

Class:

Options Strategies in a Bear Market



This document discusses exchange-traded options issued by The Options Clearing Corporation. No statement in this document is to be construed as a recommendation to purchase or sell a security, or to provide investment advice. Options involve risk and are not suitable for all investors. Prior to buying or selling an option, a person must receive a copy of Characteristics and Risks of Standardized Options. Copies of this document may be obtained from your broker, from any exchange on which options are traded or by contacting The Options Clearing Corporation, One North Wacker Dr., Suite 500 Chicago, IL 60606 (1-800-678-4667).

Class: Options Strategies in a Bear Market

Options Strategies in a Bear Market (Options 304) is designed to expose the different ways that options can limit risk or increase profit in a Bear Market. This course discusses the various option strategies that take advantage of a Bear market. At the conclusion of this course and prior to the final quiz the student should be comfortable with the all Bear market strategies.

The difficulty rating for this class is: **ADVANCED**

Chapter 1 - Introduction

The introduction sets the groundwork for the differences between bear market option strategies and outright stock or index ownership. The three main benefits of bear market option positions of protection, limiting loss, generating income are introduced.

Chapter 2 - Buying Puts

In this chapter the purchase of puts is discussed in two forms- the purchase of puts in conjunction with stock purchase / ownership and the purchase of puts as a speculative strategy.

The differences between these two strategies are explained. The purchase of puts with stock is explained as a protective strategy, while the purchase of puts by themselves are speculative and offer leverage in a bear market.

Chapter 3 - Uncovered Calls

This chapter gives discusses the use of calls in a bear market. The maximum profit and maximum loss are explained along with margin maintenance requirements of uncovered calls. This chapter has an interactive example that illustrates these points at expiration.

Chapter 4 - Covered Calls

For this chapter the advantages of covered calls are introduced. This chapter explains how covered calls are similar to protective puts while enumerating maximum profit / loss and risks associated.

Chapter 5 - Index Puts

The uses of Index puts in a bear market are explained here. The important need to have the particular index match your portfolio is stressed, along with the differences in settlement types of American and European style options.

Chapter 6 - Vertical Spreads

Vertical spreads for a bear market are introduced in Chapter 6. These spreads can be debit or credits and are explained and prefaced for the following two chapters.

Chapter 7 - Bear Put Spread

In this chapter the uses of a bear put spread are explained. The maximum profit and loss computations are explained. This chapter also explains how this spread is a debit spread and differs from a credit spread.

Chapter 8 - Bear Call Spread

For this chapter the uses of a bear call spread are explained. The similarities and differences between this spread strategy and the bear put spread are compared and contrasted.

Conclusion

The conclusion briefly recaps how minimizing loss can be balanced with limitations on profit potential using these bear strategies.

Quiz

Test your knowledge.

Introduction

Many investors turn to options in a bear market because they may offer more opportunities for **return** than stocks and other investments that tend to be profitable only when market prices are rising.

When the market, a particular sector, or an individual stock is falling, several options strategies can help you **protect** investments you've already made. And if you're considering a new stock purchase, for example, you can buy put options to lock in a selling price, and **limit loss** on the position, in case the stock price falls. Options may be used to **generate income** for your portfolio in a declining market.

Choose your objective

But it's important to decide before you trade what your main objective is — to protect new or existing stock investments against losses, speculate to realize profit from a falling stock price, or add income with limited protection — since the strategies that fit each of those goals are different.

Buying Puts

In a bear market, one of your primary goals is probably protecting the value of an existing stock portfolio. In that case, **buying puts** can be very useful. For example, if you own shares of a particular company's stock, and you want to protect against a loss in their value, buying puts on the stock allows you to lock in a selling price.

1. You could buy one put contract for every 100 shares of stock you own.
2. You'd choose a strike price that's high enough to protect most of the stock's value, but low enough so that its premium doesn't take too big a bite out of the value you're trying to protect.
3. If the market price of your stock falls below the strike price you've chosen, you might sell your put for more than you paid or choose to exercise, which would mean selling your shares at the strike price.

This protective put works like an insurance policy, and the premium you pay for the put is the price of the insurance.

For example, if you bought 100 shares of XYZ stock when it cost \$43 and it's now trading at \$52, you might want to protect the unrealized gains, or **paper profits**, you've made so far. If you buy a put at a strike price of \$50, it might cost you \$2.00, or \$200 total, in premium.

- If the stock price falls below \$50, the strike price of your put, your option will be in-the-money. If you think the price is due to rebound, or you'd like to keep the stock in your portfolio for another reason, you might sell

Underlying assumptions

For simplicity's sake, calculations of profit or loss do not include the impact of commissions, transaction fees, or taxes. You should discuss these with your brokerage firm before making a transaction. Similarly, the discussions that follow assume the use of regular calls and puts — that is, contracts whose terms have not been adjusted due to an underlying stock split or any corporate action such as a special dividend, spin-off, merger, or acquisition. The examples also assume that all contracts in the course represent 100 unadjusted shares with a strike and premium multiplier of 100.



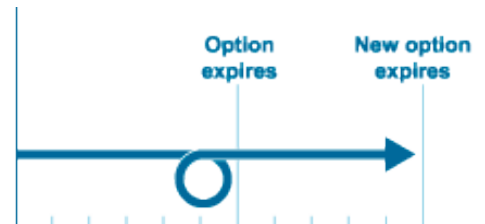
Comparing returns

Notice that your potential profit of for selling the option back is 50% of your premium, while the potential profit from selling the stock is 11.6% of your investment. Both are calculated before transaction costs and possible taxes. That difference is one of the reasons investors often choose to sell an in-the-money option rather than exercising it.

your option back—for maybe \$3.00. That's a **net profit** of \$100, which will partially offset the paper losses you've suffered on the protected stock profits.

- If the stock drops below \$50, you could exercise the option and sell the shares for \$50 each, making a net profit of \$5.00, or \$7.00 per share over your initial purchase price less the \$2 premium per share.

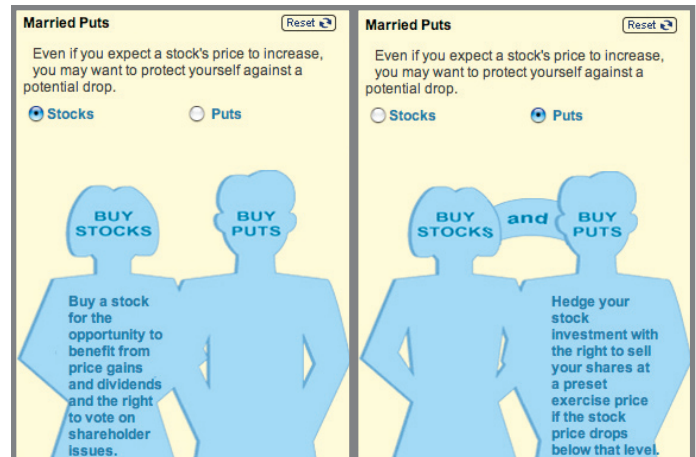
If the stock price doesn't fall below \$50 by **expiration**, your put will expire out-of-the-money, and there would be no reason to exercise it. As expiration approaches, however, if you're still concerned about a future drop in the stock price, you might consider **rolling**. That means selling your option if it has value and purchasing another put option with a later expiration.



Limited maximum risk

When you buy puts, whether as a protective or more speculative strategy, your **maximum risk** is limited to the amount you pay for the premium. If you use long puts as a protective strategy, you'll enjoy the benefits of stock ownership—such as voting rights and dividend distribution—as long as you hold the shares. At the same time, you limit the capital you could lose if the stock price falls.

Buying puts can also help protect your investment if you're making a new stock purchase. In a bear market, you might be more cautious about investing in stock, and might want to **hedge** your portfolio against potential losses. You could use a **married put**, which means buying puts on a stock at the same time that you buy shares of that stock.



Alternative scenarios

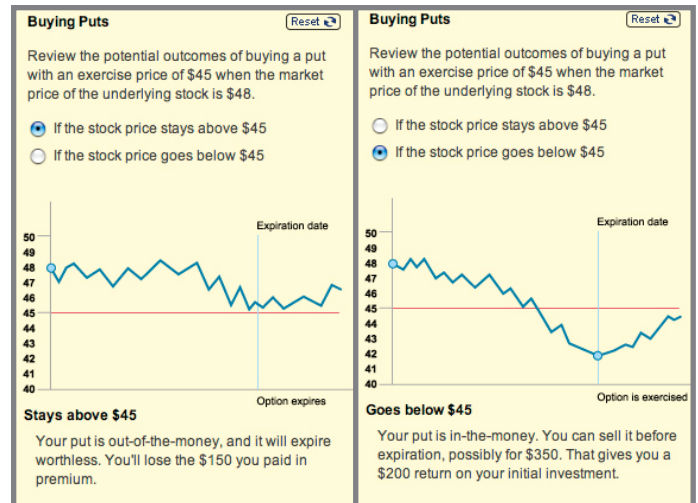
Since you're buying the stock, you probably anticipate that it will increase in value. If that happens, your put might expire **out-of-the-money**, with no value. The only downside is that the cost of the put will increase the amount you paid to invest in the stock, or its **cost basis**.

If, however, the price of the stock falls, you could sell the option. If you sell at a profit, you'll reduce the cost basis of your shares. On the other hand, you might decide you don't want to keep the stock in your portfolio. In that case, you could exercise your put and sell your shares at the strike price, limiting your loss.

You can also use a **long put strategy** to profit from a drop in the market price of a stock you don't own if you correctly anticipate the way the market is going to move. If you're fairly confident how far a stock price will decline

within a certain period of time, you could buy a put on that stock. If it moves as you predict, your option can increase in value. You can then sell it for more than you paid to purchase it, pocketing the **net profit**.

1. For instance, if you predict that stock XYZ, now trading at \$48, will fall below \$45, you could buy a 45 put, which might cost you \$1.50, or a total of \$150.
2. If your prediction is accurate, and the stock price drops to \$42, your put might be worth \$3.50, or a total of \$350. That would mean a net profit of \$200.
3. If your prediction isn't accurate, your maximum loss is \$150, the total amount you paid in premium.



This strategy appeals to investors who like options because they offer **leverage**, or the ability to control an investment with a much smaller amount of money than would be required to purchase it outright.

Writing Uncovered Calls

Another bear market strategy is **writing uncovered calls** on stock you don't own. If you are confident a particular stock price is going to drop in price, or at the very least stay neutral, you could write a call with a strike price higher than you think the stock will reach.

You'll receive the **premium** as proceeds from your sale, and if you are not assigned, that premium is your **maximum profit**.

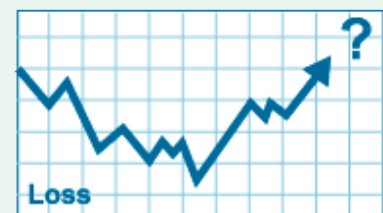
The risk you run

If, however, the stock price has risen above your strike price by expiration and you don't **close out** your position, there is a good chance you will be **assigned**. If you are, you'll be obligated to buy the underlying stock in the open market and deliver it at a potentially significant loss compared to its current market price.

If you do choose to close out by buying the option you sold, either before or on its last trading day, you may have to pay significantly more than the premium you received, producing a **net loss**.

If you're wrong:

There are **significant risks** to uncovered call writing. If the stock doesn't perform in the way you predict, a call you write could move in-the-money, which means its holder would likely exercise it on, or possibly before, expiration. And since there's no limit on how high a stock price could rise, at least in theory, your potential loss is **unlimited**.



If you write calls on a stock that you don't own, you're writing naked calls. You'll have to open the transaction through a margin account with your brokerage firm, and you'll need to maintain the minimum margin requirement in your account, which can be significant.

Maintaining a minimum

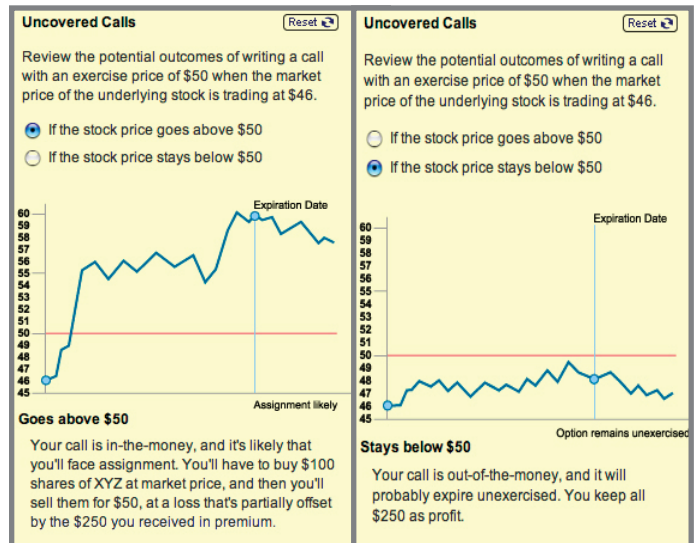
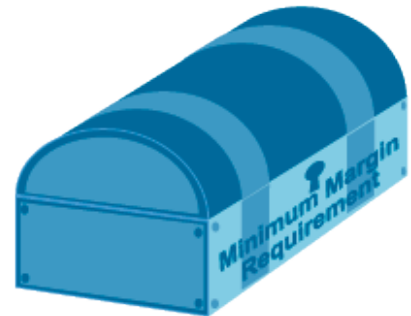
For naked calls, the minimum margin requirement will generally be 100% of any premium you receive, plus a percentage of the underlying security value, but the exact requirement can vary among brokerage firms. That cash is held in order to guarantee that you can meet your obligation if your option is exercised.

It's important to keep track of any dividends to be distributed on the stock underlying your short call. Early assignment is possible if the underlying stock has an upcoming dividend distribution and your call is deep in-the-money. If you want to close out instead, you should make that decision well in advance of the ex-dividend date. If you wait too long, you might face assignment.

For example, if you think stock XYZ, currently trading at \$46, is going to decline in price, you can write a 50 call with an **expiration date** that's several months in the future. You might sell it for \$2.50 and receive a total of \$250 in **premium**.

1. If, as you anticipate, the stock remains below \$50 — the call's strike price — your position should expire unexercised. You'll keep \$250 as your profit.
2. If the stock price rises to \$60 at expiration, assignment is likely. If you're assigned, you'll have to buy 100 shares of XYZ stock at a market price of \$60, and sell them at the strike price of \$50 to meet your call obligation, taking a net loss of \$750, or the \$1,000 loss on the stock transaction less the \$250 option premium.

Alternatively, if while the stock price is rising, you're convinced that it will continue to do so, you could close out your position before expiration by buying the option you sold. While you would have a net loss, it could be substantially less than the \$750 plus transaction costs that assignment at expiration would cost you.



Covered Calls

A **covered call** is a call you write on stock you own. If you think a stock you own will decline modestly in price in a bear market, but think it will rebound over the long term, you might write a covered call as an alternative to purchasing a **protective put**. The premium you receive offers some **limited downside protection**.

- If the price moves down as you anticipate, and the call expires with no value, you'll keep any **premium** you received. That premium can at least partially offset any paper loss on the stock.
- If the stock price increases, your call might become **in-the-money**. If you think you might face assignment, you can always close out your option position by buying back the call you wrote, possibly at a **net loss**. However, you'll hold onto your stock and have an unrealized profit.
- If the option is exercised and you're **assigned**, you'll have to sell your shares at the strike price. That means you'll miss out on any future gains the stock may have. In addition, you may owe capital gains tax on the transaction.

Covered calls can be considered less risky than naked calls if the price of the underlying stock increases because you already own the **underlying shares** you'll have to deliver if assigned. You won't have to purchase them at higher-than-current market price. In other words, with covered calls the **maximum upside risk** you face is having your stock called away from you, which would mean missing out on potential future profits

Anticipating the unexpected

Of course, in a bear market, the underlying stock could drop significantly in price. The written call, in this case, offers only **limited downside protection**, by the amount of the premium you received.

But if the price of the underlying stock increases unexpectedly, you always have the alternative of buying the option you sold, closing out your position and eliminating the risk of being assigned. This can result in a realized loss on your written call, but one that can be offset by any unrealized profit on the shares, which you keep.



If you write a call on stock you already own, it's sometimes called an **overwrite**. If you buy shares of stock at the same time that you write a call on them, it's commonly called a **buy-write**.

Buying Index Puts

If you want to profit from a downward move in the broad market or a particular industry sector, or if you're concerned about protecting your stock portfolio from a loss in a bear market, you might consider buying **index puts**.

Consider the similarities

Profiting from the purchase and sale of an index put or call works the same way as with an **equity option**. If you buy at one price and sell for a higher price, then you profit. The **multiplier** for index options is also generally 100, as with equity options. In other words, if the price for a call or put is \$2.50, then you will pay a net \$250 if you're buying it, or receive \$250 if you're selling it.

You might think the market is due for a downturn, so you buy a broad market index put for \$2.50 and pay a net \$250. If the **underlying index** declines as you expect and you sell your put for \$7.00, you'll receive \$700. Your **net profit** is \$450, or the \$700 sale price minus \$250 purchase price.

Exercise and assignment for puts and calls on indexes work differently than for puts and calls on stocks. Instead of exchanging shares at exercise, index options are **cash-settled**, which means you, as the holder, receive cash when you exercise an **in-the-money** option. The amount of cash settlement is generally based on the difference between the strike price of the option and the **exercise settlement value** of the underlying index, or the amount it is in-the-money, multiplied by \$100.

Calculating net profit

For example, if you own an index put with a strike price of 500, and the **underlying index** closes at 490 at expiration, the amount of cash you'll receive at exercise is \$1,000. That's 500 — the strike price — minus 490, the closing index value, which equals 10. That number is multiplied by \$100, for a total of \$1,000. Your **net profit** will be this amount less the **premium** you paid for the put to open the position.

Choice of index:

Calls and puts on a wide variety of underlying indexes are listed on the various U.S. options exchanges. These options can be based on indexes on the broad market, on specific industry sectors such as technology, oil, pharmaceuticals, or retail issues, and on overseas markets.

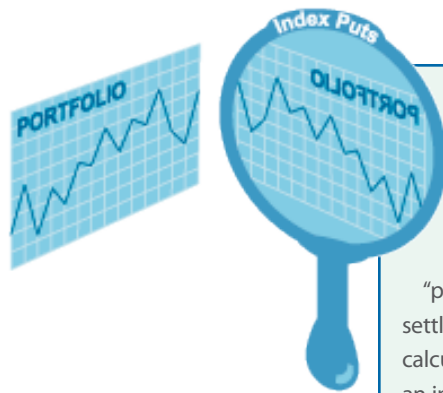


A matter of style:

You should also note that index options can be **American-style** or **European-style**. American-style options can be exercised at any time up until their expiration date. European-style options can be exercised only during a specified time just prior to expiration. If you purchase an index option, you should find out its expiration style, since that will have a major effect on your exercise strategy.



If you're considering index puts as a **protective strategy**, the key is finding an index that mirrors the movement of your portfolio. If it doesn't, the actual losses your portfolio suffers might not be offset by the return on the index options you purchase.



A word on settlement values:

Exercise settlement values for index options can be classified as either "a.m. settlement" or "p.m. settlement." With an a.m. settlement, the settlement value is calculated using the opening prices of an index's component stocks on the morning after the last trading day. On the other hand, p.m. settlement means the settlement value is calculated with the component stocks' closing value on the day of exercise. Before buying or selling any index option contract, make sure you know which method is used.

Narrowing your choices

You can start by choosing an index that tracks the same sector of the market as a segment of your portfolio. Or, you might choose an index whose components have **market capitalizations** that parallel the market capitalizations of your portfolio (or the segment you want to protect). Once you've narrowed your choices, you might choose to look at past performance or **historical volatility** to gauge how closely an index's movement has matched your portfolio's movement.

No matter how carefully you choose an index, however, there's no guarantee that it will continue to behave in the exact same way as your portfolio.

Here's a sense of how an index put may help provide the protection you seek:

- If your portfolio closely mirrors the movement of a particular index, the **percentage loss** your portfolio will suffer in a downturn might be approximately the same percentage loss that the stock index suffers.
- At **expiration**, if the index value has fallen and your put is in-the-money, you'll receive a cash profit when you exercise it. The amount of cash you receive is determined by how far the index has fallen below the option's strike price.
- Since your portfolio will theoretically have fallen in the same proportion as the index, your **return** on the index put should at least partially offset the losses to your portfolio.

If you buy index puts to **hedge your portfolio**, you'll have to determine an appropriate strike price and the number of puts that will provide the right amount of insurance. There are several ways to do this, and different options experts advocate different approaches. You'll have to choose the one that's right for you.



Upside profit potential:

In your selection of an appropriate put strike price you might consider the degree of downside protection you want versus its cost. Out-of-the-money puts can offer insurance for a more drastic decrease in the market, and will cost less than at-the-money or in-the-money puts. But the more costly puts offer more insurance at current market levels. In either case, by purchasing index puts you still have upside profit potential in case the market goes up.

Vertical Spreads

In a bear market, you'll probably be pretty cautious about the new investments you make. But you may want to capitalize on market losses.

If you'd like to profit from a downward move in an underlying stock, you might use a bearish **vertical spread**, or open two options positions simultaneously. With this kind of spread you purchase one option and write another on the same underlying stock, with the same expiration but with a different strike price.

Debit or credit

The premium you receive from writing one option helps to offset the cost of buying the other. And the risk that you take by writing one option is balanced by the protection you purchase with the other option.

If the option you buy is more expensive than the one you write, opening the spread will cost you money. That's known as a **debit spread**. On the other hand, if the option you buy is less expensive than the one you write, you'll collect money when you open the transaction. That's known as a **credit spread**.

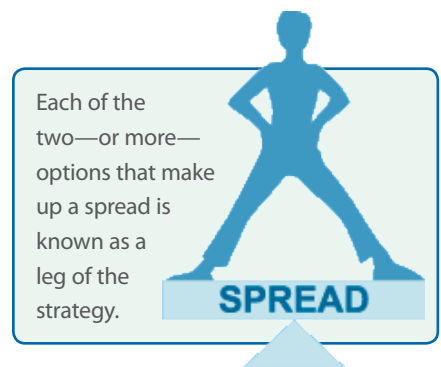
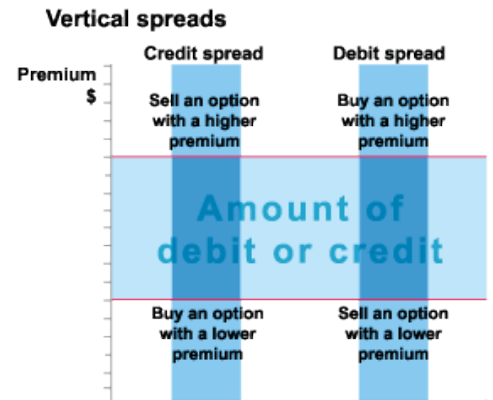
In a bear market, there are two vertical spreads that you might consider:

- Bear put spread
- Bear call spread

Both the bear put and bear call spreads involve buying one option and selling another option with a lower strike price. In the **bear put** spread, you buy and sell puts. For the **bear call** spread, you buy and sell calls.

Facing the limits

The appeal of vertical spreads is that they can expose you to **reduced risk** compared to the outright purchase of a speculative put. The tradeoff, however, is that they offer **limited profit**, as well.



Bear Put Spreads

To use a bear put spread, you buy a put with one strike price, and sell a put on the same underlying stock with a lower strike price. Since the put you buy costs more than the one you write, you'll pay more **premium** than you receive. The bear put is a **debit spread**.

Anticipating possible results

With any debit spread, the most you can lose is the debit. In this instance, that will happen if the price of the stock closes above the strike price of your long put at expiration, and both options expire **out-of-the-money** with no value.

Similarly, your **maximum return** is the difference between the strike prices less the debit you originally paid for the spread. You'll realize that return if the price of the stock closes at expiration below the strike of the put you wrote. In that case, both options are **in-the-money**, so you can close out both position with offsetting transactions, or sell the spread and receive cash.

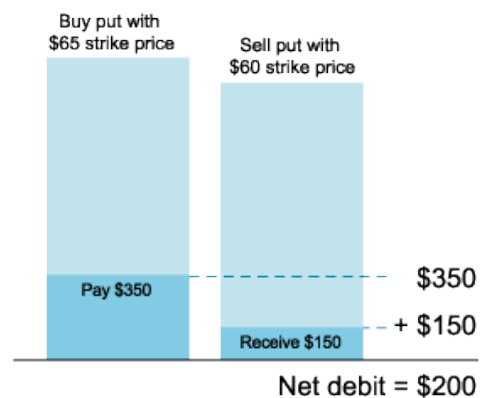
For example, if you think stock XYZ, now trading for \$67, is going to drop below \$60 in a certain amount of time, you might decide to open a **bear put spread** on that stock.

1. You buy a put with a strike price of 65, spending \$3.50.
2. You sell a put with a strike price of \$60, and the same expiration date. You receive \$1.50, which partially offsets the cost of your long put.
3. Your net debit for the spread is \$3.50 less \$1.50, or \$2.00. The total amount you pay is this \$2.00 debit times 100, or \$200.

If the stock price drops and closes at \$57 at expiration, below both strikes as you predicted, both of the puts will be **in-the-money** and have market value. You have two choices: close out the position with offsetting transactions or let the exercise and assignment process yield your maximum profit.

If you can close out both positions—sell your long put and buy your short put—for their **intrinsic values**, then you'll end up with a profit of \$3.00, or a total of \$300. That's the spread between the strikes, or \$5.00, less the debit of \$2.00 originally paid for the spread.

Maximum return equals the difference between the strike prices less the debit originally paid.



If, close to expiration, you can close out both positions—sell your long put and buy your short put—for their **intrinsic values**, then you'll end up with your maximum profit:

- You buy the short 60 put for its intrinsic value of \$3.00 (\$60 strike price minus \$57 stock price).
- You sell the long 65 put for its intrinsic value of \$8.00 (\$65 strike price minus \$57 stock price).
- The net amount you'll receive is \$5.00 (\$8.00 less \$3.00) x 100, or \$500 total. Your profit is the maximum: \$300, or \$500 for selling the spread minus \$200 debit you originally paid.



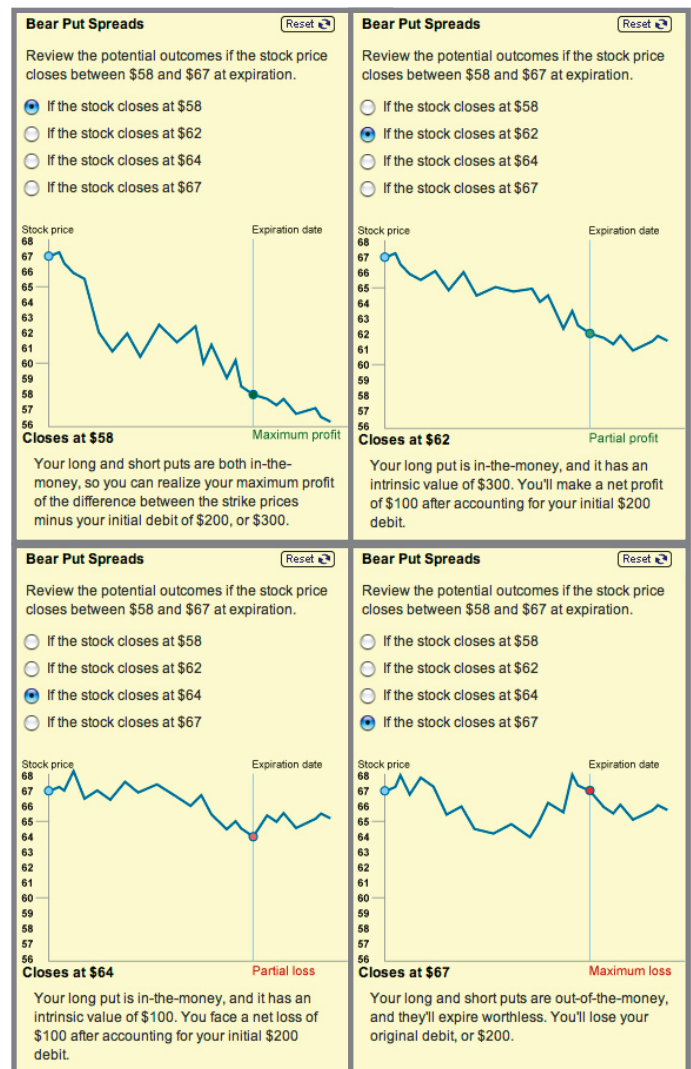
If you don't close out the spread before expiration then you'll be assigned on your short 60 put and buy stock at \$60 per share. By exercising your long 65 put you can sell those shares at \$65 per share. You'll realize your **maximum profit**, or \$500, based on the \$5.00 spread between the strike prices, less the debit of \$200 you paid when you opened the position, for a net profit of \$300.

While the profit in both cases may be the same, the commissions you pay for closing out the spread with offsetting transactions may be less than the fees incurred from the exercise and assignment process.

On the other hand, if the stock price closes between \$60 and \$65 at expiration, your long put will be **in-the-money** so you can sell it and let the short put expire with no value. (Remember, though, that your brokerage firm may not allow you to carry a naked short position.)

- If the stock closed at \$62, and you could sell the long put for its **intrinsic value** of \$3.00, your net profit would be \$3.00 less the \$2.00 debit originally paid for the spread, or \$1.00. That's a **partial profit** lower than the maximum.
- If the stock closed at \$64, and you sell the long put for its intrinsic value of \$1.00, your net loss would be the \$2.00 debit originally paid for the spread less \$1.00, or \$1.00. That's a **partial loss** lower than the maximum.

If the stock price closes above \$65, both the long and short put will expire **out-of-the-money** with no value. You'll see your **maximum loss** of \$2.00, or a total of \$200, which is the amount of the spread's original debit.

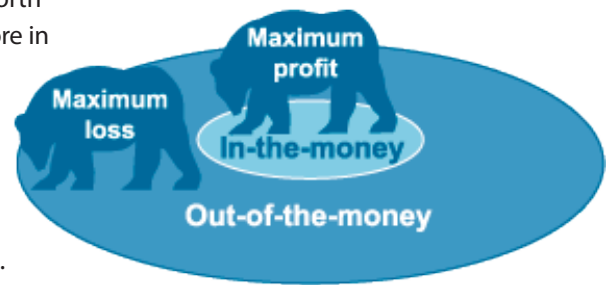


Bear Call Spreads

When you open a bear call spread, you buy a call at one strike price and sell a call with a lower strike price. The lower strike call you sell will be worth more money than the higher strike call you buy, so you'll receive more in premium than you pay. That makes it a credit spread.

Your **maximum profit** is the amount of that credit.

- You'll realize this profit if the stock price falls below the strike prices of both options, and they expire out-of-the-money with no value. You'll keep all the credit premium you initially received.



Your **maximum loss** is limited as well.

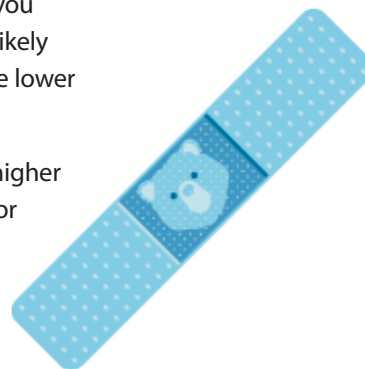
- You'll realize this loss if the stock price rises above both strike prices, and both options expire in-the-money. Your loss is the difference between the strikes less the credit you received when you opened the spread in the first place.

Since your maximum profit results if the stock price declines below both strike prices, the bear call spread is especially useful in a bear market. It's important, however, to analyze how low you think a stock will drop, and choose the **strike prices** of your calls accordingly. Strikes that are too low mean there's less chance your strategy will be successful. But strikes that are too high might mean that you receive less credit when you open the spread, lowering your **potential profit**.

Offsetting potential loss

If the stock price closes above both strike prices at expiration and you haven't **closed out** the spread with offsetting transactions, you're likely to face assignment on the written call and have to sell shares at the lower strike price.

Then you can exercise your **long call** and buy those shares at the higher strike to meet your obligation. Your loss in this case is the **spread**, or the difference between the two strike prices times 100. However, this loss will be partially offset by the amount of **credit** you initially received when you opened the spread.



Say you think stock XYZ, now trading at \$49, will drop below \$45 in the next four months. You decide to open a **bear call spread**:

1. You can **buy a call** with a strike of 50 that might cost you \$4.00.
2. At the same time you sell a 45 call, receiving \$6.75 in **premium**.

Both calls have the **same expiration**. The **net credit** for the spread will be \$2.75, or the \$6.75 you received minus the \$4.00 you paid. The total premium you keep is this \$2.75 credit times 100, or \$275.

Say your prediction is correct, and the stock falls to \$44 by expiration. Both your long call and your short call expire **out-of-the-money** with no value, which means you keep the initial credit as profit.

What if your bearish opinion on the stock proves inaccurate, and the price rises to \$52 at expiration? Both calls will expire **in-the-money**, and if they're exercised, you'll realize your **maximum loss**. That is, you'll have a loss of \$500 based on the \$5.00 spread between the strike prices less the credit of \$275 you received when you opened the position, for a net loss of \$225.

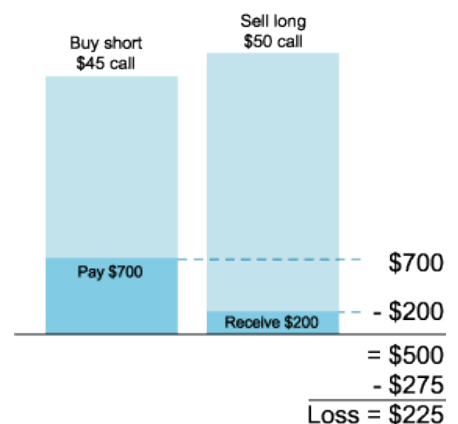
Instead, you might consider closing out the spread in the marketplace with **offsetting transactions**. In other words, you could buy the short 45 call that you initially wrote, and sell the long 50 call. If close to expiration these options are trading for their **intrinsic values** at this point, here's what might happen:

- You buy the short 45 call for its intrinsic value of \$7.00 (\$52 stock price minus \$45 strike price).
- You sell the long 50 call for its intrinsic value of \$2.00 (\$52 stock price minus \$50 strike price).

Limiting loss

In this instance, the net amount you pay to **close out** the spread is the \$7.00 minus \$2.00 = \$5.00, or a total of \$500. However, you initially received \$275 in **credit** when you opened the spread, so your actual loss is \$225, or \$500 minus \$275. While the loss in both cases may be the same, the commissions you would pay for closing out the spread with offsetting transactions may be less than the fees you'd incur from the exercise and assignment process.

$$\begin{array}{r}
 \text{Premium received } (\$675) \\
 - \text{ Premium paid } (\$400) \\
 \hline
 = \text{ Credit per share } (\$2.75) \\
 \times 100 \\
 \hline
 = \text{ Net credit } (\$275)
 \end{array}$$



Conclusion

Since you'll probably use options at least in part to **limit your exposure to risk** in a bear market, you should weigh the protection a particular strategy offers against any **limitations on your profit**, as well as the cost of opening the strategy. You should also consider how much capital you're willing to commit to any one trade, and what portion of your portfolio you'd like to allocate to options. While options can offer great benefits, it's important to keep their costs in perspective.

Do your research

Another important step as you begin investing is to carefully research and choose the underlying stock or other instrument on any option you choose. Whether you choose a simple strategy such as buying puts or a more complicated spread strategy, the choice of the underlying and a precise prediction for its movement is especially important.



Options Strategies in a Bear Market Quiz

(Answers on next page)

1. What's your maximum risk when you buy a put?

- A. The difference between the strike price and the stock price at expiration
- B. The amount you paid in premium
- C. The implied volatility x \$100

2. If you buy a protective put, you hope the put will expire:

- A. In-the-money
- B. Out-of-the-money
- C. Either one

3. If you use a married put strategy, your goal is generally to:

- A. Protect your existing paper stock profits
- B. Speculate on future downward stock movement
- C. Hedge a new stock position

4. When writing uncovered calls, which of the following describes your potential profit and potential loss?

- A. Potential profit is unlimited and potential loss is limited
- B. Potential profit is limited and potential loss is unlimited
- C. Potential profit is limited and potential loss is limited

5. Which of the following is one reason to write a covered call in a bear market?

- A. Limited downside protection for shares you plan to own for the long term
- B. Increase your cost basis for a stock you own
- C. Leverage your position in a particular stock

6. When using index puts to protect a portfolio you should own the exact combination of stocks traded by that index. True or false?

- True
- False

7. Which of the following is NOT a reason to purchase index puts?

- A. To profit from premium received
- B. To profit from an anticipated market or sector downturn
- C. To protect a stock portfolio

8. The appeal of vertical spreads is tied to their:

- A. Limited profit
- B. Reduced risk
- C. Long-term expiration date

9. The goal of a bear put spread is to have both puts:

- A. Move and expire out-of-the-money
- B. Move and expire in-the-money
- C. Decrease in value

10. If you open a bear call spread, you start with:

- A. A net credit
- B. A net debit
- C. High intrinsic value

Options Strategies in a Bear Market

Quiz Answers

1. B

When you buy a call or put, your maximum risk is what you pay in premium when you buy the position. If the option is out-of-the-money at expiration, the most you can lose is the amount of the premium.

2. C

When you buy a protective put, you're concerned that a stock you hold might drop in value, and the put protects you against losses below the put's strike price. If it's in-the-money at expiration, you'll be able to exercise the put and sell your stock, or sell the put itself and cut your losses with the proceeds. If it expires out-of-the-money, your stock price hasn't dropped as far as you anticipated, so you don't have the same losses to cut. Either way, your profits are protected.

3. C

A married put is the simultaneous purchase of both stock and a put on those shares. Generally, your objective is to hedge against possible losses in the newly acquired stock.

4. B

When you write an uncovered call, the premium you're paid is your maximum profit. Your maximum loss, however, is theoretically unlimited. If the stock price rises and you're assigned on the short call, you'll have to purchase underlying shares at the current market price and deliver those shares at the lower strike price, potentially at a substantial loss. Since the profits are limited but the potential loss is theoretically unlimited, writing an uncovered call is a very risky strategy.

5. A

In a bear market, writing a covered call can provide limited downside stock price protection. If the stock price drops and the call expires out-of-the-money and unexercised, the premium you initially received for writing the call, and which you keep, can at least partially offset any losses on the stock position.

6. False

It doesn't matter if you have all of the stocks that an index tracks—in fact, it's unlikely that you would. The key is finding an index that mirrors the movement of your portfolio. If it doesn't the actual losses your portfolio suffers might not be offset by the return on the index options you purchase. Once an index is chosen, you might choose to look at its past performance or historical volatility to gauge how closely an index's movement has matched your portfolio's movement, and adjust your put purchase accordingly.

7. A

When you purchase any option you pay premium for it, you don't receive one, so profiting from premium received is NOT an objective. You might, however, purchase a put to profit from a market or sector downturn, or to protect your portfolio.

8. B

The main appeal of both bullish and Bear vertical spreads is that they offer a reduced risk versus simple call or put purchases. As a tradeoff, most investors are willing to accept these spreads' limited profit potentials.

9. B

When you establish a bear put spread, you anticipate that the stock price will move below both strike prices, and that both puts will be in-the-money at expiration. If this is the case, you can exercise your long put to meet the terms of your short put, which will likely be assigned, and realize your maximum profit. Or, you can close out the position just prior to expiration at or near your maximum profit.

10. A

A bear call spread is a credit spread, which means that you receive more premium on your short call than you pay for your long call. You hope that the options both expire out-of-the-money, allowing you to keep the premium as profit.