Taking on Risk and Hoping the Strategy Doesn't Backfire

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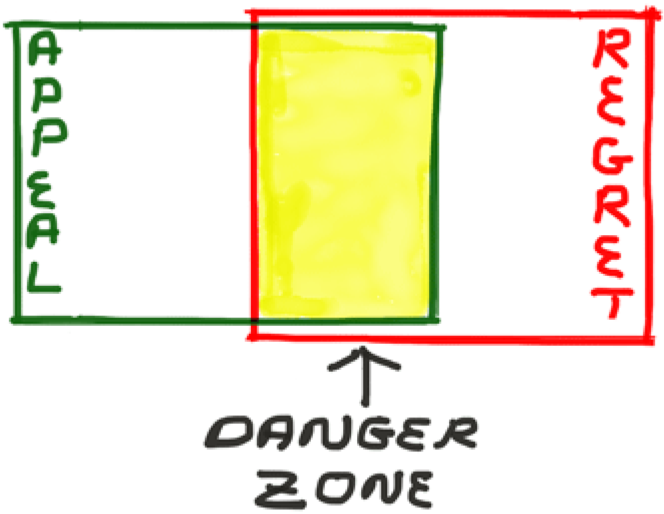
Oh boy. There's something new to be filed under the category of, "Well, it seemed like a good idea at the time." It is cash secured puts on the S&P 500. According to The Wall Street Journal, pension funds in Hawaii and South Carolina are using the strategy to generate income. It is a strategy that works until the market incurs a sizeable drop. At that point, the feeling of regret will loom and the bottle of aspirin will be opened.



For those you not familiar with option strategies, a put option gives its owner the ability to sell an asset at a specified price within a certain period of time. A put contract on a stock with, say, a strike price of $50 and an expiration of December 2016 will allow the put's owner to sell the stock at any point between now and the close of trading on December 16. (From a practical standpoint, options contracts on stocks expire on the third Friday of a calendar month). If the stock stays above $50 between now and mid-December, the contract will expire worthless since there is no reason for the put holder to exercise the contract when the stock can be sold on the open market at a higher price. If the stock were to fall to any price below $50 (e.g., $40), the owner of the put can sell the stock for $50.

One of the key things about options is that they are binding contracts. When an option is written, the writer is obligated to honor it. Furthermore, the writer of the contract has no control over when or if the contract will be exercised. The investor who purchases the contract has the sole right to exercise it. The put writer must buy the stock at the price specified in the contract (the "strike price") no matter what the stock's prevailing market price is. So, if a put has a strike price of $50 and the stock falls to $35, the writer of the put can be forced to buy the stock at a price of $50 per share. (It's the opposite for a call strategy. The buyer of a call option can force the call writer to sell the stock at a below-market price.)

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The Week Ahead

Just five members of the S&P 500 are scheduled to report: Brown-Forman Corp. **(BF.B)** and

Salesforce.com **(CRM)** on Wednesday, and Broadcom **(AVGO)**, Campbell Soup Co. **(CPB)** and H&R Block **(HRB)** on Thursday.

The week's first economic report of note will be July personal income and spending, released on Monday. Tuesday will feature the June S&P Case-Shiller Home Price Index and the Conference Board's August consumer confidence survey. The August ADP employment report, the August Purchasing Managers' Index (PMI) and July pending home sales will be released on Wednesday. Thursday will feature August motor vehicle sales, revised second quarter productivity, the August PMI manufacturing index, the August ISM manufacturing survey and July construction spending. August jobs data—including the change in nonfarm payrolls and the unemployment rate, July international trade and July factory orders will be released on Friday.

Four Federal Reserve officials will make public appearances: Boston president Eric Rosengren and Minneapolis president Neel Kashkari on Wednesday; Cleveland president Loretta Mester on Thursday; and Richmond president Jeffrey Lacker on Friday.

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