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Using Index Options
as Insurance

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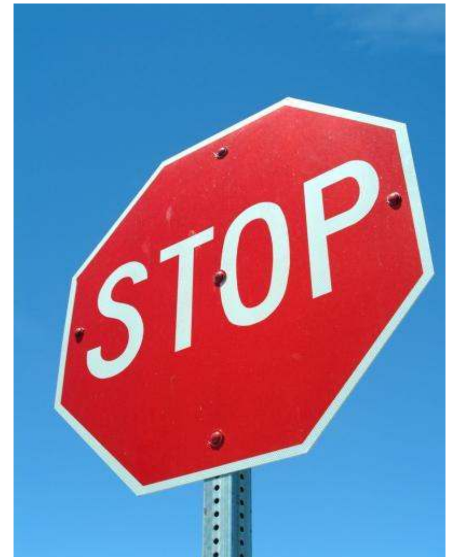
While the typical share investor might regard a stop loss order as the best way to protect their share portfolio against the downside, the informed investor knows the most effective way to protect their capital is by hedging, using Put Options.



That's certainly not to say "don't use a stop loss", in fact when trading any market, you should always set a pre-determined price that is the maximum you'd be willing to lose in the event of the position moving against you.

Put Options however, allow you to ensure <u>you don't lose at all</u> as they give you the right to sell your shares at a fixed price anytime throughout the life of the contract.

When you own shares in a blue chip performer, taking out insurance with Puts is a simple process, however if you own shares in a company who is not registered on the options market, you won't be able to buy put options relating to your shares because they won't exist.

These stocks are referred to as 'non-optionable' stocks. Now that doesn't mean that you can't insure non-optionable stocks at all, because there is a strategy that allows you to insure your portfolio as a whole that not too many people know about and it uses Put Options over the Index.

What is an Index Option?

Index options give you exposure to the stocks that make up an index collectively. Just like Stock Options, Index Options are available in Puts and Calls however where they differ greatly is in the way they are settled. Index Options are European style contracts which mean they can only be exercised at expiry (*quarterly on the Australian XJO*) and they are settled in cash.

So instead of buying or selling the underlying asset as we do with Stock Options, with index options you pay the difference or receive the difference between the strike price (*index value*) at the time you traded, and the underlying value of the index at expiry.

An index option strike price and premium is expressed as points and each point is worth a particular dollar value (*on the ASX each point is worth $ 10.00*)

Example:

If we had bought an Australian index option with a strike price of 4,500 points and the current index value was 4,800 then we are looking at a $ 3,000 difference.

4,800 – 4,500 x $ 10 = $ 3,000

Index Options offer many benefits and a lot of flexibility and they can be traded in exactly the same way as stock options, however, rather than execute multiple trades on individual stocks, you can trade your view on the general direction of the market in just one transaction.

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How Do Index Options Work as Insurance?

If you owned shares in 5 different companies and you bought a Put Option over each one individually, you would pay a different price for each dependant on such factors as implied volatility as well as varying liquidity and you would pay a brokerage fee every time.

When you buy Puts on the index, you are actually buying a blanket coverage that protects you against a downside move in the market, so you are able to insure the value of your whole share portfolio with just one transaction (*even non-optionable stocks*) and you save on transaction fees as well.

Let's walk through an example:

Let's imagine those shares in 5 different companies have a total value today of $ 90,000

The dollar amount of each contract varies, but if we were to assume the index was trading at 4,500 points and the multiplier was $ 10 then one Put option contract would cover $ 45,000 (4,500 points x $ 10) worth of stock at prices that relate to the index being at that level.

So you could purchase 2 x Put option contracts and cover the value of your whole $ 90,000 portfolio. 2 x 4,500 points x $ 10 = $ 90,000

Now if the market were to fall to say 4,000 points and the value of your portfolio was now only valued at $ 86,000 then your put option contracts would be worth $ 5,000

4,500 – 4,000 x $ 10 = $ 5,000

The money you would have made on the index put options offset the loss in your portfolio because if you owned a 4,500 Put Option, it would be the equivalent to actually selling shares at the 4,500 point level.

And just like stock options, you are able to close out of your option at any time before expiry so this gives you the ability to not only use index options as insurance, but to apply the same strategies and techniques as you would when trading shares and/or stock options.

Want to learn more?

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