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So why do people trade options?

Note: The securities in this video are fictional. Everyone’s situation is different, and this video is not financial advice. Do your own research.

Hedging their Investments

Investors can hedge their holdings from losses beyond a certain point

People trade options for a variety of reasons

One reason is to hedge their holdings from future losses over a period of time with a protective put.

Before we explain hedging with a protective put, we would like to make you aware of some key concepts:

A protective put is one example of a hedging strategy. A put is a type of option that represents the right to sell. Each contract represents 100 shares and includes an agreed upon price known as the strike price, and a specified time frame, known as the expiration date.
Every example that we use is for illustrative purposes only and we do not include any commission and fees.

If you own shares of stock, you could hedge them by buying a “Put” option.

Imagine you own 100 shares of XYZ, which is currently trading around $50 per share.

If XYZ falls to $20, perhaps due to some calamitous event or announcement, your position would lose $3,000 in value.

If you’re worried about potential future losses, you can buy what’s called a “protective put.”

To hedge, you would choose a strike price and a time frame. You now own the right to sell XYZ at the agreed strike price at any time within the specified time frame.

To put it another way, you’re hedged against some loss for any time during that period in exchange for the premium you paid for the protective put.

If you choose to sell, your position only loses $1000 in value, compared to losing $3000 without the option.

This is how people can use options to hedge their investments.

Disclosure:

Options involve risk and are not suitable for all investors. Certain requirements must be met to trade options. Before engaging in the purchase or sale of options, investors should understand the nature of and extent of their rights and obligations and be aware of the risks involved in investing with options. Please read the options disclosure document titled "Characteristics and Risks of Standardized Options" before considering any option transaction. You may also contact us call at 1.877.653.4732 for a copy. A separate client agreement is needed. Option orders are subject to a per-contract charge.

The maximum loss, gain and breakeven of any options strategy only remains as defined so long as the strategy contains all original positions. Trading, rolling, assignment, or exercise of any portion of the strategy will result in a new maximum loss, gain and breakeven calculation, which will be materially different from the calculation when the strategy remains intact with all of the contemplated legs or positions. This is applicable to all options strategies inclusive of long options, short options and spreads.

Long options are exercised and short options are assigned. Note that American-style options can be assigned/exercised at any time through the day of expiration without prior notice. Options can be assigned/exercised after market close on expiration day.
View definitions for investment terms in our Glossary.

For purposes of all the computations discussed in this article, commissions, fees and margin interest and taxes, have not been included in the examples. These costs obviously will impact the outcome of any stock or option transaction. Any strategies discussed, including examples using actual securities and price data, are strictly for illustrative and educational purposes only and are not to be construed as an endorsement, recommendation or solicitation to buy or sell securities. Past performance is not a guarantee of future results.

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