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As Stocks Surge, Is It Time for Some Protection?

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You buy insurance for your home, your car and maybe even your iPad. Should you buy it for your portfolio as well?

Many investors, as they watch stock prices rebound to levels last seen in 2007, might be wondering if it is time to cash in some of their gains.

The downside to selling, of course, is that you risk missing out if the market keeps going up—and face a potential tax hit on capital gains.

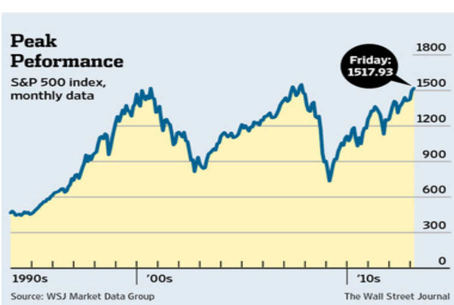
Traders in the S&P 500 pit at the Chicago Board Options Exchange.

Another strategy is to buy insurance against a market downturn via options on individual stocks or a broad market index, such as the Standard & Poor's 500-stock index. In simple terms, a put option is a type of derivative that gains value as a stock or index falls. Put options can be bought through any brokerage, for a small commission, and trade in round lots as small as 100, equivalent to insurance on 100 stocks or units of the index.

Even though the stock market has gone up recently—and the risks to your portfolio have therefore increased—the cost of this insurance has come down. That is because the volatility of the market has declined. Option prices tend to move in the opposite direction of volatility.

"Options are at a very reasonable price right now," says Charles Zhang, managing partner of investment advisory firm Zhang Financial in Kalamazoo, Mich., with $1.5 billion under management. Prices are now back to levels last seen in 2007, just before the crash, adds Sean Heron, who manages options-based portfolios at Philadelphia-based investment company Glenmede, which has $22 billion under management and buys and sells options.

Given the low prices and the market's strong rally from its 2009 low, now might be a good time to consider buying puts. The Dow Jones Industrial Average this week came within a whisker of a record.



Strategists note that stocks are only about 14 times expected earnings per share for the next year, which is roughly in line with historical averages. But by other measures, such as earnings over the past 10 years, stocks are quite expensive by historical standards. John Hussman, manager of the $5 billion Hussman Funds, wrote this week in a note to clients that based on technical and fundamental measures, current market conditions are among the most dangerous in history—right up there with 1929, 2000 and 2007.

In normal circumstances, one could help protect a portfolio by owning more long-term Treasury bonds, which often rise in value when stocks fall. But thanks to the Federal Reserve's aggressive bond-buying campaign, Treasurys also are priced near record highs.

Investors who are worried, or who are at a stage in their lives when they simply can't handle another downturn, can always reduce their exposure by selling some of their stocks and mutual funds, or by switching from more-volatile stocks, such as small and midsize companies, to high-quality large-capitalization companies.

Put options make sense only for investors who want to stay in stocks to collect profits if the stocks keep rising, but also want to protect themselves from a sharp fall.

For them, the key to smart options investing is to keep a close eye on costs.

Most insurance policies come with a deductible: The policyholder agrees to cover some of the initial losses himself, in return for much lower insurance premiums. Glenmede's Mr. Heron suggests investors use a similar strategy in the put-option market. Options that start to pay out only after the stock market has fallen by at least 10% offer a better deal than those paying out immediately, he says.

Investors who want to insure their exposure to the S&P might find it easier to buy put options on the SPDR S&P 500 (SPY) exchange-traded fund, which mimics the performance of the index. The minimum purchase amounts are one-10th as much, because the SPDR trades for 10 cents per point on the index. The fund currently trades for $152 a share. For $4.60 a share you can buy put options good until January 2014, which will pay out if the SPDR falls below $135. That is equivalent to the S&P falling 10% to 1350.

There are even cheaper options available, equivalent to insurance policies with even higher deductibles.

For $2.20 per share you can buy one-year puts that start to pay out if the SPDR S&P 500 ETF (SPY5.LN) fell below $120—equivalent to the S&P falling 20% to 1200. This looks like cheap disaster insurance, or a cheap wager on a market crash.

Choosing whether to buy insurance or just sell some stocks is a matter of circumstances as well as forecasts. Mr. Zhang says for most clients it is still cheaper to reduce risk by selling stocks, because they don't have to pay for insurance. But he is buying puts for clients who want protection but who couldn't sell without triggering big taxable gains. George Kiraly, a financial adviser in Short Hills, N.J., with $15 million under management, says he will start buying puts if the market rises much further.

Keep in mind that options can be cashed in at any point before they mature by selling them in the market. Their price fluctuates depending on what has happened to the price of the stock or index they insure.

Options aren't for everyone, and they can be complex. But they aren't always as risky as many investors think. Buying puts is one of the safest ways an investor can get some protection while keeping skin in the game.

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