainly, these are two choices that you have to consider. There is not always going to be one superior to the other. A stop loss has its place, as does another choice here. If you're concerned, maybe you just size down, and you just sell some of the shares you bought and you reduce your risk that way. That's another choice of yours. You know, very quickly on that choice, if the stock were to rally sharply as you expected, you would have rather had that full-size position than a smaller one. As far as the stop loss is concerned, it doesn't cost you anything, but it's not working for you around the clock. After hours, over the weekend. Things can happen. The market moves based on domestic or international news that's either of an economic nature or a political nature or a military circumstance. And the stop loss order is only going to be active when the market is open. So you're susceptible there to the market opening up much, much below 100 and not actually getting out at that level. The put option is going to give you the right to sell your shares at 100 up until the strike -- the expiration date of the option. And you have that right no matter where the stock goes or when it goes there. So this is what I say: the put option is working for you around the clock, 24/7.

And here's where I'm gonna come back to that discipline factor, and I speak from experience. We've all been there. You own stock at 120; you've got your stop loss in at 100. Sometimes it just becomes far too easy when you see the shares get down here to 105, 104, 102, and you're thinking, boy, I really don't want to get out of this trade, so all of a sudden you move your stop loss down to 95, and next thing you know the stock's trading 96. You move the stop loss down to 92 and you think, "oh, that's it, I can't take any more," and then you get out of your trade. It's just a little too easy to do that with stop losses -- cancel, replace, move those prices around, and end up taking a larger loss than you wanted. If you find yourself struggling with that discipline on bad trades, the put option, the protected put, can help you with that, because it's a lot harder to get out of the put option. You'd have to close the put, maybe open up a new one here, set it in, the protection is there for six months. If it gets really bad, you're out at 100, you've paid for that, you paid $2 up for that privilege, but you're out at 100. You don't have to worry about yourself having that lack of discipline and moving those positions around and moving your exit levels around.

I'm gonna look at a portfolio now, and I'm focused mostly here on a couple things -- choosing strike and expiration, but then the quantity. That's the most common question that I get: When it comes to buying a put to protect a portfolio, how many puts do I need to buy? So let's walk through this example. We have a portfolio value, say, of $100,000, and the desired protection is for a greater than 10% downside move. In other words, this investor's willing to accept 10% downside, but they want protection against the rest. The other 90,000, they want protected. That's a 10% move in their portfolio. So you do have to identify an ETF, for example, that resembles the performance of your portfolio. Let's say you've done that and it's trading at $250 a share today. Remember, you're willing to give up that first 10%. So this leads you right to your strike price. Today's ETF share price minus ten percent gives you your strike price of 225. So now you know your strike.

Choice of expiration -- this is really up to you. Is it a fundamental event that you're concerned about? Is there something on the calendar that you're concerned about? Is it technicals, and does the technicals help you determine how long you want this protection to be? Depending on what you're concerned about, you might need -- that might lead you to the choice of expiration dates. Or maybe you're just generally concerned about the market for a certain period of time. But you choose. In our example, we choose the three-month, 225 strike put. Now we can go to our options chain and see -- it's trading for $3. We can buy one option for $300. Now the question is, how many of these do I need to buy to protect the $90,000 that I want to protect? And it turns out to be relatively simple math. You take the portfolio dollar amount that you want to hedge, and in this case we've said that's $90,000 that we want to protect, and we divide that by the notional value of the strike price. This is also called the aggregate value of the strike price. In simple terms, this is the dollar value of the strike price that you would get paid if you were to exercise this option. We selected the 225 strike; if we exercise, we're going to get paid 225 times 100, or $22,500. Now, if everything goes to zero -- think of it this way. If everything goes to zero -- every stock, every index, every ETF all go to zero -- we lose $100,000. We are willing to give up the first ten; we want protection against the other 90. We need the options we buy to pay us back $90,000. Each one of them is going to pay us back 22,500, so we need to buy four puts. And if everything went to zero, our portfolio would lose $100,000, and the options would pay us back 90. And we would have our protection the way we want it.

From here, now, little further analysis -- we're buying four puts, that's gonna cost us $1,200. How much do we think of that? Is that expensive? Is that effective? If we think we're willing to pay more because we're concerned about the market and we're willing to spend a little more premium for protection, then maybe we buy five puts or six puts. Maybe we increase the strike price from 225 and get better protection at a higher level. Or we think this is expensive, because we're not too concerned, and we don't want to spend that much money for -- was it three months' worth of protection? You can buy less. Buy fewer puts, and hedge a half of your portfolio or hedge a quarter of your portfolio. And again, as Colin was pointing out, we do assume with these calculations there's a one-to-one correlation between the portfolio and the hedge. That's not likely to be the case, but you will do your best here when you select the product and the underlying that you're going to use to hedge, and now you know. How do you select your strike? How do you select the expiration? And then, more importantly here, you shed some light on the quantity that you're going to use. So Colin, as we look at these examples, let's maybe go a little interactive now on the demo and take a look at this in a different light.

Colin Songer: Love to. Let's dive in there. So first, I'm gonna jump right to our landing page on fidelity.com as it flies away from me here. So in our IV index monitor, which is over to the right -- I know someone earlier asked, "How do I get to this page?" On fidelity.com, if you go to News and Research, down to Options, once you select Options, you're gonna be on the Option chain. You'll notice this tab right here, Market Overview -- that will bring you to this landing page. If you want further screeners and filters, there is this Trading Ideas tab as well to take a look at. But if I look at the IV Index Monitor, and if I go down halfway down, there happens to be an ETF that does show up in there. The first one that shows up is SPY. So let's just use that to dive in. Let's say our portfolio mimics the S&P 500. It just happened to work out that way, so let's dive in.

Once again, I'm going to bring up our profit loss calculator. People are not aware that you can use it in this method, which is, all right, let me put in my portfolio. Which is, it mimics the performance of the S&P, so I can go in here, add Simulated Position -- guess what? This is the Strategy drop-down, go all the way down to Stock. Now, what I do in here is I'm just going to say, well, my portfolio is -- we'll say roughly about 440,000. It's because I like round numbers; that's why I came up with that portfolio number. There's no particular (laughter) reason. So I'm going to put that in here and I'm going to click Apply. Now, yes, I already simulated that in here and added it in. As you can see, 1,000 at 440 under this eval price, right? I have that in here. Now I added my put. So when I have a strategy discussion, usually I will ask them about the strike and we'll go through how much you're willing to -- it's either one of the two. Either, A, how much am I willing to lose?, or they say, this is my strike.

What is so significant about the 400 selected? Four hundred is roughly the same as 4,000 on the S&P. One thing that you'll pick up about traders is they like round numbers. (laughter) It's just the way it is. So they'll navigate to those round numbers. So in this example, let's say hypothetically someone said, "All right, well, the 400 strike." So in here, what are we looking to accomplish? If I hold down the control key on my keyboard and I left-click on Stock, well, look what just happened. Now, A, for those who attended the bullish strategies, they're going to say, "Well, wait a minute, that's a long call." Well, yeah, that's correct. It's almost like simulating a long call. We have a four down below to the left -- it keeps going down, we don't lose any additional money. We're assuming a one-to-one correlation, which, we know that's probably not going to be the case, but in this case, right, that's the most that we're hoping we're gonna lose on this. And the farther up it goes up, the more money I make.

And this is showing us just that. Now, look where it stops. It's roughly -- we'll say roughly 10% down, not exact. But pretty close to 10% down. Look what happens: it stops losing the money the further down it goes below our strike, right? So we used Ed's formula to find out how many contracts, which we inputted. And notice the further it goes down -- let's be a little obscene. Let's say 100, right? It goes all the way down, so basically 1,000 on the S&P. Look what the loss is in this row. On September 17, the most theoretically we're going to lose is 42,000, which is the same as 42,000 at our strike. So you can see that it stopped those losses, because that put is gaining value, offsetting the losses on our portfolio. So this is just yet a different way that you can use the profit-loss calculator to get a better understanding. And I also wanted to throw this out here, because any time we talk about portfolio, people think, "Oh, well, it's going to gain value on the puts, which is what I'm trying to do." You're trying to make money on the puts? "Well, yeah." If you try to make money on the puts, you're not really hedging; you're speculating. There's a difference between a speculating trade and hedging. People who are trying to hedge are not really looking to use the puts. They want their market to keep going up so they make money. People who are trying to make money on the puts are speculating. Those are not the same thing, so just be honest with yourself of what you're trying to accomplish. And with that I'll kick it back over to Ed.

Edward Modla: Yeah, that imagery is very powerful. And you're right -- you can see right there. You're trying to make money on the upside; you're bullish. You don't want that downside move, and you don't want those red numbers. And I'll just point out one thing I forgot to mention earlier -- when you're doing ETFs against a portfolio, if you do get that downside move, you know, if it was a stock position you're protecting, you can let the sharers get called away, potentially. When you're doing a portfolio protection and using an ETF, you don't have shares to get called away there, so you would likely then have to make sure you're paying attention. So you sell the option that you own, you sell the ETF put option and capitalize on that move down.

Let's look at collars now -- slightly more complex strategy, because we'll have three moving parts, but really it's just merging a couple of strategies together. That protective put that we talked about -- earlier today we talked covered calls -- we're really just merging these together and trying to protect the portfolio; that's really the motivation here -- protecting the downside but not having to spend as much for it as what we just walked through. And we'll say the investor owns shares that have rallied and are sitting in a profitable position, but they don't want to give that back, so how can they protect the gains? How can they protect against a downside move with little cost? Not having to spend all that money on the put option while still maintaining some upside potential, even if that upside potential is a little bit less than if they'd just owned the shares outright. And this is where the collar comes in -- sort of moving these three pieces. I said we're merging protected puts and covered calls. We are doing that, but we're not doubling the stock position. The lowest denomination here for the collar is long 100 shares, long a put, short a call, the put is the driving force, it's protective, it's managing risk, reducing risk to the downside, but then using that covered call premium to come in and offset that cost so you can get this trade executed for very little, if any, cost at all. And now you've got protection, along with the acceptance of the obligation that comes along with selling the short call option.

Now, Colin, I don't know about you, but I do get posed the question if collars are used often when managing a concentrated position. And as an options trader and now an instructor, I don't get too much into concentrated positions and overlaying a strategy like this, but what are your thoughts? And I know you probably get that question as well -- how do you respond to those inquiries about using collars on those positions?

Colin Songer: Yeah, this is a particular interesting aspect where the collars are very popular with concentrated positions. Usually when someone with concentrated positions -- now, there is one aspect where they're trying to scale up. That's a whole different scenario, right? Because they're willing to sell those shares. The ones that it doesn't line up is where people are saying, "Well, I don't want to sell my shares, but I want to protect them." Well, here's a couple of aspects you might want to consider before utilizing something like a collar against a concentrated position. Number one, sell on a call. When you sell a call, guess what? And I like to say this -- you're not in the driver's seat anymore, right? You got compensated up front, so now at any point in time, for any reason -- it doesn't even have to be in the money -- you could be assigned. I have seen that in my career, where people have got assigned -- it wasn't even in the money. So it does occur. So be mindful of that. You know, whether it's timing or the hit that could happen from other aspects, whatever that may be, if you just don't want to sell your shares -- just remember, when you sell a call, you're not in control. Yeah, the long puts, you're in control. You get to choose what to do. You can sell that put to gain that value back, you could exercise it, that's great. You have that choice. You sell those calls, you don't get that choice. So just be mindful of that when you're using that against some position that maybe you don't want to sell those shares -- make sure you're understanding the risk at work because this might not be the right approach for you.

Edward Modla: Yeah, that was well said. If you do have a concentrated position -- and real quick, what is a concentrated position? You know, it's just one that is too large when in comparison to your overall portfolio. Follow-up question is what's too large? And again, as we've said a couple of times here today, as Colin's pointed out as well, there's not a singular answer to a lot of these questions. So what's too large? It somewhat would depend on how familiar are you with that particular investment, with that company? And you're following things much more deeply than just what their earnings is, but maybe decisions and changes at the board level or earnings announcements of its peers and its industry -- you're following a company really closely and your confidence level's very very high, then you can possibly tolerate a high percentage in your portfolio. If you're tracking your investments more loosely, which is perfectly fine, then the amount or percentage of your portfolio that you're willing to commit to that particular position might be lower. It's really up to you. I think anyone would say, once you get up to 35, 40% or more, and more of a third of your money is in one stock position, you know, now you're concentrated no matter what. But if you do find yourself there, as Colin said, if you want to sell shares, you can just sell shares to scale down. If you don't want to sell the stock, if you want to hold the shares, then doing a collar, you're taking on that obligation. So be very mindful of that.

In our example, we'll just say we own shares. We don't have a concentrated position necessarily here. We're long stock at 75; we thought the stock was going to move up to 85 or 90 -- it's not happening. Stocks sitting here at 75, it's not moving. We still think the bullish move is coming, but all of a sudden, we don't think it's going up that much. But if it does move against us, we're concerned about that. This might be another situation where the collar comes in -- risk protection comes first, where is my pain point, where do I need to get out of this if it goes bad? In our example, we're going to choose the 67.50 put option and buy that. You'll notice on the down side, this looks like protective put down here, protecting the down side. But instead of just paying for that, we don't have too much confidence in a big move to the upside, so now we're going to resemble the covered call. We gain on the shares up to the strike price of a call that we sell; we receive that premium, and now we have a capped maximum gain on the upside.

Several moving pieces here; stock and two options around it. So this, as I said earlier, you can start to tweak this -- if you have 1,000 shares, you can start choosing different strikes and different quantities on the up side. On the down side, you can do all sorts of different things here to tweak the construction of this strategy to your liking. And if you did want to see the calculations, you know, break-even point is rather simple -- it's your total cost. Seventy-five dollars plus what you spent on the options. Maximum loss calculated -- similar to protective put, where you can get out of the shares, and your maximum gain is where your shares might get called away.

Very quickly, I'll just say you may have noticed -- we're going equidistant from the stock price, seven and a half dollars either way, and the put options costs more than we're able to get for the calls. It's very common. I'm not going to talk about volatility skew here today, but there is such a thing, where the demand across strike prices for options varies. One strike has more demand than others, and generally speaking, put options, because of their protective nature, tend to have more buyers and more demand. So put options have a tendency to trade for more than calls. It's not a rule. It doesn't have to be that way. Calls could trade for more than puts, depending on the circumstances -- if no one's concerned about a move lower, if everyone wants to capitalize on up side, there could be more demand for calls and puts. You do see that. But most common, you see this dynamic, with puts trading for a little more, and that's why going equidistant leaves us with this slight net debit here of 40 cents.

Now, Colin, as we go to the demo, there's several moving pieces here. You've got order entry. We're looking at options chains. Let's take a look at this strategy, maybe from a different perspective, and see how we can put it together.

Colin Songer: Yeah, so I think this is a great opportunity to show you the new option-trading experience that's available on fidelity.com. So this is the new option trade ticket that we have in here. Now, earlier we used an example on Pinterest -- let's just use that same example. I'm going to type it in the symbol field. It's going to give us that quote right here. Now, our focus is the collar. So if I go to More Strategies and I choose Collar in there, you're going to see that it dynamically changes for me, which is wonderful. Now, when I select the action, you'll notice that the second leg is automatically going to update for me. Now, this is making an assumption that we already own the shares in the account. And what I also enjoy is the fact that putting Quantity in one automatically updates the other. And as Ed pointed out, we're buying that put, right? We'd notice -- it already updated the call, right? That's what it's going to do; it's going to automatically update with that other one -- making entry so much easier for me.

Going into the expiration field -- let's say August 20th, but go to the next month before us. When I do that -- now, I want to keep this synced with my call option as well, so I'm going to adjust that as well. I'm going to put in that same time frame. Here is the valuable part about using tickets: it allows me to shop. Just as Ed said, maybe I don't want to pay money. Maybe I'm okay with paying money, I just want that room. Or -- I'd like to bring in a little money, if I can. That's what you can do with this tool, right? As similar to what you're doing with an option chain, I can go in here and, okay, well, if I bought a put -- and it always starts with a put, it really does -- how much risk am I willing to take? Let's say we're not much of a risk-taker, but all right. Let's go down to, you know, it kind of aligns with the P&L we had, the 67.50. Let's put it in there. All right, so we'd be paying $2.76. All right, well, let's take a look at calls. Let's go equidistant. I got a hunch -- I'm just guessing here. Let me try the 77s. I don't think I'm going to be able to bring as much -- but look at here. We can. And look, we can actually -- the order type automatically updates if it's a credit or a debit. The ticket does it for you, which is wonderful. And here I can either click on the prices here or here to fill in my ticket, and now I'm off and running. It gives me the ability -- I can also do time and force to do a good 'till cancel. That way, if it doesn't fill today, all right, we'll leave it out there until it does fill. This gives me the ability to do that, and that's the beautiful part about the trade ticket. I figure we've done a lot of work in Active Trader Pro; it's time to give a little love to fidelity.com. With that, I'll hand it back over to you, Ed, to see where you'd like to take us next.

Edward Modla: It's a slick order entry. It really is, that you just went up there and displayed. And of course, what jumped out at me was that dynamic that I talked about earlier -- puts normally trading above calls. Well, here, not so much. But one comment about this -- over the past year, year and a half, I mentioned this earlier today, we're seeing a lot more talk about buying calls, a lot more questions about buying calls, for a variety of reasons we won't get into, but this is what we're seeing. There's a lot more interest in speculating on calls to the upside. It's driving demand, more buyers, and here you're seeing an instance where there is more demand for calls, and you can do this collar mostly equidistant from where the stock currently is and get a credit to do so. There's more examples of this in today's environment than I've ever seen in my 24 years trading options, and it's something you might look to take advantage of.

END OF AUDIO FILE

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