

**"THIS PAGE MUST PRECEDE THE ATTACHED PROPRIETARY DISCRETIONARY MARKETING MATERIAL AND BE PROVIDED TO ALL CLIENTS AND PROSPECTS"**

Recently, the Global Wealth Management Group of Morgan Stanley & Co. Incorporated and the Smith Barney division of Citigroup Global Markets Inc. combined into Morgan Stanley Smith Barney LLC, a new investment advisor and broker-dealer registered with the Securities and Exchange Commission.

Investment products and services are offered to you through Morgan Stanley Smith Barney LLC, member SIPC, and your account is carried by Citigroup Global Markets Inc., member SIPC. In general, references to Smith Barney or the Smith Barney division of Citigroup Global Markets Inc. should be read as Morgan Stanley Smith Barney LLC. However, some services will still be available to you through Citi or Citigroup Global Markets Inc. Please contact your Financial Advisor if you have any questions about these changes.

# Strategy Focus

## **THE PUT HEDGE:** **Protect Your Equity Investments**

The main economic reason for the success of the listed options market is the ability for investors to alter the risk/return characteristics of the stock market. It serves as a marketplace where investors can utilize different options strategies to help accomplish certain goals. The put hedge is a conservative strategy that can help protect an equity investment while still allowing for upside appreciation.

A put option gives the holder of the put the right to sell 100 shares of the underlying stock, at a predetermined price, up until the expiration date of the option. The put hedge is created by buying a put either simultaneously with stock or after a stock position has already been established. If the stock price drops below the exercise price, the put will increase in value. At first glance this may seem somewhat confusing. Does the put hedge profit with a decline in the stock price? Does the investor want the stock price to increase or decrease?

The answers to these questions are actually quite simple. The put hedge will be profitable when the stock price advances enough to cover the premium paid for the put. The put option merely serves as a hedging device in case the investor's bullish expectation for the stock proves to be incorrect. If contrary to expectation the price of the stock declines substantially, then the increase in the value of the put option would help to offset some, but not all, of the loss on the stock. The put purchase can be thought of as a time-limited insurance policy on the stock. The investor does not want the stock price to decrease, but if it does, the in-

vestor is prepared. Ideally, the investor wants the price of the stock to climb dramatically, and the put to be worthless when it expires.

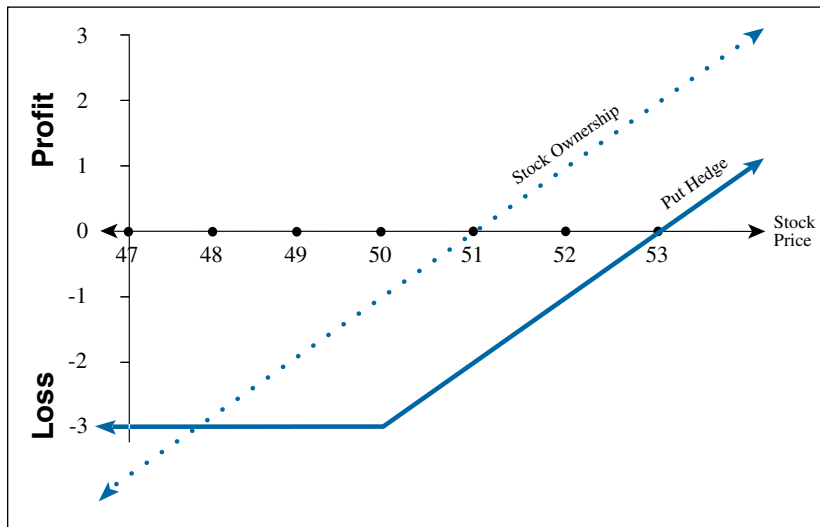
The following example will help to illustrate these points:

With XYZ common stock trading at \$51.00 per share, and the XYZ June 50 put trading at \$2.00, the investor buys 100 shares of XYZ and 1 XYZ June 50 put for a total cost of \$53.00.

**Buy 100 XYZ** @ \$51.00 x 100 = \$5,100.00  
**Buy 1 XYZ June 50 put** @ \$2.00 x 100 = \$ 200.00  
**Net Investment** = \$5,300.00

Owning the put entitles the investor to sell the 100 shares of stock at \$50.00, therefore our maximum loss, for the life of the put, will never be more than \$300.00. This is true no matter how far the stock price declines. The break-even point is \$53.00 per share. The stock price must rise above \$53.00 for the position to become profitable. If, for example, the price of the stock is at \$60.00 at the expiration date of the option, the put will expire worthless, and the net profit will be \$700.00 (\$6,000.00 - \$5,300.00).

The table and graph below show the profit and loss potential of the common stock. At any price below \$48.00, the stockholder would have been better off buying the put in conjunction with the stock. The put purchase, as pointed out earlier, does increase the break-even point from \$51.00 for holding only the common stock, to \$53.00 for establishing the put hedge.



XYZ Price at the June Expiration	Stock Profit/Loss	June 50 Put Option Profit/Loss	Net Profit/Loss
50	-100	-200	-300
51	0	-200	-200
53	+200	-200	0
60	+900	-200	+700
70	+1900	-200	+1700

The selection of which put to purchase is an important consideration in evaluating a put hedge. An out-of-the-money put will cost very little, but may not provide adequate protection. For example, if in the previous example the investor had bought a June 40 put for \$0.25, the net cost of the position would have only been \$51.25. However, the maximum potential loss would be 11 1/4 points. Conversely, the purchase of a deep-in-the-money put provides a lot of protection, but adds a great deal to the total cost of the position. For example, if

instead of purchasing the June 50 put for \$2.00 with XYZ at \$51.00, the investor purchased the June 60 put for \$9.50, the maximum potential loss on the stock position would be only \$0.50. However, the net cost of the position would now be \$60.50. Therefore, the stock would have to rally

over 9 1/2 points just to break-even. In general, the best balance between protection and cost is obtained by purchasing a slightly out-of-the-money put on the stock.

The put hedge strategy allows an investor to take a conservative approach to common stock ownership. It is particularly suitable for investors who wish to participate in the capital appreciation aspect of common stock ownership, but who also wish to purchase some downside protection. An investor may be more willing to invest in the stock market if the inherent risk of stock ownership can be reduced. It allows the private investor to expand the horizon of alternative investments. If you would like to learn more about the put hedge, please contact your Salomon Smith Barney Financial Advisor.

Commissions, taxes, dividends, margins and other transactions charges have not been included. However, they will affect the outcome of option transactions and should be considered. Options involve risk and are not suitable for all investors. For information on the uses and risks of options, you can obtain a copy of Characteristics and Risks of Standardized Options from Salomon Smith Barney, Options Department, 390 Greenwich Street, New York, NY 10013 or from your Salomon Smith Barney Financial Advisor.

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