

16. Covered Put.

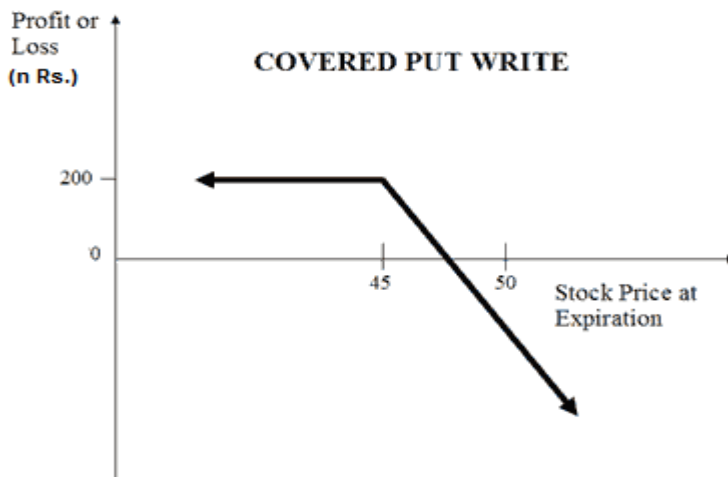
It's a simple bearish option strategy in which trader write a put option while shorting the obligated shares of the underlying stock. This strategy can be constructed as follows.

Short 100 Shares; Sell 1 ATM Put.

Example:

Suppose XYZ stock is trading at Rs.45 in June. An options trader writes a covered put by selling a JUL 45 put for Rs.200 while shorting 100 shares of XYZ stock. The net credit taken to enter the position is Rs.200, which is also his maximum possible profit. On expiration in July, XYZ stock is still trading at Rs.45. The JUL 45 put expires worthless while the trader covers his short position with no loss. In the end, he gets to keep the entire credit taken as profit. If instead XYZ stock drops to Rs.40 on expiration, the short put will expire in the money and is worth Rs.500 but this loss is offset by the Rs.500 gain in the short stock position. Thus, the profit is still the initial credit of Rs.200 taken on entering the trade. However, should the stock rally to Rs.55 on expiration, a significant loss results. At this price, the short stock position taken when XYZ stock was trading at Rs.45 suffers Rs.1000 loss. Subtracting the initial credit of Rs.200 taken, the resulting loss is Rs.800.

Covered Put payoff diagram:



Limited profits with no downside risk:

Profit for the covered put option strategy is limited and maximum gain is equal to the premiums received for the options sold. The formula for calculating maximum profit is given below,

- Max Profit = Premium Received - Commissions Paid
- Max Profit Achieved When Price of Underlying \leq Strike Price of Short Put

Unlimited upside risk:

As the writer is short on the stock, he is subjected to much risk if the price of the underlying stock rises dramatically. In theory, maximum loss for the covered put options strategy is unlimited since there is no limit to how high the stock price can be at expiration. If applicable, the covered put writer will also have to payout any dividends. The formula for calculating loss is given as follows,

- Maximum Loss = Unlimited
- Loss Occurs When Price of Underlying \geq Sale Price of Underlying + Premium Received
- Loss = Price of Underlying - Sale Price of Underlying - Premium Received + Commissions Paid

Breakeven Point:

The underlier price at which break-even is achieved for the covered put position is calculated using the following formula.

- Breakeven Point = Sale Price of Underlying + Premium Received

For more details or any doubts contact us on knowledge@grovalue.in