The Short Put Strategy

- **Mildly Bullish**
- **High Probability**
- **Undefined Risk**
- **Defined Reward**

www.sharenavigator.ie

Hippo Financial Trading Ltd Trading as Share Navigator
Company Number 547242

1. The Short Put Strategy Explained

Welcome to the Short Put Option strategy course. This is one of our favorite Option Strategies! Explained in its simplest terms the Short Put strategy allows you to profit by insuring the value of somebody else's shares at much lower prices into the future. In other words you will get paid in advance for agreeing to buy shares that you want to own at cheaper prices into the future.

1.1. Short Put 1 minute explainer

CLICK HERE to view.

1.2. Short Put: Introduction

Imagine the following scenario: The share price of Apple is currently trading at $109. You are considering buying 100 shares of Apple at $105 which is $4 lower than the current price. Rather than place a limit buy order at $105 and wait for the share price to fall to $105, you consider insuring somebody else's 100 shares of Apple at $105 instead.

By doing this you will take in an insurance premium while you are waiting to buy the shares. This allows you to generate an income by agreeing to buy another investors' 100 Apple shares at $105 by some date in the future. The investor doesn't have to sell you their shares and will only do so when the share price falls below $105.

Either-way, for you to take on the risk and obligation to buy the shares of Apple at $105, you will need a risk premium from the investor and you get to keep that risk premium, irrespective of what happens.

This is known as the 'short put' strategy.

1.3. Short Put: How to construct a Short Put trade.

The short put is constructed by selling a put option on a stock or index. An investor with this position can be said to be holding a short put, or in more casual terms to be short a put.

Short Put = Sell a Put Option

1.4. Short Put: Debit vs. Credit

A short put will always be established at a credit. In other words, you are receiving cash upfront for selling the put option.

Short Put = credit

Note: When you sell a put option, cash goes into the 'cash' section of the trading account. Because you sold the put option the value of the put will be negative for you under the 'positions' tab. This is because it will cost you that amount to buy back the put option to close the short put position.

Don't forget that the cash you initially took in when you sold the put option is in the 'cash' section of your trading account.

1.5. Short Put: AAPL Example

Look at the put option quotes for Apple below. Apple was trading at $109 when this option quote was taken. To establish a short put with AAPL options, we might sell 1 AAPL Jan 20th $105 put option for $0.98 per share or $98 total.

Description	Delta	Gamma	Put Theta	Bid	Ask
JAN 20 '17					
105	-0.224	0.042	-0.024	0.98	0.99
110	-0.488	0.063	-0.028	2.56	2.61
115	-0.780	0.049	-0.020	5.70	5.80
120	-0.932	0.022	-0.008	10.10	10.30

We are now said to be short 1 contract of the Apple $105 put option. We have obligated ourselves to buy 100 shares of Apple between now and Jan 20th for $105. In return for taking on this obligation we received a risk premium of $98 into our cash account.

This is what the transaction might look like when we first place it:

	Cash Account	**Positions Value**
-1 AAPL $105 put	+$98	-$98

1.6. Short Put: Share price outlook

The short put is a moderately bullish position. We are bullish on Apple, and expect to profit from an increase in its price or when the share price stays above the $105 short put strike price.

However, it's a moderately bullish position since we expect the share price of Apple to stay above the $105 short put's strike price by expiration. Above that level, the profit is capped. A more bullish investor might instead simply buy AAPL calls, use a bull call spread or buy the AAPL stock.

Short Put: moderately bullish

1.7. Short Put: Reasons for placing a Short Put

Investors can look at the short put strategy in 2 ways:

1. A Return Based Strategy–The investor believes that the stock or index will remain above the short strike and they are happy to simply collect the premium.

2. A Stock Positioning Strategy –Instead of waiting for the share price of the stock to fall, the investor instead will sell a put option, happy in the knowledge that if the share price falls below the short put strike they will have to buy the shares of the stock. Since the investor was going to buy the shares anyway at the lower price, it makes perfect sense to take in additional premium by selling the put option (further reducing the risk in the stock purchase).

Short Put: Income return or stock positioning

1.8. Short Put: Maximum Profit

The maximum upside profit for a short put is limited to the net credit initially received when establishing it. This profit will be seen if the AAPL share price closes at or above the $105 strike price of the short put at expiration, no matter how high AAPL shares increase.

Max Profit Short Put

= Net Credit Received

In our AAPL example our max profit is $98. When we compare the short put strategy to just buying the stock, you can see from the matrix below that the max profit is capped for the short put, but is unlimited for buying the stock. If you simply bought AAPL shares at $109 and the share price jumps to $120 you will make $11 per share in profit. By selling the $105 put you will only make $0.98 per share in profit. This is the only drawback of the strategy.

	Sell the $105 put	**Buy the shares at $109**
Max Profit	$98	Unlimited

The counter argument is that you didn't intend buying AAPL at $109 in the first place, you intended buying at $105, so you would not profit from the upside anyway.

1.9. Short Put: Maximum Loss

The maximum downside loss for a short put is said to be unlimited. A loss will be seen if AAPL closes below the $105 strike price of the short put at expiration, minus any credit received. Since the value of AAPL (albeit unlikely) can theoretically go to zero, the risk in this trade can be substantial.

One thing you must remember about the short put strategy is that losses can mount quickly if the share price falls suddenly. That is why we encourage you to make sure that you are comfortable with the fundamentals of the company. Think of it like this, if you are not happy owning the company at the strike price, don't place the trade.

A safer option for novice traders would be the bull put spread.

Maximum loss = Unlimited

Comparing the short AAPL $105 put to simply buying the shares, you will see that they both have the same maximum loss characteristics. But we will show you later that the short put is less risky:

	Sell the $105 put	Buy the shares at $109
Max Profit	$98	Unlimited
Max Loss	Unlimited	Unlimited

1.10. Short Put: Margin & Risk

If you establish a *short* option position you may be required to *margin* this position. This means that you must provide funds or securities as a guarantee since a short option position usually entails you assuming an obligation and you must show that you are financially able to do so.

Some *short* options will be considered *covered* and will not require any margin. Margin requirements for the more complex option strategies can be difficult to calculate. Fortunately, this task has been automated at most brokerage houses.

The margin for our short $105 AAPL put example was $1,624. Please note that this margin requirement will rise and fall as the share price moves up or down. Margin can also increase if there is a spike in volatility. This is not a static figure.

A common mistake with amateur option traders is that they use up too much margin on trades. This generally leads to margin calls at some point. The key is to trade small and trade often. Be happy to take small profits often.

Note: For people who are beginners to option trading, you should stick with option strategies that carry 'defined' risk. This means that you know exactly what you can lose before you place a trade. An alternative strategy for total beginners would be the bull put spread.

Trading on margin is risky, when you don't understand or know what you are doing.

Comparing the margin requirement on the AAPL short $105 put versus buying the AAPL stock at $109 you will notice that there is more margin requirement in buying the stock versus selling the put. This indicates that selling the $105 put is less risky than buying the stock at $109.

	Sell the $105 put	Buy the shares at $109
Max Profit	$98	Unlimited
Max Loss	Unlimited	Unlimited
Margin	$1,624	$2,796

1.11. Short Put: Return on Margin

The best way to try and estimate return on investment for short naked option strategies is to use a 'return on margin' calculation. It is not perfect as margin is not a fixed number but it is the best way to compare strategies.

The return on margin formula is simply:
(Max profit potential/margin) * 100

Looking at our AAPL example:
{$98(Max Profit) / $1,624 (Margin)} * 100
= 6.03%

Now let's compare selling the AAPL $105 put and /or buying the AAPL shares at $109.

	Sell the $105 put	Buy the shares at $109
Max Profit	$98	Unlimited
Max Loss	Unlimited	Unlimited
Margin	$1,624	$2,796
Return on Margin	6.03%	Unknown

1.12. Short Put: Break-Even Price

The break-even price for a short put at expiration is a closing underlying stock price (or index level) equal to the strike price of the short put minus the credit received for the spread.

Break-even price = strike price – net credit received

For the AAPL short $105 put example above, the breakeven price = $105 (strike price) minus $0.98 (Premium received) = $104.02.

At expiry, if AAPL finishes above $104.02 we will make a profit. This is one of the major advantages of the short put strategy over purchasing the stock. The short put strategy is less risky than buying the shares. Look at the matrix below:

	Sell the $105 put	**Buy the shares at $109**
Max Profit	$98	Unlimited
Max Loss	Unlimited	Unlimited
Margin	$1,624	$2,796
Return on Margin	6.03%	Unknown
Break-even price	$104.02	$109

1.13. Short Put: Downside leeway and Probability

Another major advantage of the short put strategy is the downside leeway it gives you. The share price of AAPL could fall by a certain amount and we would still make a profit.

Remember in our Apple example. The share price of AAPL was $109 when we sold the $105 put option. The breakeven on the short $105 put is $104.02. This means that the share price of AAPL could fall $4.98 ($109-$104.02) before we make a loss at expiration. This is the equivalent of a 4.57% fall in the value of the AAPL share price. We call this the ‘downside leeway’.

Now let’s consider our chances of winning. Which is more likely, AAPL to close above $104.02 or Apple to close above $109? Obviously, AAPL has a much better chance of closing above $104.02. Most online brokers will tell you the probability of profit on every option trade you place. The probability with the AAPL example was 80%.

Does this mean we are guaranteed to make profit? No, but it means that you have much better odds. In fact, when you buy a share you only have a 50/50 chance of profit. That’s why using the short put strategy is more likely to produce a profit than buying the shares. Look at the matrix below:

	Sell the $105 put	Buy the shares at $109
Max Profit	$98	Unlimited
Max Loss	Unlimited	Unlimited
Margin	$1,624	$2,796
Return on Margin	6.03%	Unknown
Break-even price	$104.02	$109
Probability of profit	80%	50%

This is the real attraction of the short put strategy, the high probability nature of it. This of course depends on what strike prices you pick. The further out-the-money you go with the strikes, the higher the probability but with lower payoff.

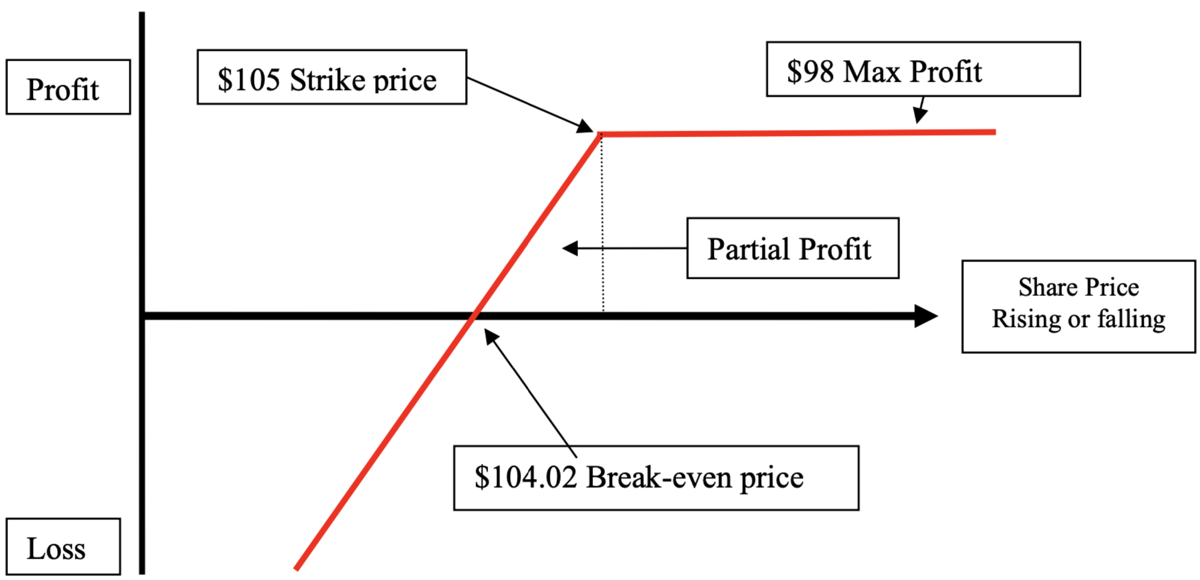

Figure 1: Profit and Loss Dynamics for the AAPL Short $105 Put

1.14. Short Put: Partial Profit

At expiration, if AAPL closes at a price between the break-even price of $104.02 and the $105 strike price, a partial profit would be seen. Above the break-even price there would be a full profit; below the break-even point there would be a loss.

1.15. Short Put: Profit and Loss Tables

It is important for you to get into the habit of creating profit and loss tables. **CLICK HERE** to watch a video showing you how to do P&L tables for the short put strategy.

Here is an example of a P&L table for the AAPL Jan 20th short $105 Put option. Remember we received premium of $0.98 for selling the put option:

AAPL price at Expiration	Short $105 Put Value	Premium Received	Profit/Loss
$100	- $500	$98	-$402
$101	- $400	$98	-$302
$102	- $300	$98	-$202
$103	-$200	$98	-$102
$104	-$100	$98	-$2
$105	0	$98	+$98
$106	0	$98	+$98
$107	0	$98	+$98
$108	0	$98	+$98
$109	0	$98	+$98
$110	0	$98	+$98

1.16. Short Put: Profit & Loss Before Expiration

Before expiration, an investor can take a profit or cut a loss by purchasing the put in the marketplace. This involves buying the short put, which will be done at a net debit. Profit or loss would simply be the net difference between the credit initially received for the put and the debit paid to close it.

1.17. Short Put: Effect of Volatility

Since implied volatility is a key factor in the pricing of options it is best to place the short put strategy when implied volatility is high. This means that you will get paid a higher premium for the sale of the put. Any reduction in implied volatility thereafter benefits the short put position.

CLICK HERE to watch a video showing you how to chart IV.

1.18. Short Put: Effect of Time Decay (Theta)

Theta is the rate of decay in the time value of an option. For a short put, theta (Time Decay) is positive. As each day passes time decay works in the favor of the put option seller. Let's look at the AAPL short Jan 20th $105 put again:

Description	Delta	Gamma	Put Theta	Bid	Ask
JAN 20 '17					
105	-0.224	0.042	-0.024	0.98	0.99
110	-0.488	0.063	-0.028	2.56	2.61
115	-0.780	0.049	-0.020	5.70	5.80
120	-0.932	0.022	-0.008	10.10	10.30

You can see above that the theta value is -0.024. This means that the time value of the put option will erode by $0.024 per share or $2.40 total per day. But remember, we sold the put option so the theta value becomes a positive for us of +0.024. What does this mean? It means that $0.024 per share of time value will erode daily from the value of this option.

Now theta is working to our advantage as the value of the put option continues to decay as time passes. This is one of the main reasons we prefer to be option sellers (under the right market conditions) as opposed to option buyers.

1.19. Short Put: Delta

Delta is the rate of change in the value of an option for a $1 move in the underlying share price. Let's look at the AAPL short Jan 20th $105 put again:

Description	Delta	Gamma	Put Theta	Bid	Ask
JAN 20 '17					
105	-0.224	0.042	-0.024	0.98	0.99
110	-0.488	0.063	-0.028	2.56	2.61
115	-0.780	0.049	-0.020	5.70	5.80
120	-0.932	0.022	-0.008	10.10	10.30

You can see that the delta value is -0.224. Delta for put options is a negative number because puts go up in value as the share price falls and vice versa.

Again, we sold the $105 put option, therefore the delta sign changes to positive. We now have a +0.224 delta position in our account. This means that the value of the AAPL short $105 put will go up by $0.224 per share or $22.40 per contract for every $1 rise in AAPL and vice versa.

We can also consider delta as having 22.4 shares of AAPL. Think about it...if AAPL rose by $1 and we owned 22.4 shares we would make a profit of $22.40. The exact same as the short $105 put option position.

A couple of things to know about Delta:

1. Positive delta is a bullish bias
2. Negative delta is a bearish bias
3. You should always consider the overall delta position in your portfolio – we like to be option sellers and keep our overall portfolio delta as neutral as possible. In this way we do not get too upset in moves in the market up or down. As a general rule of thumb we like to keep our deltas below plus or minus 1% of the value of our portfolio.

1.20. Short Put: What strike prices to pick?

Some short puts can be considered more bullish than others. The degree of bullishness depends primarily on the strike price of the short put, which determines how high the underlying stock (or index) needs to increase for maximum profit to be realized at expiration.

- **Most bullish:** A put sold in-the-money. You will receive more premium but the probability of profit will be lower.
- **Moderately bullish:** A put sold at-the-money. You will receive less premium but will have a better chance of making a profit.
- **Least bullish:** A put sold out-the-money. This offers the best chance of winning but the premium received will be lower. We prefer using out-the- money puts.

1.21. Short Put: Assignment Risk

Assignment on any Equity option or *American*-style index option can, by contract terms, occur at any time before expiration, although this generally occurs when the option is in-the-money.

1.22. Short Put: Equity Options

For an equity put option, early assignment generally occurs when the short put is deep in-the money, expiration is relatively near, and its premium has little or no time value. If a short put holder is assigned early on the short put, then he might sell shares purchased. In this case, a loss on the short put may be realized.

An investor contemplating the use of a short put should consider the consequences of early assignment, and in advance discuss with his broker a course of action to take if assigned.

1.23. Short Put: *American*-Style Index Options

If early assignment is received on a short in-the-money put, the cash settlement procedure for index options will create a debit in the investor's brokerage account equal to the cash settlement amount. This cash amount is determined at the end of the day the long put is exercised by its owner.

1.24. Short Put: Actions to take at expiry

The action you take at expiry will depend on where the share price is trading at:

1. **If the share price is above the short put strike price:** The put option is out-the-money and worthless. The position will disappear on the next trading day. Simply enjoy the profits.
2. **If the share price is below the short put strike price:** The put option is in-the-money and has value. You may be in a partial profit or a heavy loss depending on where the share price is trading. You have several choices available to you which will depend on your outlook for the stock:
    - **Option1–Roll-out:**Roll out the put options for another month to the same strike and most likely generate more premium to reduce your breakeven. You would only do this if you were still bullish on the stock or believed it will trade above the strike price.
    - **Option 2 – Roll-out and down:** Rollout the put options for another month and down to a lower strike. There may be a cost to do this but the break-even will be lowered.
    - **Option 3 –Take assignment:**Take assignment of the shares. If you do nothing you will be assigned the shares and they will appear in your account on the next trading day. From there you can sell the shares or implement a repair strategy.
    - **Option 4 – Buy back the Put:** You can simply buy back the put option. This may be done at a profit or loss depending on where the share price is trading.

1.25. Short Put Vs Buying Shares

CLICK HERE to view.

1.26. Short Put: Our view

This is one of our favorite strategies. Selling out-the-money put options offers you a higher probability of profit. When implied volatility is high it is an excellent strategy to use. We use this strategy around earnings announcements as this is when implied volatility is usually at its highest for stocks.

The short put strategy should not be used unless the stock is fundamentally sound and the investor is comfortable with the valuation of the company.
CLICK HERE to watch a powerpoint summary of the strategy.

Novice traders should use the bull put spread strategy as an alternative to the short put. This is because the bull put spread offers the investor defined risk. The undefined risk nature of the short put strategy makes it riskier. Finally, we prefer to use the put ratio spread strategy when trading indexes like SPY.

1.27. Short Put: Knowledge Check

1. Pick any stock or index that you are bullish on.
2. Login to your personal simulated trading account.
3. Please contact us if you don't have a personal simulated trading account.
4. Sell 1 contract of a put option with an expiry of 1-2 months.
5. Monitor the trade and write down as many questions that spring to mind.
6. Contact us with your questions.

2. How to place and manage the Short Put

2.1. How to place a Short Put Trade

CLICK HERE to view.

2.2. How to manage a Short Put Trade

CLICK HERE to view.

2.3. How to roll out a Short Put Trade

CLICK HERE to view.

2.4. How to close a Short Put Trade

CLICK HERE to view.

2.5. Position Size and the Short Put

CLICK HERE to view.

2.6. Test Your Knowledge

CLICK HERE to take the quiz and test your knowledge of the Short Put Strategy.

2.7. Please leave a Review on Google

CLICK HERE to leave a review of this course on Google. We would love to get your feedback. Thank you.

3. Mentoring Service

Embark on a streamlined journey to financial proficiency with our Stock and Options Mentoring Service. Elevate your learning curve by enlisting a **personal** mentor who will guide you through the intricacies of stock and options trading. Our comprehensive program offers:

- Weekly one-on-one mentoring sessions, ensuring personalized attention and targeted skill development.
- Gain a competitive edge with daily live market updates
- Exclusive access to curated stock watchlists
- Insights into our meticulously crafted options and futures trades.
- Save valuable time, effort, and money as you fast-track your education with our dedicated support system.

With daily assistance and a wealth of resources at your fingertips, you'll not only navigate the markets more confidently but also accelerate your journey toward financial success.

Join us in unlocking the full potential of your trading endeavors.

CLICK HERE to book a FREE Mentoring session to find out more.