

Consider buying “stock insurance” against loss

Does buying stocks and never losing more than 10% on any single purchase sound attractive?

You can obtain such downside protection by purchasing put options on your stocks. But just as you pay for insurance on your home or car, stock market protection comes at a price.

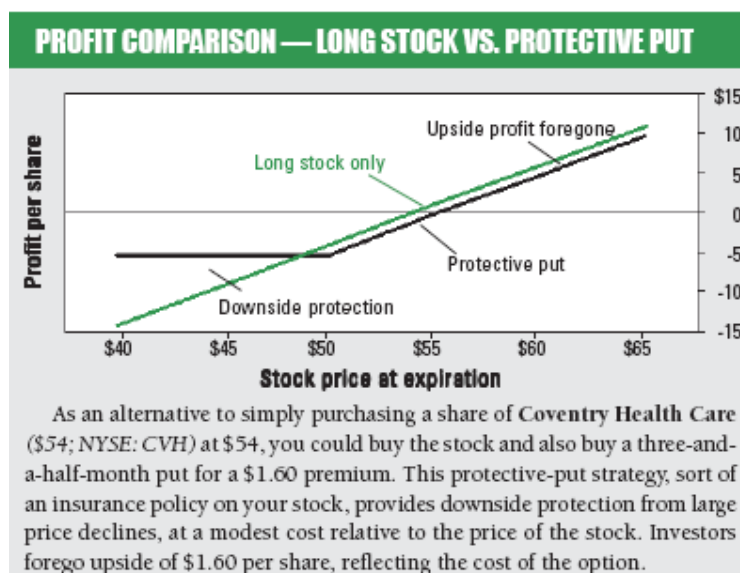
The good news: prices for some put options are at their lowest level in several years. So, whether you’re uncomfortable with the market’s inherent riskiness or looking for some short-term protection for a specific stock, consider whether put options make sense for you.

Purchasing a put option on a stock you already own (commonly called a “protective put”) gives you the right, but not the obligation, to sell your shares at a specified price (the strike price) for a predetermined time. For this right, you pay the price of the option contract, or the premium.

If the stock’s price falls below the strike price near the expiration date of the option contract, exercising the option will be advantageous, as you can sell your shares at the strike price. If the stock’s price remains above the strike price, the option expires worthless. The owner of a protective put prefers not to exercise the option, just as owners of insurance policies don’t want to use the coverage.

The chart shown here, based on April 3, 2006 closing prices for **Coventry Health Care** (NYSE: CVH) shares and put options, compares a stock-only strategy to a protective-put strategy. The option strategy requires the purchase of one put contract for each 100 shares of underlying stock. Note the relatively small sacrifice in upside potential versus the potentially large downside protection.

This difference drives the strategy’s popularity. If the stock price increases by an amount equal to the option



premium, the investor will break even. Once you have decided to purchase a protective put, two questions must be addressed. First, which strike price to select. Second, which expiration month to choose. The strike price you select should reflect the amount of downside protection you desire. Think of the stock price minus the strike price like the deductible on your auto insurance. A lower stock price provides less downside protection, since the put doesn’t “kick in” until the stock falls to the strike price.

The expiration month you select should match your desired duration for stock protection. If long-term coverage is desired, puts are available for up to three-year periods. Otherwise, purchase shorter-term puts, which provide the flexibility of purchasing new puts as worthless puts expire. Regardless of the form of protection, during the lifetime of the put contract you continue to receive any dividends paid to stockholders.

The table below shows the effect of strike price and option duration on put costs. Not

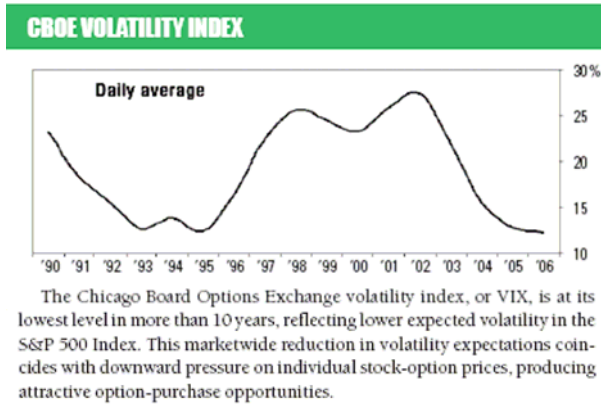
THE IMPACT OF DOWNSIDE PROTECTION AND DURATION ON PUT PRICES												
Underlying Stock	June Expiration						September Expiration					
	Strike Price	Put Price	% of Stock Price	Maximum Loss (\$)	% of Maximum Loss (%)	Implied Volatility	Strike Price	Put Price	% of Stock Price	Maximum Loss (\$)	% of Maximum Loss (%)	Implied Volatility
McDonald’s (\$35; MCD)	\$32.50	\$0.50	1.4%	\$3.00	8.5%	21%	\$32.50	\$1.00	2.9%	\$3.50	9.7%	23%
	35.00	1.25	3.6	1.25	3.4	20	35.00	1.90	5.1	1.90	5.1	22
General Motors (\$20; GM)	17.50	1.50	7.5	4.00	18.6	77	17.50	2.60	11.5	5.10	22.6	76
	20.00	2.45	12.3	2.45	10.9	69	20.00	3.70	15.6	3.70	15.6	71

surprisingly, puts with more downside protection and longer lives cost significantly more. Note the **McDonald’s** (NYSE: MCD) September 35 put costs more than three times as much as the June 32.5 put.

Option prices also depend on expected volatility, a measure of the expected variability in the underlying stock’s price. As volatility expectations increase, the probability of needing downside protection increases, so put buyers are willing to pay more for the right to sell shares at a set price.

The implied-volatility metric, a proxy for expected volatility, reflects both general market and company-specific factors. Overall market-volatility expectations are measured by the VIX, a popular volatility index. Recently reformulated, this Chicago Board Option Exchange index approximates short-term expected volatility in the S&P 500 Index. The chart on p. 3 shows the recent downtrend of this index.

Recent VIX readings near 12% compare favorably to the 1998 to 2003 average of more than 24%. And this trend has translated to decreases in individual stock volatilities.



To illustrate the importance of this decrease, the table below shows hypothetical put prices for a range of implied volatilities. Note how a volatility change to 20% from 30% in a three-month put reduces the price by nearly 70%.

The table on page 2 shows how put pricing can differ between companies, again due to market perception of future stock movements. For similar protection, the **General Motors**

(NYSE: GM) puts cost several times as much as the McDonald’s puts, reflecting uncertainty about GM’s future. Once a protective-put position has been established, closely follow the stock’s price. After a sharp rally in the stock, the put will provide little protection because the stock price will be well above the strike price.

Implied Volatility	— Time to Expiration —		
	3 Mos.	6 Mos.	3 Yrs.
20%	\$0.28	\$0.66	\$2.43
30	0.88	1.67	5.08
40	1.64	2.83	7.91

The table above assumes a hypothetical stock price of \$50 and put-option strike price of \$45, with option prices based on a theoretical option-pricing model. With lower implied volatility, prices for put options are lower.

A put holder can close out the option position at any time by selling the put. So consider selling the put and purchasing one with a higher strike price to provide better downside protection.

If a large downside move pushes a stock well below the strike price, the put will have significant value. Since the stock and put will move almost equally in opposite directions (a completely hedged position), the original bullish position is no longer intact.

Significant funds may be tied up in this position, so consider selling both the stock and the put. However, if the stock remains a desirable holding, sell only the put and purchase another put with a lower strike price to re-establish the bullish hedged position.

Further considerations

As an alternative to purchasing puts on individual stock holdings, consider puts on such exchange-traded funds as the S&P 500 Depository Receipts (AMEX: SPY), the Diamonds Trust (AMEX: DIA) tracking the Dow Jones Industrial Average, or the technology-laden Nasdaq 100 (NASDAQ: QQQQ). These options protect against general market declines.

Buying put options to protect stock holdings is one of the simpler and more conservative option-related strategies, but there are still numerous factors to consider when implementing this popular strategy. An excellent tutorial is available at the Chicago Board Options Exchange’s Web site, www.cboe.com. Long-term protection may necessitate frequent put purchases, so use a discount broker to minimize commissions. Also, the tax rules associated with protective puts are complex, so consult your tax adviser before employing this strategy.