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WRITING OPTIONS TO PROFIT FROM SIDEWAYS MARKETS AND SELLOFFS

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The last five years was easy – simply buy and hold

You're not a raging bull anymore. There, I said it. It's okay to admit it. After all, the S&P 500 has almost tripled from the lows five and a half years ago. Plus, there's more than a few issues to be concerned about. The Fed may soon embark on a path towards higher interest rates. The European economic recovery remains uneven. China's economy is slowing down. Geo-political tensions continue in Ukraine and the Middle East.

While we acknowledge the risks out there, we remain encouraged by the many positive traits exhibited by U.S. equities. The U.S. economy continues to steadily improve across a variety of indicators, including production, consumer confidence, housing and employment. In Q2 earnings growth came in at 9% year over year, the best quarterly growth rate in two and a half years. Higher earnings should remain the primary driver for higher stock prices going forward.

But I think we can all agree on one thing – while the outlook still looks positive returns for the stock market are likely to be lower over the next five years. After all, it's pretty difficult to top a five and a half year total return of close to 24% per year. Add in the possibility of more sideways markets and increased volatility, I think we can also agree that it might be time to consider additional investment strategies aside from simply buy and hold.

Need more options for the next five years?

Selling (or writing) call and put options within an equity portfolio can be a great way to generate income in a flat or moderately growing stock market, to protect gains on existing positions or to take advantage of market dips by acquiring stocks at lower effective prices.

The buyers of call and put options use the contracts to hedge positions, buy and sell stock, and speculate. The speculators are either very bullish (in the case of calls) or very bearish (in the case of puts) investors that want to make leveraged bets on a stock's directional move.

But if you are neither very bullish nor very bearish, and your return expectations are more modest, writing options might be a preferable strategy.

Call options have got you covered

Suppose you've been a happy owner of Apple stock, which has risen 32% in the preceding six months. Trading at $100 a share currently, you believe the stock's short-term prospects might be muted given the significant rally already witnessed leading up to the new product releases. To generate some income and protect existing gains, you can sell (or write) Apple call options with a strike price of $102 and an expiry date of October 31. The price (or premium) received for writing these call options is $2.35 per share. This strategy of owning the stock and selling call options against the position is known as a covered call strategy. For the sale of one contract (representing 100 shares of Apple stock) you will receive $235 (100 shares x $2.35 premium per share) in option premium income from the buyer of the option.

Under a variety of Apple stock scenarios, this strategy makes sense versus the alternative of just simply owning the stock. If Apple stock declines from $100 over the next month, the buyer's call option to purchase the stock at $102 will expire worthless. You will have pocketed the premium income of $2.35 per share, which would help offset the lower value of Apple's stock that you own. Theoretically, Apple's stock could decline by $2.35 (from $100 to $97.65) and you would still be break-even on your entire position over the month. If Apple stock is flat over the next month, you also win. The buyer's call options expire worthless while you have no obligations after earning the $2.35 premium. Essentially your return on the position for the month is 2.35% whereas a long only position in Apple stock would have returned nothing. The covered call strategy can be superior even if the stock's return is positive over the period. Even if Apple stock returns 2% over the month and rises to $102, the options will still expire worthless. So the seller of the option will have benefited from a $2.00 increase in Apple's stock price plus the

$2.35 premium received for a total gain of $4.35 (return of 4.35%). If Apple's stock price rises above $102 the call options will ultimately get exercised by the buyer and the seller will be obligated to deliver their Apple shares for a price of $102 per share. The covered call strategy makes sense as long as Apple's stock doesn't increase beyond $104.35, which is the stock price where the profits for the long-only position and the covered call strategy are equal. With any Apple stock price above $104.35, you'd be better off avoiding the covered call strategy because the premium income of $2.35 wouldn't compensate for the lost profits above the strike price of $102.

Put options will pay you while you wait

Selling put options is a great way to acquire a stock that you wouldn't mind owning if the price falls to a certain level. Suppose you like Apple's long-term prospects but want to be more opportunistic instead of paying the current $100 share price. To generate some income while you wait patiently, you can write Apple put options with a strike price of $98 and an expiry date of October 31. The price (or premium) received for writing these put options is $2.27 per share. This strategy of selling puts against stocks you wouldn't mind owning is known as a short put strategy. For the sale of one contract (representing 100 shares of Apple stock) you will receive $227 (100 shares x $2.27 premium per share) in option premium income from the buyer of the option.

Under a variety of Apple stock scenarios, this strategy makes sense versus the alternative of just simply buying the stock at the current market price of $100. If Apple stock increases from $100 over the next month, the put option to sell the stock at $98 will expire worthless. You will have pocketed the premium income of $2.27 per share, which would help offset the lost profits from not owning the stock outright. Theoretically, Apple's stock could increase by $2.27 (from $100 to $102.27) and you would still be indifferent between buying the stock or writing the put option. If Apple stock is flat over the next month, you also win. The buyer's put options expire worthless while you have no obligations after earning the $2.27 premium. Essentially your return on the position for the month is 2.27% whereas a long only position in Apple stock would have returned nothing. The short put strategy can be superior even if the stock's return is negative over the period. Even if Apple stock returns -2% over the month and declines to $98, the options will still expire worthless. So the seller of the option will have avoided a $2.00 decrease in Apple's stock price while still retaining the $2.27 premium received for a total gain of $2.27 (return of 2.27%). If Apple's stock price falls below $98 the put options will ultimately get exercised by the buyer and the seller will be obligated to accept delivery of Apple shares for a price of $98 per share. Even under these circumstances, the short put strategy is preferable to an outright purchase of the stock because the premium received for the written puts helps subsidize the purchase cost of the stock.

Risks with options

The main risks when writing options comes with significant moves in the underlying stock prices. For example, a stock with covered calls written against it gets acquired and you miss the majority of the upside move in the price. Or, you've written short puts for a company that cuts their earnings outlook and the stock plummets. But even under these circumstances, it depends on how you view the situation. The alternative for writing puts against the stock that plummeted would have been to simply buy the stock since you liked it anyway. Without the option premium from the written puts you'd actually be paying more for that stock. And in the case of the covered calls, those are typically written on stocks where the short-term upside appears muted. It could be argued that without the income generation of a covered call strategy, the investor's alternative might have been to sell that stock outright and replace it with another with better near-term prospects. Either way, that significant upside move may not have been realized by the investor.

Getting active with options

Options allow you to tailor investment strategies to take advantage of different market environments. The possibilities are truly endless. It can be a daunting task to screen over a thousand companies with listed options available and then filter through tens of thousands of options with different strike prices and expiry dates.

The Norrep US Dividend Plus Fund has been writing options for several years. It's not a systematic approach that blankets the entire portfolio with options. Instead, it's quite opportunistic and tailored to the specific risk/reward expectations for existing and new positions. Their use was quite limited in the past however over the past year the Fund has broadened their use in the portfolio. In an environment where returns are more volatile and stocks might move sideways in the short term, we believe option writing can enhance the active management of the Fund, help differentiate us from our peers and most importantly add value for our clients.