



How to protect your portfolio

The Duke of Wellington once observed: "What makes a great general? To know when to retreat; and to dare to do it."

In stock market parlance what this means is when to sell the stock you so expectantly bought. While it is easy to book profits, it is a difficult call to book losses.

But in these days of abundant hedging products it is not necessary to actually sell your stock if you don't want to.

In the following article, we have taken RNRL just as an example to give the readers a real life perspective. Its not a recommendation.

1. Buy Puts

The best way to actually hedge your stock is to buy a Put in the stock concerned. There are currently 190 stocks and four indices, which are traded, in the derivative segment.

When you buy a Put option you are buying a right to sell the stock in the settlement period for which you have bought the Put. You are required to choose a strike price and buy a Put for that strike price.

For instance, for RNRL, strike prices are available with an interval of Rs 5. The RNRL stock closed at Rs 52.65 Friday. You should choose a strike price immediately below the current price. One could buy the 50-strike price Put for the May series for Rs 3.5.

If the price tumbles to Rs 20 by the end of settlement, you will get Rs 30 (50-20) in the deal, compensating you for the slide in price. You deduct the premium you paid of Rs 3.5 and you gain Rs 26.5 in the transaction.

In the same example, if the price instead of tumbling goes up sharply to, let's assume Rs 70, you don't lose anything more except the premium you paid. The stocks are with you and all the appreciation is yours.

Buying a Put option is like eating your cake and having it too!

2. Construct Bear Spreads

Your insurance begins from the level of the strike price for which you buy the Put option. In the above case, for instance, from Rs. 50. You may then feel that the stock may not go below Rs 40. So you may Sell or Write the Put for the May series for the 40-strike price for Rs 1.55. Since you are selling this option, you will get the premium. So your net cost of protection would become Rs 2.35 (Rs 3.50-Rs 1.15). But your protection would end at the strike price for which you sell the option.

When you construct a bear spread, you reduce your cost of insurance but limit your insurance zone.

3. Initiate collars

Collars represent the most popular method for protecting portfolio value against a market decline.

To build a collar, you buy a Put option for strike price lower than the current price and Sell a Call Option for a higher strike price, granting someone else the right to buy the same shares.

Cash is paid for the put at the same time cash is collected when selling the call. Depending on the strike prices chosen, the collar can often be established for zero out-of-pocket cash (but not always). That means the investor is accepting a limit on potential profits in exchange for a floor on the value of his or her holdings. This is an ideal tradeoff for a truly conservative investor.

One could, for instance buy the 50 strike price Put for Rs 3.50 and Sell the Call Option for the 60 Strike Price for Rs 1.55. You bring down your cost of protection to Rs 1.95 in this case.

4. Replace stocks with options

The three previous strategies are relatively easy to use and involve little risk. The stock replacement strategy, on the other hand, can be tricky. If not done properly, the investor's portfolio can vanish.

The idea is to eliminate stocks and replace them with call options. The point of this strategy is to sell stock, taking cash off the table.

In this RNRL case you could, for instance, Sell your RNRL in the cash market and buy the Call Option for Rs 55 Strike Price at Rs 2.75.

Conclusion

We have seen how one could use the options for hedging a stock.

But we need to remember a few things.

It is useful only in those cases where the stock is in the eligible list of derivatives. There are only 190 stocks currently.

But not all the stocks, which are there in the list, have liquid options.

Portfolios can also be hedged by using the Nifty Options, which are most liquid. But it may not be a perfect hedge as your portfolio may be drastically different than the Nifty constituents. Using a sector Index as a hedge may help, but options are not very liquid here, except for Bank Nifty Hedging through a similar stock in which options are liquid may help.

Finally, hedging can only be done for a reasonable size of a portfolio, as derivatives are available in market lots. So unless you have stocks that match the market lot of an Option contract, you may be over hedging.

As hedging comes at a cost, hedge only when necessary.

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