The Low Cost Put - Call Hedge Strategy

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Between 2010 – 2017, buying puts or buying calls as a hedging vehicle gradually lost its appeal, as the long bull market gave most investors and traders a sense of security. They no longer wanted to pay the premium necessary to insure their risk. In 2017, VIX, which measures the fear in the market, closed below 10 (extremely low) more times than in all of the other years combined since the index was created, almost 25 years ago. Many money managers decided that they did not need to offset risk by buying puts/calls because their competition wasn't buying them, and they were getting better returns since they didn't have the added expense.

Hedging a portfolio with put/call options can be expensive. But what if there was a way to insure your risk without paying a premium for the puts/calls? Is it possible to buy puts that protect your downside in case of a sudden drop or calls if it is a rally in the market without incurring the additional cost? The answer is yes. Over my twenty plus years of trading on the floor, I developed a strategy that accomplishes this goal. I called it 'The Low Cost Put/Call Hedge Strategy'.

To create The Low Cost Put/Call Hedge, you need to use horizontal option spreads. Horizontal spreads are option transactions that involve the purchase of a deferred option (call or put) and the selling (writing) of a near term vertical credit spread (call or put) with the same strike prices. Let me begin by explaining the specifics of how the transaction works and then I will show you how to manage the trade to protect either a long or short stock position with little or no cost.

The trade structure is based on the status of the Market Edge - ***'Market Posture'*** which is a computer generated market timing model that has been operative since 1992. The Market Posture is produced every Friday after the close and is either ***Bullish, Bearish*** or on rare occasions ***Neutral***. When the Market Posture is Bullish, Optionomics list stocks with a Bullish Market Edge Opinion as potential Low Cost ***Put*** Hedge plays. Conversely, when the Market Posture is Bearish, Optionomics list stocks with a Bearish Market Edge Opinion as potential Low Cost ***Call*** Hedge plays.

The trades are done in two steps. First you buy an ***anchor put or*** **call**. The anchor put/call is your insurance policy against a collapse or large rally in the stock's price. I like to use a deferred serial month, usually one with a quarterly expiration since the put/call will be held throughout the duration of the trade. The second step is to sell the ATM +1,-1 ***weekly vertical put or call credit spread.*** When Market Edge ***'Market Posture' is Bullish***, you would buy a stock and sell a vertical put spread which will give you the maximum opportunity to the upside. When the ***'Market Posture' is Bearish,*** you would short a stock and sell a vertical call spread. In either case, you are financing the anchor put/call with the credits received from selling the vertical spreads. Your profit potential is unlimited and your position is always protected from an adverse move in the underlying stock.

Look at the two option chains located below for Tesla Motors (TSLA) which closed on Friday, 01/15/18 at $336.22. The first table is for the weekly expirations that expire on Jan 19, 2018. The second table (the deferred serial contract) is for the quarterly option that expires three months later on April 20, 2018. If you wanted to hedge your long position in TSLA, the old-fashioned approach would be to buy a put in either the nearby or deferred contract. You could use any strike, but I always prefer the ATM since it gives you the most protection. The problem arises when you consider the cost of the put/call option. In this example, the weekly ATM put (335 strike) was trading around $4.80 (For simplicity, I am using the mid-point of the Bid - Ask spread and round it to an even number). If you did this trade, you would have to buy the ATM put/call 52-times a year. That would be a cost in the neighborhood of $250 ($4.80 x 52) a year or almost 75% of the total value of your stock position ($250/$336 = 74%). This obviously is not a good way to insure your position.

Last X	Net Chng	Bid X	Ask X	Exp	Strike	Bid X	Ask X	Last X	Net Chng
19 JAN 18 (4) 100									33.47% (±10.223)
17.50 N	0	16.55 X	17.85 Z	19 JAN 18	320	.86 A	1.12 N	1.12 Z	0
15.01 C	0	14.25 H	15.65 H	19 JAN 18	322.5	1.10 A	1.36 H	1.27 A	0
13.25 X	0	12.40 X	13.50 Z	19 JAN 18	325	1.61 N	1.82 I	1.60 I	0
11.30 Z	0	10.65 C	11.45 N	19 JAN 18	327.5	2.20 Z	2.43 I	2.25 Q	0
9.25 N	0	8.90 X	9.65 N	19 JAN 18	330	2.80 N	3.05 C	3.00 Z	0
7.74 C	0	7.30 C	8.00 Z	19 JAN 18	332.5	3.65 H	4.00 Z	3.70 M	0
6.07 X	0	5.90 C	6.50 N	19 JAN 18	335	4.65 A	5.10 Q	4.85 Z	0
4.84 X	0	4.75 Z	5.00 Z	19 JAN 18	337.5	5.90 X	6.40 Q	6.00 Q	0
3.80 N	0	3.70 X	4.05 Q	19 JAN 18	340	7.35 N	7.95 C	7.75 X	0
3.10 E	0	2.89 C	3.25 N	19 JAN 18	342.5	8.95 N	9.70 X	9.12 E	0
2.45 Z	0	2.21 X	2.54 H	19 JAN 18	345	10.75 C	11.60 A	11.60 Z	0
1.89 B	0	1.68 C	2.00 H	19 JAN 18	347.5	12.50 X	13.80 N	12.30 Q	0
1.40 Q	0	1.24 A	1.40 Q	19 JAN 18	350	14.55 X	15.50 Z	14.45 M	0
1.12 C	0	.94 N	1.15 C	19 JAN 18	352.5	16.60 X	18.20 Z	16.60 Z	0

The second way to hedge your long or short stock position would be to buy a deferred put/call option. The table below shows that if you bought the April 20, 2018 – 335 put/call, it would cost around $25 ($250 per contract). You would need to do that trade four times a year to insure your stock position. It would cost you close to $100 ($1,000 per contract) which is nearly 30% of the underlying security ($100/$336 = 29.7%). Worse yet, you wouldn't be fully insured until the stock declined by more than 7% ($25/$336 = 7.4%) to $311 ($336 - $25). Now you can see why money managers get heartburn when thinking about hedging their stock positions with puts or calls since the cost can be very high on a risk reward basis. However, if you use the two strategies in tandem, buying the anchor put/call and selling the expiring ATM, vertical – put or call spreads depending on Market Edge's ***Market Posture***, you end up with The Low Cost Put/ Call Hedge which can alleviate most of the cost of hedging a stock position. Let's set up a trade and see how it works.

20 APR 18 (95) 100									40.62% (±56.603)
47.60 Z	0	44.25 H	45.60 Z	20 APR 18	305	12.85 A	13.55 Z	11.95 X	0
41.30 H	0	40.95 N	42.20 Z	20 APR 18	310	14.45 H	15.15 Z	14.64 C	0
38.22 C	0	37.70 H	38.85 Z	20 APR 18	315	16.15 C	16.95 Z	16.49 B	0
34.25 B	0	34.65 H	35.70 Z	20 APR 18	320	18.00 A	18.80 Z	18.21 C	0
31.40 I	0	31.75 N	32.75 Z	20 APR 18	325	20.05 H	21.00 C	21.14 C	0
29.00 I	0	28.95 H	29.85 N	20 APR 18	330	22.25 X	23.25 C	22.63 C	0
26.63 C	0	26.30 H	27.20 Z	20 APR 18	335	24.50 H	25.60 C	25.03 C	0
23.15 Q	0	23.90 H	24.80 Z	20 APR 18	340	27.10 C	28.25 C	27.25 Q	0
21.95 H	0	21.65 H	22.50 Z	20 APR 18	345	29.75 X	31.00 C	30.60 Q	0
19.73 C	0	19.60 N	20.40 Z	20 APR 18	350	32.60 H	33.85 C	33.60 Z	0
18.25 P	0	17.65 H	18.45 Z	20 APR 18	355	35.30 C	36.80 C	38.50 X	0
16.30 Z	0	15.90 H	16.65 Z	20 APR 18	360	38.80 C	40.05 Z	37.02 W	0
14.60 Z	0	14.25 H	15.00 Z	20 APR 18	365	41.75 X	43.55 C	43.55 Q	0
12.55 X	0	12.75 Z	13.45 Z	20 APR 18	370	45.60 N	46.90 Z	44.75 Z	0

The first step whether you are long or short a stock is to buy your anchor put/call. In this example, you would use the April 20, 2018 – 335.0 (ATM) strike put/call as your anchor. The cost for the anchor for a $300 stock will typically be about $24. The second step is to sell the weekly ATM, ATM -1 vertical put spread against the long stock position or the weekly ATM, ATM +1 vertical call credit spread against the short stock position.. The credit you receive each week is used to pay for the anchor put/call. For a stock like TSLA, the put/call credit should average about $2.00 each week. You will be able to sell this spread every week (13 times) before the anchor put/ call expires (April 20, 2018). This trade should result in a net gain of $2.00 from the sale of the credit spreads over the period ($2 x13 = $26 - $24 = $2.00). The Put Hedge trade would look like the following.

The Market Edge - Market Posture: **Bullish**

Long Stock	Initial Stock Price	# Of Weeks	Current Stock Price	Short Put 02/06/18 Strike	Long Put 02/06/18 Strike	Credit Spread	Anchor Put Exp. Date	Anchor Put Strike	Anchor Put Debit
TSLA	$336.22	1	$336.22	335.0	330.0	$2.00	04/20/20	335.0	$24.00

When the 'Market Posture' is bearish, the trade would layout the same way, but you would short the stock, buy an anchor call and sell weekly call spreads. The Call Hedge trade would look like the following.

The Market Edge - Market Posture: **Bearish**

Short Stock	Initial Stock Price	# Of Weeks	Current Stock Price	Short Call 02/06/18 Strike	Long Call 02/06/18 Strike	Credit Spread	Anchor Call Exp. Date	Anchor Call Strike	Anchor Call Debit
TSLA	$336.22	1	$336.22	335.0	340.0	$2.00	04/20/18	335.0	$24.00

Here is the beauty of The Low Cost Put/Call Hedge. You can insure your stock position against an adverse move with little or no cost. On the surface it would seem like it is impossible to lose money on this trade. Unfortunately, the real market doesn't always reflect what the theoretical market portends. During some quarters, the market will have very little price movement and the Low Cost Put/Call Hedge will work as advertised. However, during other quarters, there will be more volatility and the spread may not work quite as well. However, you do know one thing for sure. Your downside (long positions) and upside (short positions) are protected no matter what happens at little or no cost while you have unlimited profit potential.

Managing Your Spreads

For the Low Cost Put/Call Hedge to work properly, you must monitor your spreads on a weekly basis. Keep in mind that the strategy is to first buy or short a stock depending on the Market Edge 'Market Posture'. Then you would buy an ATM anchor put or call with an expiration date of between 10 to 13 weeks for protection. Lastly, you would sell weekly, ATM +1 or -1 put /call credit spreads throughout the holding period. The process is

simple, and it takes no more than ten minutes per week to manage the various scenarios that you will encounter. The following describes these potential situations and the proper actions to be taken if they occur.

1) If the credit spread (put or call) is expiring worthless: ***Do nothing.*** The spread will be removed from your account at expiration.

2) The short leg is in the money while the long leg is out of the money: If the short leg is in the money, you have several choices.

a) You can buy back the spread, or you can buy back the short leg and allow the long leg to expire worthless. If the stock continues to move in the same direction, you will exercise and sell or buy back the stock. If the short leg has been assigned, it will replace the long leg.
b) Buy or sell the stock back and you may end up owning the long leg for free. In this case, if the stock has a big break or rally, you will have a "Free Roll" as you have no risk and only reward. If the stock rallies, you still have the stock.

3) Both legs of the spread are in the money: You can either buy the spread back as close to parity as possible or the OCC will ***assign*** the short leg and ***exercise*** the long leg. This would have no effect on your underlying equity position. Your broker may charge you a fee for this, so you need to check with your clearing house.

Profit And Loss Scenarios

The Low Cost Bullish-Put Hedge Strategy

As before, let's once again refer to the TSLA example located above. The assumption is that 100 shares of stock is initially ***bought*** at $336 and the weekly option positions are closed on the expiration date resulting in a realized gain or loss each week while the ***long*** stock position and anchor ***put*** remains open throughout the period.

Scenario #1: The stock settles unchanged at $336. You pocket the $2.00 credit from the put spread and initiate the 335-330 vertical put credit spread once again for a $2.00 credit. In this case, the anchor put will decline somewhat in value due to time decay (theta). The time decay will probably not be as large as the credit, so the worst case is that the Low Cost Bullish-Put Hedge will show a profit or break even in this case.

Score Board

Stock Account: $0

Option Account: Vertical put credit spread: 335-330 = +2.00 ($200)

Option Account: Anchor put approximate decline: -$2.00 (-$200)

Approximate Total Profit/Loss: $0

Scenario #2: With the stock unchanged at $336, you once again initiate the 335.0-330.0 vertical putt spread for a $2.00 credit and the stock rallies by about 6% (20 points) to $356. The long stock position would gain

$2,000 and you would keep the $2.00 credit from the put spread but the anchor put would decline by about $6.00.

Score Board

Stock Account: +$20.00 ($2,000)

Option Account: Vertical put credit spread: 335-330 = +$2.00 (+$200)

Option Account: Anchor put approximate decline: -$6.00 (-$600)

Approximate Total Profit/Loss: +$1,600

Scenario #3: With the stock now at $356, you would initiate the 355.0 - 350.0 vertical put credit spread for a $2.00 credit. The stock drops by about 5% (18 points) to $338. The stock position would lose $1,800. You would lose $3.00 ($2.00 credit - $5.00 spread) from the put credit spread but the anchor put would gain about $9.00 ($900).

Score Board

Stock Account: -$18.00 (-$1,800)

Option Account: Vertical put credit spread 355-350: -$3.00 (-$300)

Option Account: Anchor put approximate gain: +$9.00 (+$900)

Approximate Total Profit/Loss: -1,200

The Low Cost <u>Bearish-Call Hedge</u> Strategy

This example is the mirror of the Bullish-Put Hedge outlined above. The assumption is that 100 shares of TSLA stock is initially ***sold short*** at $336 and the weekly option positions are closed on the expiration date resulting in a realized gain or loss each week while the ***short*** stock position and anchor ***call*** remains open throughout the period.

Scenario #1: The stock settles unchanged at $336. You pocket the $2.00 credit from the call spread and initiate the 335-340 vertical call credit spread once again for a $2.00 credit. In this case, the anchor call will decline somewhat in value due to time decay but the decline will probably not be as large as the credit, so the worst case is that the Low Cost Bullish-Call Hedge Strategy will show a profit or break even in this case.

Score Board

Stock Account: $0

Option Account: Vertical call credit spread: 335-340 = +2.00 ($200)

Option Account: Anchor call approximate decline: -$2.00 (-200)

Approximate Total Profit/Loss: +0

Scenario #2: With the stock unchanged at $336, you once again initiate the 335.0-340.0 vertical call spread for a $2.00 credit and the stock rallies by about 6% (20 points) to $356. The ***short*** stock position would lose $2,000 and you would lose $3.00 (-$300) credit from the call spread but the anchor call would rise by about $6.00 ($600).

Score Board

Stock Account: -$20.00 (-$2,000)

Option Account: Vertical call credit spread: 335-340 = -$3.00 (-$300)

Option Account: Anchor call approximate gain: +$6.00 (+$600)

Approximate Total Profit/Loss: -$1,700

Scenario #3: The stock is now at $356 so you would initiate the 355.0-360.0 vertical call credit spread for a $2.00 credit. The stock drops by about 5% (16 points) to $340. The short stock position would gain $1,600. You would keep the $2.00 credit from the call credit spread but the anchor call would lose about $9.00.

Score Board

Stock Account: +$16.00 (+$1,600)

Option Account: Vertical call credit spread: 355-360 = $2.00 (+$200)

Option Account: Anchor call approximate decline: -$9.00 (-$900)

Approximate Total Profit/Loss: +900

Note that unlike the old buy a put or call hedge strategy, you lose less money when there is a small decline or advance in the stock. The bigger the drop or gain, the more you will lower or raise your average cost for the stock. If TSLA were to open 50% lower at $168 you would lose $3.00 from the put spread, but you would make about $144 on the anchor put and would have no further downside risk. You would be long the stock from $195, not $336. If TSLA opened at 0 you would be long the stock from $27. The short stock, long anchor call is the exact mirror image of the put strategy. No strategy works perfectly in all market scenarios. That is too much to hope for. However, The Low Cost Put/Call Hedge allows you to realize about 94% of the upside potential in small moves and as much as 98% in large moves while limiting your risk to no more than 8% on the downside/ upside no matter how bad it gets.

Q: What Can Go Wrong?

A: There are several scenarios which can develop that would have adverse results. Remember, this strategy involves the purchase or sale of a stock at let's say $300 per share and an ATM anchor put/call which expires in approximately three months for around $24. Each week, you sell an ATM put/call spread for $2.00 which over the time period should pay for the anchor put/call. At the end of the period, you would realize a gain if the stock goes up, down or breaks even. However, adverse results can occur under the following scenarios.

1) If over the holding period, the stock trades within a narrow range around the opening price, you would realize a series of wins and losses with the put/call spreads. Let's say that you buy a stock at $300 and sell a put/call spread for a $2.00 credit every week. If the stock trades back and forth between $305 and $295 for 12 weeks, you would have a $2.00 profit six times and a $3.00 loss six times for a net loss of $6.00. Assuming the stock settles at $300, you would lose the premium you paid for the anchor put ($24.00) plus the $6.00 for a total loss of $30.00. This would amount to a loss of 10% on the stock or a 3% hit on a $100,000 account.

   Keep in mind that a stock remains in play as long as Market Edge maintains its Bullish/Bearish Opinion. Over a 12-13-week period, it is highly unlikely that a stock which trades in a narrow range would retain its Market Edge Bullish/Bearish Opinion, so the number of small wins and losses would be reduced.

2) If over the holding period, the stock has a big move up followed by a big move down and if you did not adjust (roll up or down) the anchor put/call you could lose money. When the stock rallied or broke, the anchor put/call would lose most of its value. You could either hold the position and hope that the stock reverses course or you could sell it. In either case the proper action is to buy a new anchor put/call which is closer to the current stock price. Once again, keep in mind that a stock remains in play only if Market Edge retains its Bullish/ Bearish Opinion. Over a 12-13-week period, it is highly unlikely that a stock which has an explosive move to the upside followed by a collapse would maintain its Market Edge Bullish/Bearish Opinion.

Q. So How Does All Of This Work?

A. As a subscriber to The Low Cost Put/Call Hedge Strategy, you will have access to the Optionomics web site (www.optionomicsgroup.com). There you will find the weekly selections. In addition, you will have access to Mr. Seifert's webinars and training sessions where you will learn all of the trading tips that made Mr. Seifert a dominant option trader for over twenty-five years. The weekly report which is posted on Monday morning around 11:00 AM EST contains the current open positions, the new credit spreads, and any new selections along with the recommended anchor put/calls and the updated Model Portfolio.

Summary

I think that you will agree that The Low Cost Put/Call Hedge Strategy makes a lot of sense and can be a very profitable endeavor. It is an ideal approach for those who have an intermediate-term time horizon and a low tolerance for risk. But that is only half the story. As always, to get good results we combine the mathematical applications of this strategy with the Market Edge Opinions when making stock selections. This combination gives you the kind of edge you need when looking for consistent results.

The average price for the stock selections is around $125 per share while the maximum number of Open Positions at any time is twelve. Therefore, a fully invested cash account would require risk capital of around $150,000. While the strategy is designed to hold stock positions for twelve weeks, the holding period can be reduced if the Market Edge Opinion for an underlying stock is downgraded. The maximum number of Open Positions at any time is twelve but that number may be smaller at times due to adverse market conditions. Finally, it is not necessary to purchase all of the recommendations since each is an independent event with similar technical characteristics, so the performance should be comparable. That being said, diversification into a number of selections is always recommended.

Put Hedge - 1 Week Put Credit Spread - (Short Put Above Long Put) & 12 Week Put (Debit)										
							Stock	Anchor	Put	Spread
Symbol	WK	Mon Open	Short Put ATM	Long Put ATM -2	Credit	Div Date / $ Amt	F-Close	Put	Debit	Loss
			/	/		/		/		
			/	/		/		/		
			/	/		/		/		
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			/	/		/		/		
			/	/		/		/		
			/	/		/		/		
				NEW			Stock	Anchor	Put	Spread
Symbol	WK	Mon Open	Short Put ATM	Long Put ATM -2	Credit	Div Date / $ Amt	F-Close	Put	Debit	Loss
			/	/		/		/		
			/	/		/		/		
			/	/		/		/		
				Closed						
Symbol	WK	F-Close	Put-Credit	Reason	% P/L	**Symbol**	F-Close	Put-Credit	Reason	% P/L

Call Hedge - 1 Week Call Credit Spread - (Short Call Below Long Call) & 12 Week Call (Debit)										
Short							Stock	Anchor	Call	Spread
Symbol	WK	Mon Open	Short Call SP	Long Call SP	Credit	Div Date / $ Amt	F-Close	Call	Debit	Loss
			/	/		/		/		
			/	/		/		/		
			/	/		/		/		
			/	/		/		/		
			/	/		/		/		
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			/	/		/		/		
			/	/		/		/		
			/	/		/		/		
Short				**NEW**			Stock	Anchor	Call	Spread
Symbol	WK	Mon Open	Short Call SP	Long Call SP	Credit	Div Date / $ Amt	F-Close	Call	Debit	Loss
			/	/		/		/		
			/	/		/		/		
			/	/		/		/		
				Closed						
Symbol	WK	F-Close	Reason	P/L	% P/L	**Symbol**	F-Close	Reason	P/L	% P/L