Selling (Writing) Puts

Puts give the buyer the right to sell an underlying asset to the put's writer at the exercise price before expiration. The price paid for the option to sell the underlying asset is the premium. The buyer's goal is to sell the asset for more than it is worth. The buyer of a put anticipates the underlying asset's market price falling below the exercise price. This allows them to exercise their option and sell the underlying asset for a higher value exercise price, earning a profit.

The writer of a put expects the price of the put to rise or stay the same, so they won't incur a loss by paying more for an asset than it is worth. If the price does not decrease, the writer of the put keeps the premium as free income. If the price falls they'll be purchasing an asset for more than its value. Writers will always need to post collateral or margin to write puts. If the option is used they will be obligated to purchase the underlying asset, and exchanges will not simply trust them to be able to meet their obligations. The profit for put option holders is very simple:

Put Writer's Profit = Premium Earned – Commission & Transaction fees – (If Exercised: Underlying Market Price)

(Where market price is the underlying price at any point for an American style option, at expiration for a European option, or average market price before expiration for an Asian style option)

The writer is making a heavy bet that the underlying asset's price will not decrease in price before the put's expiration date. If the asset's price sinks, the writer may incur large losses since they must purchase the underlying asset from the put holder at a far higher price than it's worth on the market. The maximum loss is limited only by the difference between the strike price and zero.

There are ways to mitigate losses if the share price drops below the exercise price. However, the strategy must be set up before the put is written. A short sale targeting the same asset as a put for the same duration protects the put writer. A short sale borrows an asset from another investor, sells it at the current market price and waits for the price to fall. The borrower reimburses the lender for any dividends received during this time period. They purchase the same asset at the lower price and return it to the investor who loaned to them. The price sold minus the price purchased is the short sale's profit.

Writing a put on the same asset as an open short sale is a "covered" put. For example: you write a put on an underlying asset that has a market price of $40, a premium of $3, and a strike price of $35. The asset's market price drops to $30 and the option will most likely be exercised. You will be paying $35 for an asset that is only worth $30, which results in a $5 loss. That becomes a $2 loss after including the $3 gained from the premium. If you opened at short sale at $38 and closed it at $30, you would earn $8 from the short sale. This turns your $2 loss into a profit of $6.

Beware: This strategy becomes especially dangerous if the price begins to rise. If the price rose to $50 after you opened the short sale at $40, your loss would initially be $10. The $3 gain from the premium reduces the loss to $7. A rising price first erodes profits from the premium and then creates losses. Even worse, short sale losses created by rising prices are potentially infinite. Prices can only fall to zero but they can rise to an unlimited value.

The solution is a Buy-Stop order. Buy-Stop orders instruct your broker to purchase an asset if it rises above a specific price. If you placed a buy-stop at $42 you would automatically purchase the underlying asset if it rose to that price. You would close the short and only part of your premium would be lost if the price rose to $50, instead of the $7 lost without the buy-stop order. This expands your range for profit: the price can fall below $35 and be exercised, but the short provides you with profit exceeding your losses. The price can rise above $42 and eliminate some of your premium profit,

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but the buy-stop saves you from losses beyond that value. Note that this is before commissions and fees, which will reduce gains and increase the losses of all the scenarios above.

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