

## DERIVATIVES

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## COORDINATOR'S MESSAGE

**By Ian Flack**

This month we are fortunate to have an extensive overview of *Buy – Write covered call strategies* by Marcus Addison. Marcus overviews the recently available research on the performance of Buy–Right strategies. He looks at this strategy for both individual stocks as well as the use of index options to enhance your total portfolios performance.

Danny Moss and Owen Beattie explain the “Channel Spread” Options strategy and its power particularly in a range bound market.

We have again this year had a great variety of articles relevant to the current market. Thank you to all contributors. I would love to hear feedback from anyone who has tried any of the strategies discussed this year and particularly if you are prepared to include a case study or traders diary in a future issue.

Membership of the AIA continues to be a great investment and I take this opportunity to thank Silvana and the committee for their continued work to assist members' needs and interests.

An enjoyable and safe Christmas to all.

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# BUY RIGHT WITH BUY-WRITES

By Marcus Addison

Buy-write or covered call strategies are nothing new to investing for growth. However, it is only in the last decade or so that genuine studies have emerged to test their strengths and weaknesses. Most of these studies have covered markets that have seen bull, bear and sideways markets from the late 1980's until the present day. The hypotheses have been to test whether Buy-Write strategies can achieve superior returns while enjoying less risk than simply trading shares alone. But as with most studies they all have theoretical assumptions that leave the investor asking 'Can I rely on this information?'

Fortunately, in 2002 the CBOE and Standard & Poor got together to create an actual buy-write index (BXM Index) to test the theory going forward with the S&P 500. Furthermore, the ASX created a similar Australian buy-write index called the XBW Index, which tracks the strategy over the ASX200.

It seems these studies have some merit. For both the Australian and US indices we've experienced bull and bear markets to further test the hypotheses and the results closely match the theory. But is this good or bad news for Buy-Write strategies? We'll get to that soon...

## Firstly, what is a Buy-Write Strategy?

A Buy-Write strategy is when an investor buys a single stock or a portfolio of stocks *and* couples this with writing a call option or an index option that covers the portfolio.

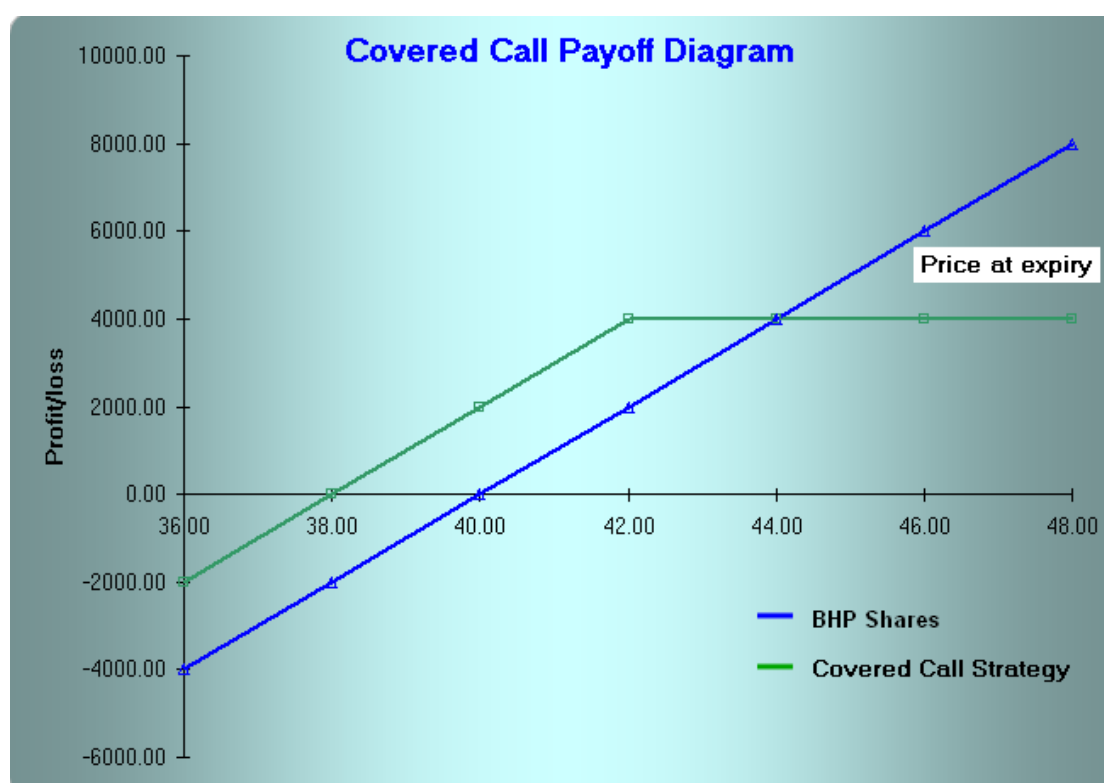
A single stock example would involve buying 1000 BHP shares, then writing (or selling) 1 call option. (This assumes an option ratio of 1000:1).

Thus, your position is:

**Long 1000 BHP shares**

**Short 1 BHP call option**

The many scenarios that may occur at the expiry of the option, as compared to holding the BHP on their own, look like this:

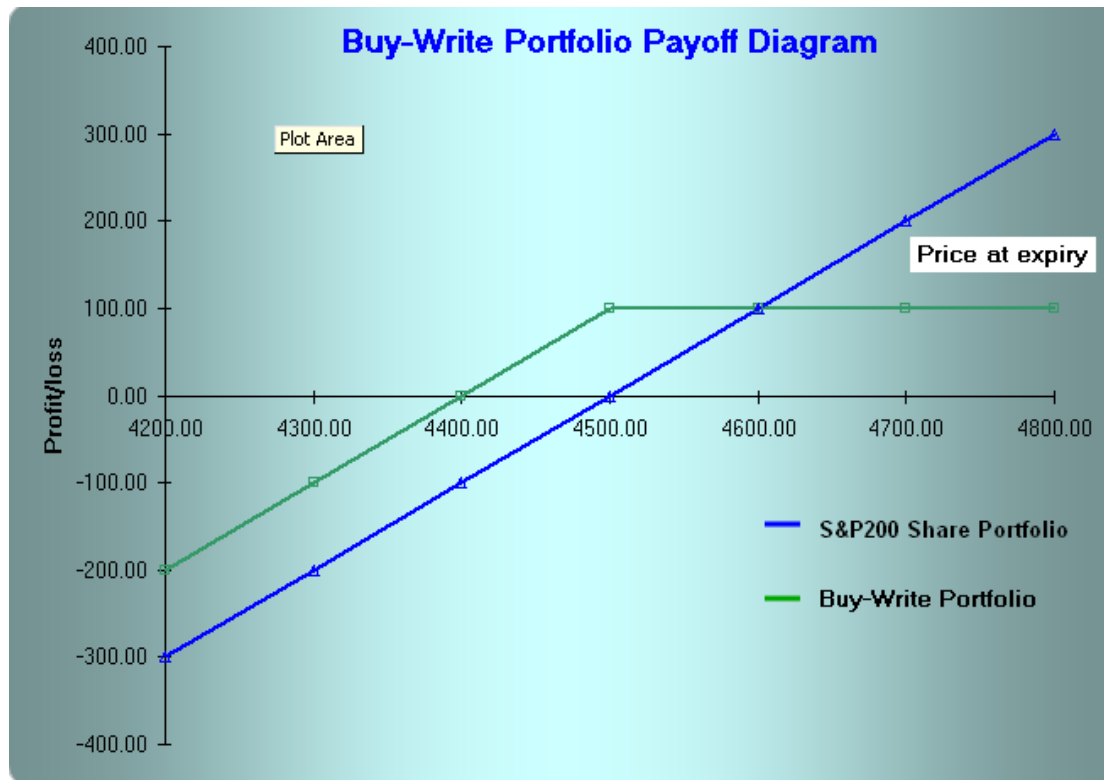


For a portfolio of shares (ideally 12 – 20 shares that represent all sectors of the index) you would write an index option that equals the total value of your shares. In the Australian market, if your basket of shares equals \$180K, then you would write 4 ASX200 Index call options (assuming the ASX200 Index is at 4500).

Thus, your position is:

**Long \$180K share portfolio**

**Short 4 ASX200 Index call options**



### So what do the studies suggest?

Interestingly, the studies\* conducted using the S&P 500 index (namely Callan (2006), Ibbotson (2004) and Whaley (2002)) almost mirror the Australian studies based on the ASX200 (by University of Technology, Sydney (2004) and SIRCA (2004) (a provider of financial data and eResearch services to over 200 Universities worldwide)).

Essentially, the main studies agree on a few points.

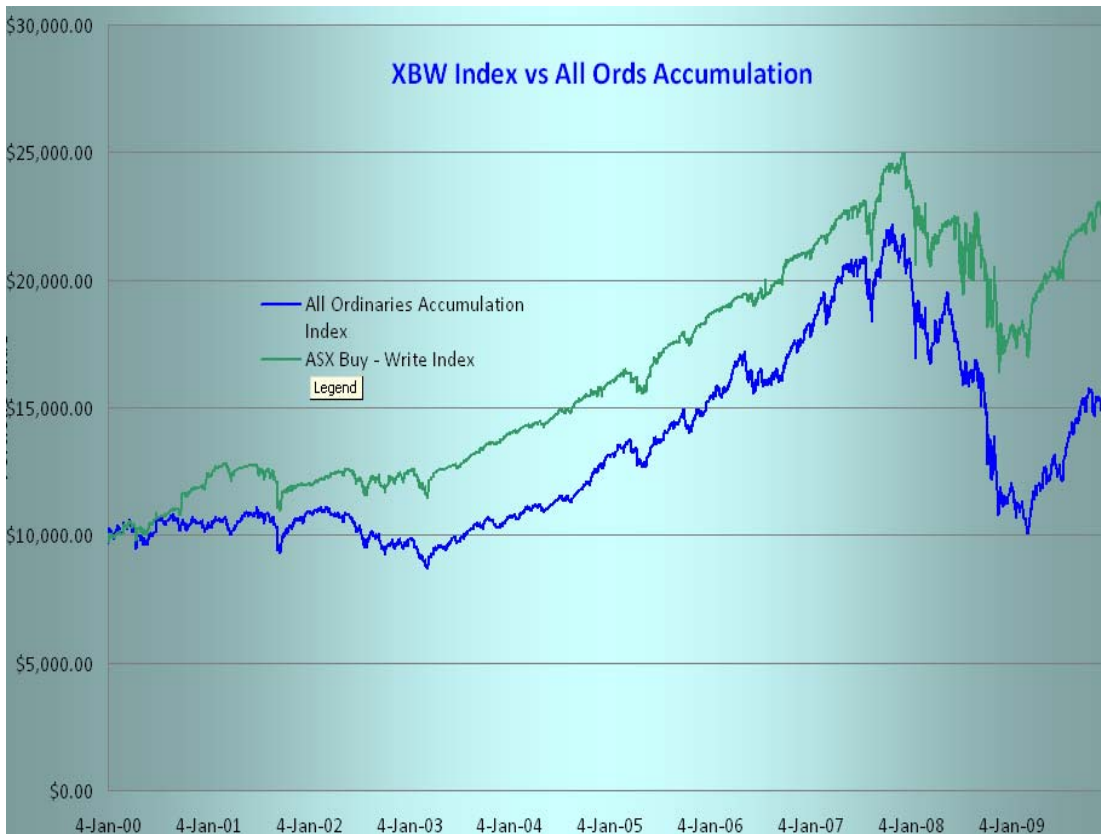
1. In a strong bull market, a Buy-Write strategy will perform with positive results, less standard deviation but less profit than a basket of shares.
2. In a sideways market, the same strategy will outperform a basket of shares with less risk.
3. In a bear market, the strategy will lose less than a basket of shares due to the buffer of premium earned.
4. Overall, a Buy-Write strategy enhances the average returns of the portfolio, reduces the standard deviation (risk) and thus improves the risk-adjusted returns as well.

As an added edge, Whaley argues that Index put options are over-priced because of their large demand from fund managers. This in turn pushes call option pricing up (due to the put-call parity relationship). This simply means you receive more premium just because fund managers need insurance.

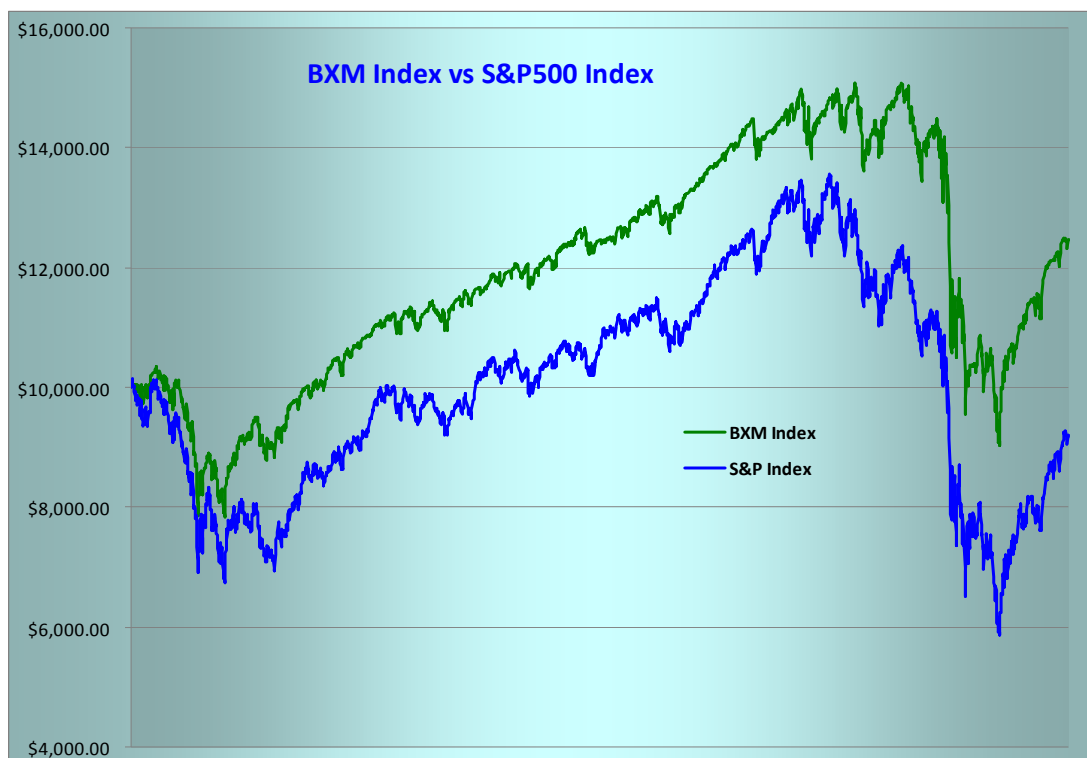
## XBW vs ASX200

A few points of interest:

- ~ Since 1992 the XBW has outperformed the S&P200 index 47 out of 71 quarters.
- ~ The buy-write index performed spectacularly better than shares alone from 1992 to 2000. However, we have chosen to look at the period since 2000 for a more modest comparison.
- ~ The average annual returns of the XBW for this period is 9.02% compared to the ASX200's 6.11%.
- ~ The risk-adjusted returns (return divided by standard deviation) for the XBW over this period are almost double the ASX200.



## BXM vs S&P500



### What are the potential benefits and consequences?

One instant benefit is that when you write an option you receive a type of income called a *premium*. The premium varies based on how far above the market price your chosen strike is and a combination of factors such as volatility and time to expiration. Most investors use this as a buffer on the downside or a way of generating an income during sideways markets.

One consequence is that if the stock price is above your option's strike price at expiry, you are forced to sell the stock at the strike price level. Is this a bad thing? It is if the price moves well beyond the strike price. Remember, you've still earned the premium and the move up to the strike price so effectively you haven't done too badly. Basically you are forgoing blue sky potential on a month to month basis in exchange for a more consistent investment return during a bull market and higher returns in a flat or downwards market.

Another consequence is that when your portfolio of stock takes a downward hit, so does your Buy-Write portfolio. However the advantage is that the Buy-Write has the buffer of the premium that you've earned as the market moves down.

### THE BIG QUESTION: Who best suits a Buy-Write Strategy?

Imagine a competitive couple, Brad and Angelina, limbering up for a game of golf, getting ready to tee off. As always, Brad challenges Angelina to a bet on the very first hole. She readily accepts and turns away to hide her smile.

It's a par four with a slight dog-leg to the left. Brad fancies his chances of drawing his shot around the corner and staying on the fairway. Without offering for the lady to go first, he pulls out his brand new driver, tees up and smashes it over 260 yards. Unfortunately, instead of a draw he manages a slight slice and finds himself on an adjacent fairway.

Angelina breathes in the fresh air, listens to the magpies calling as she tees up with her three iron. A soft breeze breathes across her face and she adjusts her stance accordingly before hitting her shot straight down the fairway, her ball finishing at the turn with a view to the green.

On their next shot, Brad has a small window to the green but wants to go for the flag. He's further from the green, so he grabs a fairway wood. It's a better attempt than his first, but strikes a branch and fortuitously bounces back onto the fairway, just short of the green. Angelina simply aims for

the centre of the green and with a modest four iron in hand she follows her normal routine. Her shot is slightly off centre to the right of her aim, thus veering toward the flag. It lands over Brad's lie and rolls onto the green and three yards from the pin.

Brad pulls out the wedge and decides to go straight for the hole, ignoring the downward slope that follows. He only slightly over-hits, but his aim is great rolling only half a foot from the pin before rolling down to the lowest point of the green and onto the fringe. He's further away from the hole than Angelina so he lines up his putter, once again deciding to go for the hole. Again his aim is great but the upward hill is hard to judge and he leaves his ball 5 feet past the cup.

Angelina allows him to putt through, and holds the flag for him. It's not a gimme but he spends little time before stepping up and knocking it in for a bogey.

Angelina has enjoyed watching Brad zig-zagging around the course, but she has also taken the time to notice the sun's rays interacting with the thin layer of morning dew still remaining on the near-perfectly maintained lawns. While the lifting fog over the undulating greenery has been enough to take her breath away, she has also had the presence of mind to note how the greens are behaving and decides to ease off a little on the length of her putt.

She putts. Her aim isn't perfect but she has judged the length well and leaves the ball a few inches past and to the left. It's a 'gimme' but Brad makes her putt it out for a respectable par.

Brad slams his putter into his bag and mutters something about 'double or nothing' but Angelina pretends not to hear and comments on the troop of kangaroos bounding away through the trees. She's let him off the hook for the second hole, but won't be so kind at every juncture.

Throughout the round, the bets continue sporadically. Angelina has a few minor setbacks as usual while Brad manages a few spectacular comebacks, on one occasion punching an impossible shot through a forest of trees to land on the green, but hits a tree root on the follow through and jars his wrist. On another he squarely hits a tree trunk and in his anger wraps his five iron around another nearby trunk. Eventually the challenges become less and less frequent and by the nineteenth hole his wallet and ego have taken a battering.

Brad hasn't fared much worse than Angelina (except for an injured wrist and a damaged club). Angelina hasn't really focussed on the bets, just enjoying the great outdoors and has finished close to her normal score. Such is her euphoria that she offers to play another round on the following morning, but it seems Brad's not so keen.

### **How is this even remotely relevant?!**

In the world of investing, Brad is the stock market, pure and simple, and Angelina represents a Buy-Write Strategy.

Brad's course is less predictable, with a lot of 'zig-zagging' and is sometimes over-ambitious. Angelina has some setbacks but her journey is more calculated and fruitful in many ways. On some holes Brad did beat his lovely wife but in the long haul he came out second best. (Actually, according to SIRCA (2004) the Buy-Write strategy returned better 52 out of 60 months).

Also, Angelina stuck to her plan, kept relatively quiet and took in the benefits of the great outdoors along the way, paying little attention to Brad's shortcomings. She was able to adjust her game after seeing how the ball reacted on the greens and took the wind direction into account, much like a Buy-Write strategy.

### **Things to remember**

In my experience, everybody likes to receive income in the form of a *dividend*. Receiving income in the form of *premium* should therefore be even more attractive.

The goal of a Buy-Write strategy is not only to reduce risk (or smooth your equity curve), but also to outperform the relevant index. The main studies referred to have trialled a cut-and-dry method of comparing the Buy-Write to the respective index. Obviously you can further enhance your returns by picking the right stocks.

Furthermore, you can actually choose the amount of premium you receive (also known as yield). However, the greater the premium, the more likely that the market will trade through your strike price, so a balanced approach is needed in choosing which call options to sell.

Lastly, it is important to remember that there is a theoretical minimum amount to invest in a Buy-Write strategy (\$100K if possible). This is so because an investor should be mindful to purchase enough individual stocks to broadly represent the market as a whole.

### **What next?**

There's no doubt this type of strategy is not for everyone. Furthermore, it's not the only way to invest for growth. But, in answer to the question, 'who best suits a Buy-Write strategy?' it really depends on whether you prefer the roughs or the fairways, whether you like the big-hits or a more predictable campaign and whether you want to enjoy the journey or just aim straight for the pin. I suppose it's whether you prefer Brad, or you prefer Angelina. If you are leaning towards the latter, then further reading into Buy-Write strategies would certainly be time well spent.

*Marcus Addison is an authorised representative of Belmont Securities Pty Ltd, ABN 47 119 852 890, the holder of Australian Financial Services License number 331625. For a full copy of several studies on Buy-Write strategies please visit the Belmont Securities resource centre at [www.bellmontsecurities.com.au](http://www.bellmontsecurities.com.au). Marcus can be contacted at [maddison@bellmontsecurities.com.au](mailto:maddison@bellmontsecurities.com.au).*

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# THE CHANNEL SPREAD

By Danny Moss & Owen Beattie

## Firstly, what is a Spread?

In reference to options, a 'spread' is a stand alone strategy which involves more than one series of options. All but the most basic of option strategies are considered 'spreads', as they will involve buying or selling options of different series to construct a trade which will reward a specific market event or outcome.

In this article we will explain in lay terms the structure of a Condor, or 'Channel Spread'. This particular option spread involves a bullish spread and a bearish spread packaged together and rewards a range bound market environment.

## Now, what's a channel spread?

A channel spread is a four 'leg' (series) option strategy which allows the trader to profit from a stock simply trading within a range or 'channel' for a set period of time.

To construct a Channel Spread the trader will sell both an out of the money Call Option and a Put Option for the same expiry month while simultaneously buying a Call Option at a higher strike than our sold call and buying a Put Option with a lower strike than our sold put.

This creates a 'profit channel' and capped danger zones. The ideal outcome is that volatility in the stock remains low and the stock continues to trade above our sold put option and below our sold call option until the Channel expires.

## Example of Channel Spread

We opened a Channel trade in October on ASX Limited (ASX) – Our chosen Channel was between \$32 on the lower level and \$36 on the upper level, or a channel range of around 12.5%. If the stock traded below \$32 we were protected at \$31 (with our bought put). If the stock traded above \$36, we were protected at \$37 (with our bought call).

The maximum risk on each side was \$1. The **credit received was on average 38 cents**. This equates to a return on risk of around 38%, double that of the traditional one sided credit spread and with the same financial risk – Remember, **risk is fungible**.



As ASX closed at 33.32 at the end of October the Channel expired worthless and we retained the full premium for the trade. It was a winning Channel Spread.

## How do I make money on this?

Due to the fact we are selling options which are closer to the money than we are buying, this strategy will be opened at a credit, meaning the investor is paid immediately.

If at the 'expiry' of the Channel Spread the stock is still trading within that channel the strategy simply expires and trader retains the full premium they received for opening the spread in the first place.

## The best market for 'Channelling'

The best market environment for Channel Spreading a stock is one of low volatility and a tight, consistent trading range. This market dynamic will often be witness during times of consolidation

after a significant trend (such as a bullish uptrend or bearish downtrend). It is at this time the trader may wish to profit from a neutral view and a flat market.

Channel Spreads can also be utilised in conjunction with existing stock holdings as a form of additional income yield above traditional methods of stock income such as dividends and covered calls.

### **What can I Channel Spread?**

A trader can utilise Channel Spreads to profit on most ASX/50 stocks (overlying option market liquidity depending) and the ASX/200 index itself (known as the tick code 'XJO').

### **Benefits of a Channel Spread**

The largest benefit of the Channel Spread is the 'double premium' the spread will attract. Because we need the stock to trade within an upper and lower limit you will receive a double premium.

However, the **risk** of the strategy is virtually identical to most other 'directional spreads' such as Bull Put Spreads (credit spread) or Bear Call Spreads (Credit Spread). The reason this is the case is that the Channel Spread (like all credit spreads) will only actually **lose** at the expiry of the spread. At that point, if the spread is a loser, the stock will be breaching either the upper or lower limit – it can't breach both at once!

### **Marginable?**

Yes, a Channel Spread will be margined by the Australian Clearing House (ACH) due to the sold put and call being closer to the share price than our protective bought put and call. The margin on this strategy should remain relatively constant and depends on underlying volatility etc.

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