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Two Options Strategies Adapted for Different Investor Profiles

Options are financial instruments that can be used to implement protective or speculative strategies. They can also serve to generate additional income on the shares and the cash held in a portfolio. In the simplest of cases, options can be used to purchase or sell shares at better prices compared to the prices that could be obtained by purchasing or selling shares directly through the stock market. Ultimately, options allow investors to define their market risk exposure at a desired level.

In portfolio management, risk management can be accomplished by diversifying into different asset classes depending on the risk profile of the investor. Investor profiles are defined according to their investment horizon, liquidity needs and the market risk tolerance specific to each investor. Model portfolios are then constructed in order to fulfill the needs of specific investors. In general, when the investor's level of market risk tolerance is low, the portfolio will contain fewer shares. Conversely, when the investor's level of market risk tolerance is high, the portfolio will contain more shares. In this article, we focus our attention on "balanced" and "growth" oriented investor profiles and we construct an appropriate investment strategy using options for each profile.

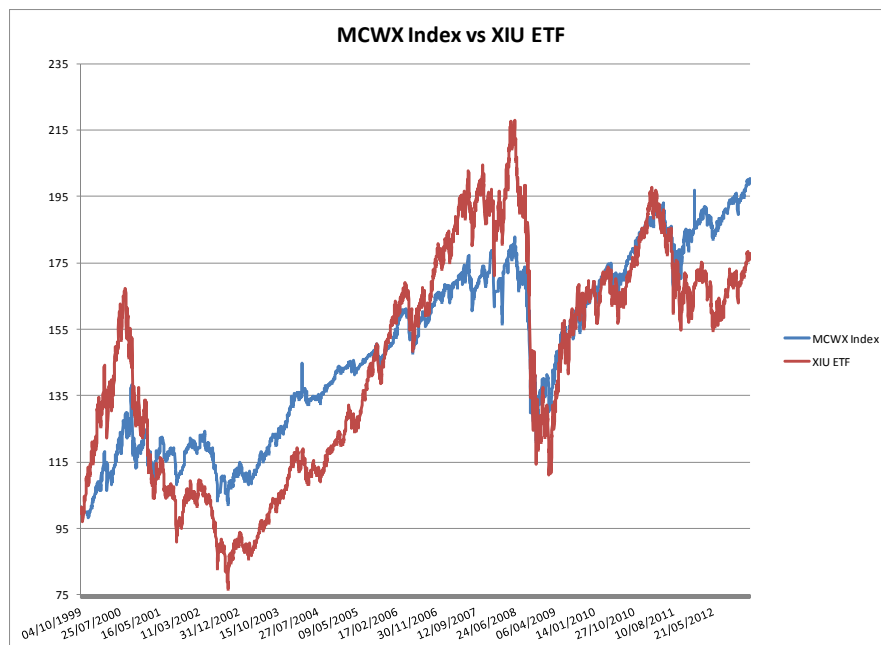
"BALANCED" INVESTOR PROFILE

Generally speaking, an investor with a "balanced" oriented investment profile seeks long-term growth with a moderate risk level. As a result, the portfolio will be equally diversified between different asset classes. Based on the investors' criteria for a moderate level of risk, we suggest a covered call strategy as the perfect strategy for investors whose objective is to realize the general market return over the long term with a lower level of market risk.

However, the use of options to generate returns does not free investors from their responsibility to select blue chip securities. Indeed, the covered call strategy requires an investor to hold the underlying shares against a position to sell 100 shares for every call option sold. Investors are thus exposed to the specific risk inherent in each security against which the strategy is applied. The sale of the call options allows investors to collect a premium which reduces the average purchase cost of the underlying shares while offering a small cushion against a decline in the price of the shares.

In order to avoid being exposed to the specific risk linked to the selection of a particular security, more and more investors are relying on index and sector exchange-traded funds (ETF) when implementing a covered call strategy. For example, implementing a covered call strategy on the S&P/TSX 60 Index ETF (XIU) on a monthly basis will generate, on average, superior returns compared to the market in general during market declines, and will underperform when the market rises sharply. The superior returns during market declines result from the cumulative effect of the premiums collected from the sale of the call options, a phenomenon that cannot be reproduced by simply owning the stock. Conversely, when the market rises, an investor will not fully benefit from the sale of the call options since the shares will be sold at the strike price defined by the call options which will most likely be lower compared to the actual market price of the shares. This explains why the returns are lower when the market advances. In essence, the fluctuations in returns are less pronounced and, as a result, the level of risk is lower.

The following chart illustrates the returns of the MCW Covered Call Writers' Index (MCWX) compared to the returns of the XIU ETF since October 4, 1999¹.



Source : Montréal Exchange and Yahoo.com

The MCWX Index is a passive total return index based on selling near-term close-to-the-money call options against a long position in the XIU ETF that was developed by the Bourse de Montréal in collaboration with Richard N. Croft. As illustrated in the preceding chart, the fluctuations in the MCWX Index are less pronounced compared to the fluctuations in the XIU ETF. We observe as well that the return over the total time period is higher compared to simply holding the XIU shares. As a result, one can conclude that investors with a “balanced” oriented profile can integrate a covered call strategy in their investment portfolio since the strategy meets the objectives of long-term growth and moderate risk level.

¹ Note that dividends or distributions are not included, neither for the MCWX Index nor the XIU ETF.

For more information on the MCWX Index, and how to replicate the index, we invite you to visit MX website at http://m-x.ca/indicesmx_mcxw_en.php.

"GROWTH" INVESTOR PROFILE

An investor with a "growth" oriented investment profile generally seeks sustainable material long-term growth and a high level of risk in the short term. As a result, the weight of the shares in the portfolio is more important. Based on the investor's criteria for a high level of risk, we suggest the purchase of long-term call options on a portion of the portfolio to take advantage of the potential high returns the call options can generate during bullish market conditions.

Even though the losses on the long call options position are limited to the premium paid, the risk associated with the position is high and therefore the investor must seriously take it into consideration prior to establishing the position. Consequently, on an annual basis, an investor should not invest more than what it can afford to lose without dramatically impacting the total return of the portfolio. For instance, an investor could invest 5% of the total value of the portfolio every year to purchase long-term call options while another investor might consider investing only 3%. For this strategy to be successful, it is very important to select blue chip securities that have a strong potential for long-term growth.

For example, let's take two fictitious securities ABC and XYZ² which were trading at a price of \$45 and \$101 respectively at the time of writing this article. These two securities were trading at a price of \$35 and \$66 respectively at the start of 2011, for a return of 29% for ABC and 53% for XYZ as at February 2013. These very important price gains, if they were to be repeated this year, could have the potential to push the price of ABC to \$58 and the price of XYZ to \$155. By taking 50% of the potential expected return, we can target a price objective of \$52 for ABC and \$128 for XYZ. Amongst all the available options expiring in January 2015, an investor could choose in-the-money (ITM) options in order to reduce the impact of time decay inherent in the call options, whereas, another investor might choose to buy out-of-the-money (OTM) options in order to take advantage of the higher leverage they offer. In this article, we will use the following at-the-money (ATM) long term call options: ABC 2015 JAN 46 at \$2 and XYZ 2015 JAN 100 at \$10.

² Although the symbols have been changed, the data has been taken from actual securities listed on the Bourse de Montréal.

The following table illustrates the potential results following the purchase of the two call options relative to the two target price objectives on the underlying shares at the expiration of the call options in January 2015. We assume that the investor will invest 5% of the portfolio on an annual basis to purchase long-term call options for a total of 10% for the two years leading to the expiration of the call options in January 2015. Consequently, 5% will be invested to purchase long-term call options on ABC and XYZ.

	ABC	XYZ	Portfolio
February 2013	ABC = \$45 Buy 1 ABC 2015 JAN 46 option contract at \$2	XYZ = \$101 Buy 1 XYZ 2015 JAN 100 option contract at \$10	
	Value = \$200/contract	Value = \$1,000/contract	
Break-even Price	\$48	\$110	
Initial Investment as a Percentage of the Portfolio	5%	5%	10.0%
January 2015			
Target Price (conservative)	\$52	\$128	
Potential Profit	\$4/share	\$18/share	
Potential Return	200%	180%	
Potential Portfolio Return	+10.0%	+9.0%	+19.0%
Target Price (aggressive)	\$58	\$155	
Potential Profit	\$10/share	\$45/share	
Potential Return	500%	450%	
Potential Portfolio Return	25.0%	22.5%	47.5%

We observe that, under the conservative case, the potential return is 19%, and the return is 47.5% under the aggressive case. These are very appealing potential returns that offer a risk/reward ratio varying between 1.9 and 4.75 depending on the price target realized. Investors typically require a risk/reward ratio of 2/1 in order to accept this level of risk. Overall, the maximum potential loss is limited to 10% if the price of the underlying shares closes below the strike price of the respective call option at the expiration of the call options in January 2015. This is a very aggressive strategy that offers investors with a "growth" oriented profile the potential for material returns in bullish market conditions without jeopardizing the return of the total portfolio in case of a negative outcome.

Please take note that for the basis of this article, we used only two securities to implement this strategy. In practice, the old adage that investors should not put all their eggs in the same basket applies to options as well, and as a result, investors should invest their available capital in a greater number of blue chip securities in order to reduce the potential risk.

CONCLUSION

The covered call strategy is an option strategy whose objective is to provide investors with the general market return over the long term while reducing the risk linked to market fluctuations. Consequently, this strategy is perfect for investors with a "balanced" oriented investment profile since it offers attractive long-term returns when implemented using blue chip securities, or index and sector ETFs.

Investors with a "growth" oriented investment profile are comfortable taking increasing short-term risks in order to realize higher returns over the long term. The purchase of long-term call options on blue chip securities offers attractive potential returns during bullish market conditions; however, when the strategy fails, potential losses may be material. Consequently, it is important that investors consider this potential risk, and accordingly invest only a percentage of their portfolio using this strategy, in order that it will not dramatically affect the total return of the portfolio in case of a negative outcome.