

# Equity Options:

## AAPL Cash-Secured Put



### Catalyst

On April 26, Apple, Inc. (AAPL, B17, \$120) announced that 2Q sales were down 13% ending its streak of 51 consecutive quarters of sales growth. Despite this down quarter, BAML Research analyst Wamsi Mohan reiterated his Buy rating on the stock based on a strong capital return program, Android switch rate, and interest in iPhones/demand for iPhone 7. Mohan did lower his PO to \$120 from \$130 as the company's management guided lower on revenue.

### Sales Idea:

(All terms are indicative as of 04/27/2016. Actual trade subject to current pricing.)

Apple, Inc. (AAPL, B17, \$120) trading @ 96.65

- Sell 10 AAPL 15Jul'16 95.00 Put @ \$3.15
- Maintain \$95,000 cash in the account

If the stock is above the strike at expiration

- Actual % return: **3.36%\***
- Annualized % return: **15.51%\***

*Rates of return are calculated using a \$0.03/share option commission (subject to a \$65 minimum) and a stock commission of \$0.04/share (subject to a \$75 minimum) plus exchange fees*

### What is a cash-secured put writing strategy?

A cash-secured put is an options strategy designed to help an investor generate income and potentially build an equity portfolio over time. In this strategy, an investor sells put options on a stock and deposits funds to cover the actual purchase of the security, should it become necessary due to exercise. These funds are generally invested in short-term interest-bearing instruments for the duration of the option. In these instances, the investor may be able to purchase a stock below its current market price.<sup>1</sup>

*A put option is a contract that gives the buyer the right to sell an underlying stock at a specific price — the "strike" price — for a defined period of time.*

### When should investors consider a cash-secured put strategy?

Investors can use a cash-secured put strategy to achieve two investment objectives:

1. **To generate income.** Selling a cash-secured put is often compared to entering a limit order to buy the stock below the current price, but the cash-secured put has the advantage of generating income while the investor waits.
2. **To acquire a stock at a price lower than the current market price.** By using out-of-the-money options, an investor can acquire the stock at a price lower than the current market price. Although the investor's primary investment objective may not be to purchase the underlying stock, he or she should not be adverse to buying the stock. This strategy can be employed over time to acquire and build a portfolio for the long term. Note that although the investor may acquire the stock below the price of the underlying stock at the time the puts are sold, the investor may be faced with either buying back the short puts at a loss or acquiring the underlying stock below the current price, resulting in an unrealized loss.

### How does a cash-secured put strategy work?

An investor sells a put option, effectively giving someone else the right to sell to him or her the underlying security based on the terms of the contract. The following shows a hypothetical example of this strategy in action:

AAPL stock is trading at \$96.65, and a 15Jul'16 95.00 put option selling for \$3.15 has 79 days until expiration.

If an investor sells 10 contracts, he or she, as the "seller" of the options, would then collect the options premium of \$315 per contract (standard option contracts cover 100 shares of stock), for a total of \$3,150 in income.



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Assuming the investor does not close out the position before expiration, there are three possible outcomes if the option position is held to maturity.<sup>2</sup>

Scenario 1	The stock is flat or unchanged.
Scenario 2	The stock price increases.
Scenario 3	The stock price declines below 95.00.

### Examples of each scenario

#### Scenario 1: The stock remains unchanged at \$96.65

Since the stock is above the strike price of \$95.00, the investor who bought the options would choose not to sell the stock at \$95.00 when he or she could sell it in the open market for \$96.65. Hence, the options would expire worthless, and the seller would keep the \$3,150 for the 10 contracts, less any commission or transaction costs.

#### Scenario 2: The stock increases from \$96.65

Similarly to scenario 1, the investor who bought the options would choose not to sell the stock at \$95.00 when he or she could sell it in the open market for more. The seller would therefore keep the total premium of \$3,150, less any commission or transaction costs.

**Note:** In this scenario, the seller of the put does not participate in the upside appreciation, but rather is limited to the initial premium received, in this case \$3.15.

*Maximum profit is realized with the stock price closing at or above the strike price and is equal to the initial premium received up front.*

#### Scenario 3: The stock price below to \$95.00

Since the stock is below the strike price of \$95.00, the investor would likely choose to exercise the option, requiring the seller to purchase the underlying stock at a price of \$95.00. Since this outcome is possible, investors who sell cash-secured puts should be comfortable with the risks of owning the underlying stock.

The cost basis of each share is the strike price of \$95.00, less the \$3.15 in income that was received for the put, equaling \$91.85 per share, plus any commissions. The put position has downside risk similar to that of a long stock position when the price of the stock drops below the strike price by more than the premium.

Investors who believe that the underlying stock could decline substantially during the term of the option would be better off using other options strategies to pursue their goals.

*Maximum loss potential is equal to the strike price minus the premium initially received.*

**Note:** Since this strategy obligates the investor to buy stock when the price falls below the strike, which occurs during market declines, investors employing the cash-secured put strategy should avoid selling more contracts than they are willing to own of the underlying stock.

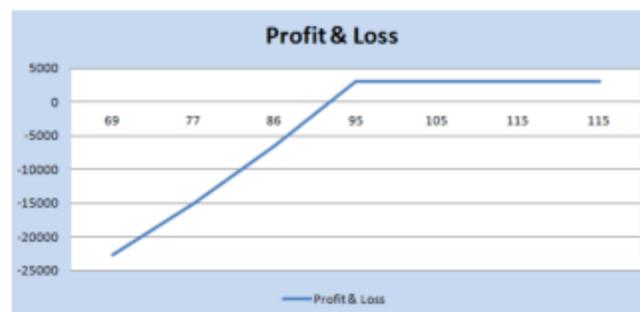
### What are the benefits of a cash-secured put strategy?

- **Generates income.** Investors receive up-front premiums from the sale of the options.
- **Takes advantage of market volatility.** Since option premiums expand during periods of volatility when all else remains equal, the cash-secured seller brings in more income during volatile times.
- **Establishes buying discipline.** Since the cash-secured writer is obligated to buy the stock should it expire below the strike price, the decision of whether or not to buy is made up front.

### What are the risks associated with the cash-secured put strategy?

- **Downside exposure.** Although cash-secured writers have less risk than the outright stock buyers, they do have downside risk below the strike price, less the premium received for selling the put. An investor must be willing to purchase underlying stock equal to the amount of shares in the written contracts.
- **Limited upside.** The maximum profit in a cash-secured put is equal to the initial amount received up front for selling the put. It does not increase if the price of the underlying stock rises.
- **Collateral.** Although the collateral can earn interest, it is not accessible to the investor until either the short options are closed out or the option expires.

The following graph illustrates the ██████ of the AAPL Cash-Secured put strategy.



<sup>1</sup> Investing in options involves risk and may not be suitable for all investors. Certain requirements must be met to trade options through Merrill Lynch. Before buying or selling an option, clients must receive a copy of the options disclosure document [Characteristics and Risks of Standardized Options](#) (ODD).

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A copy of the ODD accompanies this fact sheet. A copy is also available by contacting your financial advisor or by visiting the Options Clearing Corporation website at ██████████, clicking "Publications" and selecting "Characteristics and Risks of Options."

<sup>2</sup> Example is for illustrative purposes only and does not include exchange or SEC fees.