

Advanced Hedging

By John White

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Naked Put Hedging Review

Long stock at \$40.20

Long 40 put at \$1.50

- Must take in at least \$1.70 in call premium over life of trade to pay for downside risk
- \$1.50 put price + \$.20 from stock price to 40 strike = \$1.70

Naked Put Hedging Review

Stock bought at \$40.20

Long 40 put (now \$20 ITM)

Stock declines to \$20.00 on expiration (lost
\$20.20 on stock)

40 put is \$20 ITM so put is worth \$20.00

Hedging Downside With Puts

- Buy put that is closest to ATM
- Insurance (long put) should kick in ASAP.

Using Call for Stock Substitution Review

- Deep ITM call can be used to replace any optional stock.
- Choose time frame appropriate for trade (usually no more than 2 months out)
- Delta of at least .80 (higher the better)
- Must factor in time value of call in amount of premium to be sold to overcome time risk and put insurance cost.

Replacing Stock with ITM Call

- USO at \$39.22 call options

STRIKE	DELTA	PRICE	TIME
39	.55	1.88	1.66
38	.63	2.47	1.25
37	.71	3.15	.93
36	.78	3.90	.68
35	.84	4.70	.48
34	.89	5.55	.33
33	.92	6.35	.13

Replacing Stock with ITM Call

- USO at \$39.22

Strike	Delta	Price	Time
35	.84	4.70	.48
34	.89	5.55	.33
33	.92	6.35	.13

- If 35, 34 or 33 strike were used, the above time value would have to be taken into consideration to determine how much premium needs to be sold.

Call Option Replacement Using 34 call (delta .89)

- USO at 39.22

Buy 10 contracts of 34 call \$5.55 (.33 time)

Buy 10 contracts 39 put \$1.71

\$2.04 ($\$1.71 + \0.33) in sold call premium
needs to be collected to pay for hedge.

Selling Call Premium Review

- Sell strike OTM that gives enough premium to pay for hedge over course of trade.
- If put hedge plus downside risk is \$2.04, at least \$.51 per week would need to be sold to cover cost ($$.51 \times 4 \text{ weeks} = \2.04)

Hedging With Put Spread

- Buy closest to ATM put
- Sell another further OTM put
- Transaction is done at a debit
- Best (but not absolutely necessary) if sold put is under some type of support.

Hedging with Put Spread

USO at \$39.22 (replace with call)

Buy 39 put \$1.71

Sell 34 put \$.31

Cost is reduced from \$1.71 to \$1.40.

Put Spread Worth on Expiration

USO started at \$39.22

Buy 39 put \$1.71

Stock at \$36 – 39 put worth \$3.00

Sell 34 put \$.31-expires OTM

Put Spread Worth on Expiration

USO started at \$39.22

Buy 39 put \$1.71

Stock at \$34.50 – 39 put worth \$4.50

Sell 34 put \$.31-expires OTM

Put Spread Worth on Expiration

USO started at \$39.22

Buy 39 put \$1.71

Sell 34 put \$.31

Stock at \$30.00- spread worth max value of
\$5.00

(+\$9.00 - \$4.00)

Put Spread Worth on Expiration

- In all scenarios, the long put will gain almost exactly what's lost on the stock.
- Concern is greater if buying actual stock at \$39.22 since put spread gain is capped at the \$5.00 width of spread.
- Not as much of a concern if buying ITM call for much less, i.e. \$5, \$6, or \$7

Structure of Position

Sell 40 weekly call \$.35 (x 6 weeks)

USO at \$39.22 (replace with call)

Buy 39 put \$1.71

\$1.40

Sell 34 put \$.31

USO Doesn't Move

Sell 40 weekly call \$.35
USO at \$39.22 (replace with call)
Buy 39 put \$1.71

Sell 34 put \$.31
Buy back short 40 call and sell another for
next week for approx. \$.35, likely the 40 call
again.

USO Declines to \$37.00

Sell 40 weekly call \$.35

Buy 39 put \$1.71

USO at \$37.00

Sell 34 put \$.31

Long 39 put is worth at least \$2.00....buy back short 40 call and sell next week's call for approx. \$.35, likely the 38 call.

USO Increases to \$41.00-

Option #1

USO at \$41.00

Sell 40 weekly call \$.35

Buy 39 put \$1.71

Sell 34 put \$.31

Allow trade to be called away. Cost was \$40.27-
\$40.00 = -\$.27

Sell back put spread to market for remaining
amount.

Being “Called Out” With ITM Long Call

USO now at \$41.00(from \$39.22)

Short 40 call(\$1.00 ITM)

Long 34 call \$5.55 (now worth about \$7.33)

Since the stock increased from \$39.22 to \$41.00(\$1.78 gain), the long 34 call will have gained about same amount- can sell back 34 call for about \$7.33(\$5.55+\$1.78)

USO Increases to \$41.00-
Option #2

USO at \$41.00

Sell 40 weekly call \$.35

Buy 39 put \$1.71

Sell 34 put \$.31

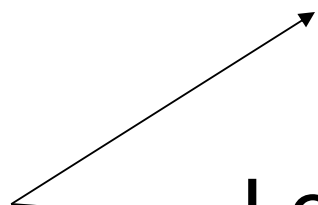
Buy back short 40 call for \$1.00 and sell
next week's call for \$.35, likely the 42.

USO Increases to \$41.00- Option #2 Continued

USO at \$41.00

Buy 41 put

Long 39 put (sell)



Sell 36 put

Short 34 put (buy back)



Rolling Up Puts Review

- Roll up long put for no more than 30% of strike being moved.
- For example, pay no more than \$.60 debit to roll up put from 39 to 41.
- Buying back short put and reselling higher put will bring in credit to help with cost.
- For example, rolling up long put (39 to 41) might cost \$.72, but rolling up short put (34 to 36) might bring in \$.13 credit= \$.59 total

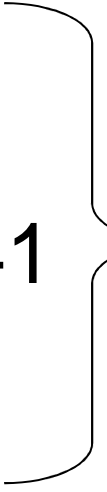
Butterfly Basics

Long Stock \$39.22(or call replacement)

Buy 39 put \$1.71

Sell 34 put(x2) \$.41

Buy 29 put \$.15



\$1.04

Butterfly Basics

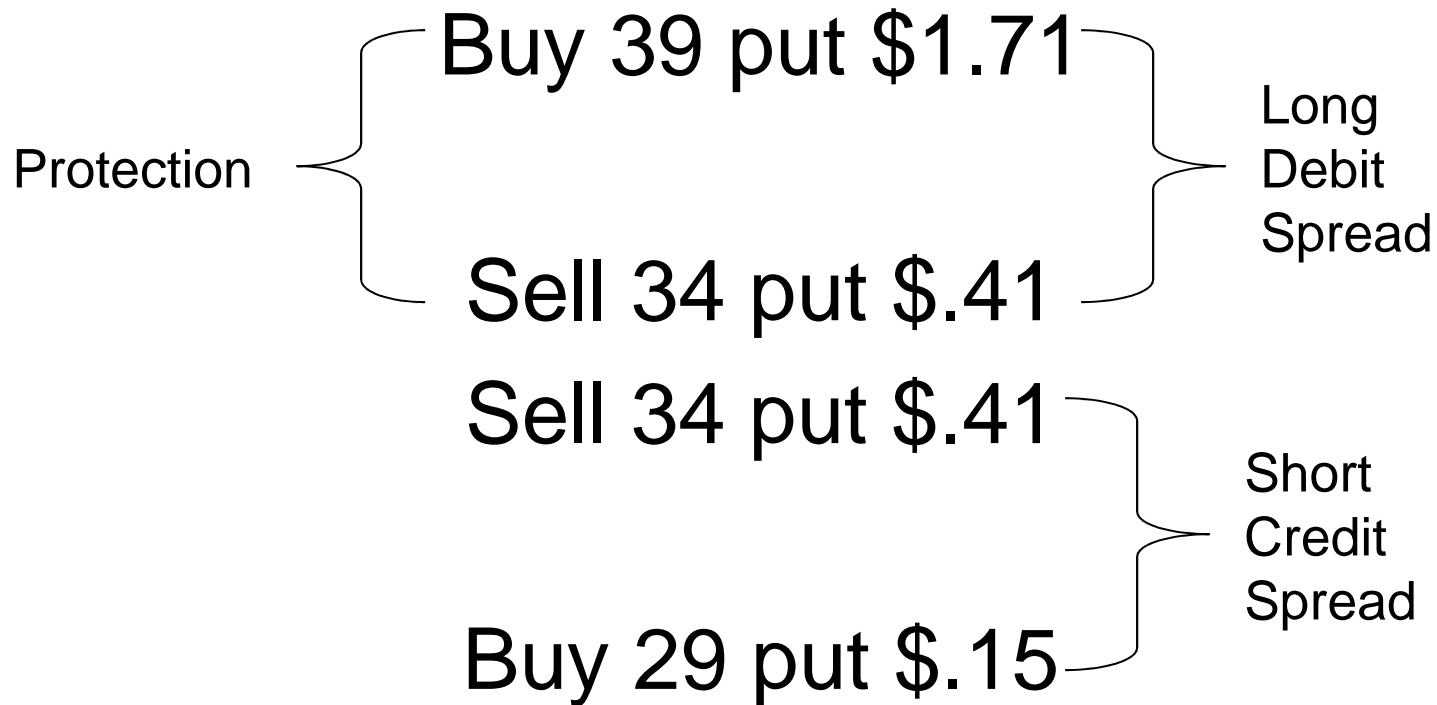
Buy 39 put \$1.71

Sell 34 put(x2) \$.41

Buy 29 put \$.15

Butterfly was entered for cost of \$1.04 debit,
which is only requirement.

Butterfly Basics- 5 pt Balance



Butterfly Worth on Expiration

Long 39 put

Stock at \$36 -39 put worth \$3.00

Short 34 put(x2)

Long 29 put

Expires
OTM



Butterfly Worth on Expiration

Long 39 put

Short 34 put(x2)

**Stock at \$33- 39 put worth \$6.00 -
\$2.00(34 put is \$1.00 ITM x 2)= \$4.00**

Long 29 put- expires OTM

Rolling Up Butterfly

- Roll up first long put following 30% rule.
- Also roll short body of butterfly which will be done at a larger credit vs that of a put spread since you are rolling two short puts for every one long put.
- Will also need to roll bottom wing put if the trader does not want to be faced with an option requirement from having on unbalanced butterfly.

Butterfly Notes

- If the underlying is approaching short strikes, the closer to expiration it is, the more the trade butterfly will open up to its full value.
- Rolling down the short strikes may be necessary if the underlying breaks support and appears likely to continue down.

Rolling Up Butterfly Example

Short USO Weekly 39 call \$.30(7 wks out)

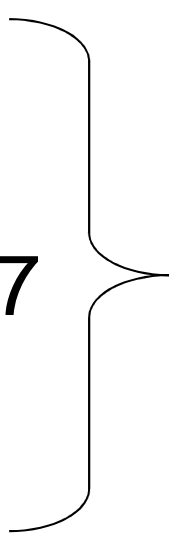
USO \$38.30(32 call \$6.45)

Long 38 put \$1.52

Short 33 put(x2) \$.27

Long 28 put \$.05

\$1.03



USO: United States Oil Fund LP (Daily bars)

www.BetterTrades.com

01/27/2012 = 38.30 (-0.07)



Sell Feb Week1 39 call \$0.30
7 weeks to go

MARCH 38/33/28 BUTTERFLY
\$1.03 VS \$1.52 FOR 38 PUT

12/14/10 01/05/11 01/27/11 02/17/11 03/11/11 04/01/11 04/25/11 05/16/11 06/07/11 06/28/11 07/20/11 08/10/11 08/31/11 09/22/11 10/13/11 11/03/11 11/25/11 12/16/11 01/10/12 02/01/12

Rolling Example – USO goes to \$40.20- Roll Wing & Body \$.56

2 Strikes → **Long 40 put \$.70 debit**
→ Long 38 put

1 Strike → **Short 34(x2) \$.07 credit**
→ Short 33 put(x2)

Long 28 put

Rolling Example#2- USO goes to
\$40.20- Roll Entire Fly for \$.57

Long 40 put .84 debit

Long 38 put

Short 35 put(x2) \$.15 credit

Short 33 put(x2)

Long 30 put \$.03 debit

Long 28 put

USO Approaches Short 33s

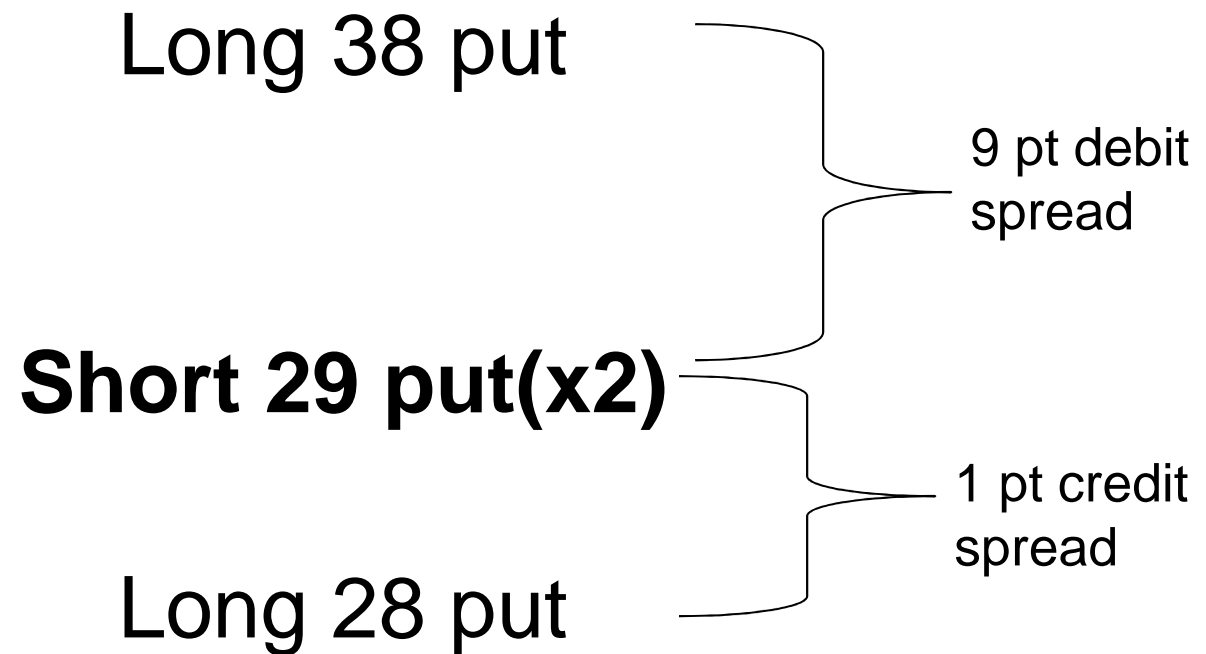
Long 38 put –leave in place

Short 33 put(x2) –roll to 29

Short 29 put(x2)-for a debit

Long 28 put –leave in place

New Butterfly With Lower Shorts



- Even if stock falls through all strikes, butterfly will be worth \$8.00

USO Approaches 33s-Option #2

Long 38 put

Short 33 put(x2) –roll to 28

Long 28 put

- Rolling down shorts to 28 will create a 10 point wide put spread.

Rolling Down Shorts to Long 28 Put

Long 38 put

Short 28 put

Changed
Butterfly into
Put Spread



- Any roll down of the shorts should create enough profit area in long spread to cover ITM call cost.

Hedging Bearish Trade With Call Butterfly

Buy 47 call

Sell 43 call(x2)

(preferable if shorts are above resistance)

Buy 39 call

Short Stock at 38.30(or ITM put)

Sell OTM puts for premium

USO: United States Oil Fund LP (Daily bars)

www.BetterTrades.com

01/27/2012 = 38.30 (-0.07)



39/43/47 Butterfly \$1.13

Sell weekly 38 put \$.42

12/14/10 01/05/11 01/27/11 02/17/11 03/11/11 04/01/11 04/25/11 05/16/11 06/07/11 06/28/11 07/20/11 08/10/11 08/31/11 09/22/11 10/13/11 11/03/11 11/25/11 12/16/11 01/10/12 02/01/12

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