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Understanding Options: Protective Puts and Collars

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Protective puts and collars are two options strategies designed to help manage downside risk, but each comes with its own tradeoffs. In Part 3 of our Understanding Options series, Head of Portfolio Operations Joe Benoit explains how these strategies work, why downside protection has a cost, and how investors can think about balancing risk, reward, and long-term portfolio objectives.

Joe explores when protective puts may be appropriate, how collars can help offset the cost of protection, and why both strategies are most effective when used intentionally as part of a broader wealth management and risk management plan.

OTHER VIDEOS IN THIS SERIES:

- Understanding Options: Understanding Calls, Puts, and Why Options Exist
- Understanding Options: The Hidden Risks of Covered Calls
- Understanding Options: How We Think About Options

VIDEO TRANSCRIPTION:

Hi, I'm Joe Benoit, Head of Portfolio Operations at Grimes & Company. Today we're going to discuss the hidden risks of protective puts.

At first glance, protective puts seem almost perfect. Imagine an investor owns a stock they love: they want all the upside, but they don't want the downside.

A protective put appears to solve that problem because the investor buys insurance against a decline while retaining upside participation.

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What's not to like?

As it turns out, quite a bit, not because protective puts don't work, but because they often work exactly as designed.

The issue is the cost, and understanding that cost is what leads us toward a different solution in many situations.

Let's start with the basics. A protective put establishes a downside floor beneath a stock position for a specified period of time.

Think of it like insurance. If you own a home, you buy insurance hoping you'll never need it, but you appreciate knowing that if something bad happens, you're protected.

A put option works similarly. Suppose an investor owns a stock trading at $100 and purchases a put option with a strike price of $90.

No matter what happens, they now have the right to sell that stock for $90 until the option expires. If the stock falls to $70, they can still sell at $90; if the stock rises to $120, they keep the upside.

This is why protective puts are appealing. They preserve upside, define downside, and reduce uncertainty.

Reducing uncertainty is often a very valuable objective. In fact, one of the primary uses of options is exactly that: reducing uncertainty.

So what's the problem?

The problem is cost.

Insurance only works because someone is being paid to assume risk. The option seller takes on that risk, and the option buyer pays for it.

Let's return to our homeowner's insurance analogy. Most years, your house doesn't burn down, and most years you don't file a major claim. Yet you still write the insurance check year after year.

The same thing happens with puts. Most of the time, the catastrophic event doesn't occur, the put expires, and the investor buys another put. Then another. Then another.

Over time, those costs accumulate.

Here is an actual example:

As of 6/9/26, AAPL trades at $291 per share, and an August $270 put costs $5.90.

To buy protection 8% below the current price costs about 2%. That seems cheap, but it is only for three months. To maintain that protection, you would have to make that trade four times per year, for an annualized cost of 8% per year.

On a $1,000,000 stock position, that 8% per year equates to an annual cost of $80,000.

For five years, that equates to $400,000, or 40% of the position's value. For ten years, it is $800,000, or 80% of the position's value.

Now importantly, that doesn't mean puts are bad. There are situations where they're absolutely appropriate.

But investors should recognize that downside protection has a price, and over long periods of time, that price can add up quickly. The challenge becomes finding a way to reduce uncertainty without continually writing large insurance checks.

This is where collars enter the discussion.

A collar combines two option positions: a long put and a short call.

The put establishes downside protection, while the call helps pay for it.

Let's use a simple example. Suppose a stock is trading at $100. The investor purchases a put at $90, and at the same time sells a call at $115.

The put protects against major downside, while the call limits some upside above $115.

What has happened? The investor narrowed the range of possible outcomes.

They gave up some upside, and in exchange they reduced or potentially eliminated much of the insurance cost.

By balancing the strike price relative to the current price, the premium received from selling the call can offset most or all of the put cost.

This is why collars often become attractive, not because they're exciting or aggressive, but because they can create more efficient outcomes. It is a more affordable way to reduce the portfolio risk of a large stock position over an extended period of time.

At Grimes, our goal is rarely to maximize option premium, and it is rarely to maximize protection.

Instead, we focus on improving the range of outcomes available to a client.

That distinction is important. When we evaluate an options strategy, we're thinking about risk management, tax impact, assignment risk, liquidity needs, diversification goals, and financial planning objectives all at the same time.

A collar can often support those objectives better than a standalone put, particularly for concentrated stock positions, long-term diversification plans, estate planning, liquidity planning, and clients seeking more predictable outcomes. Rather than maximizing upside or maximizing protection, the collar helps balance both. It creates a structure that may allow investors to make better long-term decisions because they have more certainty around potential outcomes.

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