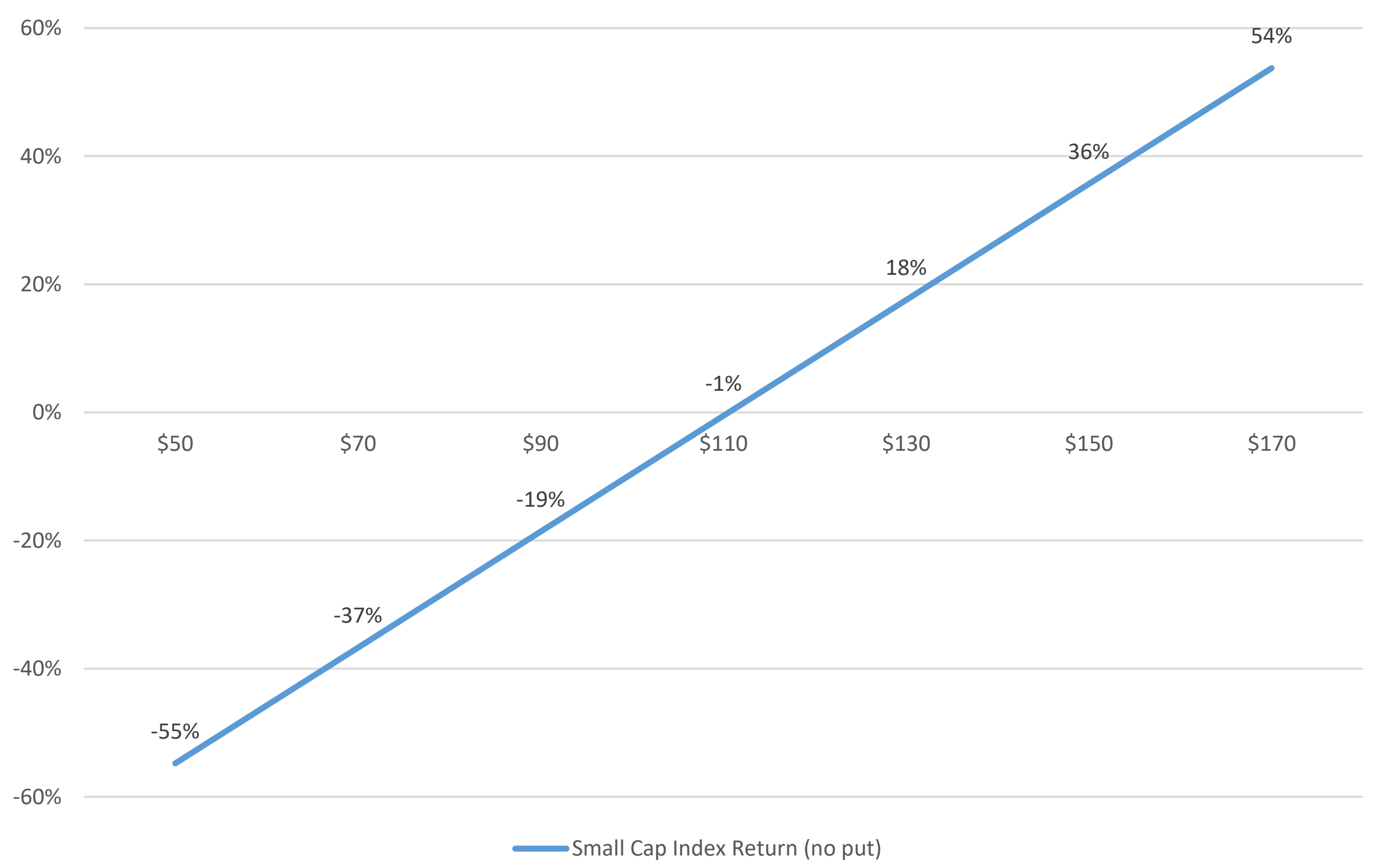
Capital Preservation

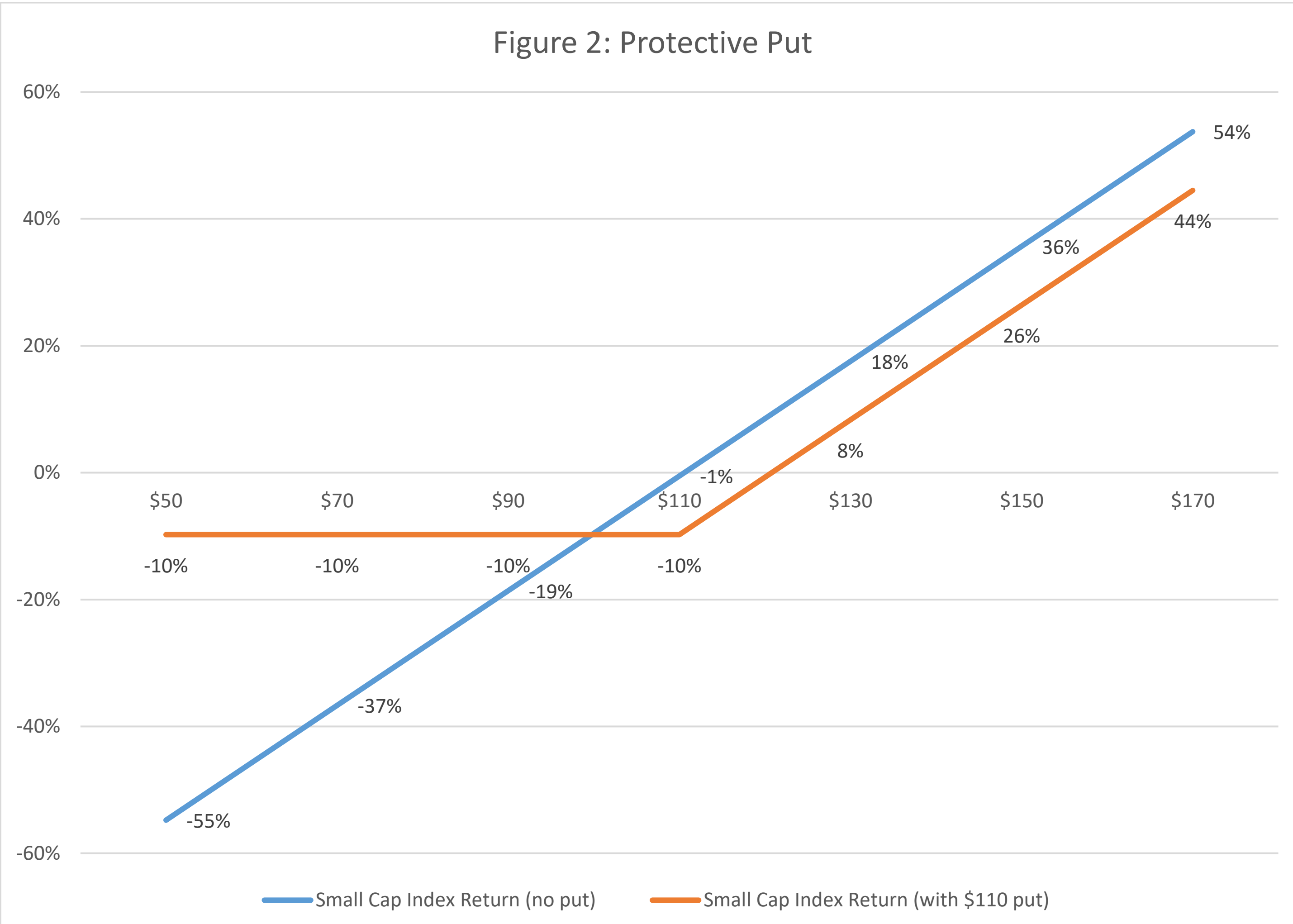
You worked hard to acquire your wealth and there is no need to take additional risks with it. One financial instrument that is not utilized by most investors is option contracts. The first exchange-traded stock option traded on April 26, 1973 at the Chicago Board Options Exchange. Despite a history of over 40 years most investors are not familiar with call and put options. You've insured your house, your car and your life. Why not insure your portfolio?

Buying options gives the owner the right, but not the obligation, to buy or sell a specified amount of an underlying security at a specified price within a specified time. Option contracts can be purchased for both indexes and individual stocks. For example, assume a client owns shares of the Russell 1000 Small Cap index (ticker: IWM) and it is trading at $111 a share. If the index goes up 36% the client will see 36% gain in his holdings. Conversely, if the index goes down 37% the client will see a 37% loss in his holdings (see figure 1).

Figure 1: Risk/Reward of Stock Ownership



You could purchase a put option to protect your downside risk. The protective put protects against losses during a price decline in the index and allows for capital appreciation if the stock increases in value. The flexibility of option contacts allows you to choose how much upside potential to give up for downside protection. For example, you could purchase a $110 put on the index. For every dollar the index trades below $110 the client would receive a dollar. If the index dropped to $90 the client would receive $20 a share for the option contract. In this example, the client would cap their losses at 10% and give up 10% of the upside (see figure 2).



Put options can be used to protect the downside of the portfolio and in some cases even profit in a down market. This is a great technique for low cost basis investments or to help protect your portfolio during a downturn in the market.

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