The Options Option

When and why should financial planners consider using options in client portfolios? By Mark S. Longo

TRADING OPTIONS IS A WHOLE LOT easier than it used to be. Investors, who can buy options online through such services as E*Trade and Ameritrade, appear to be doing so without the advice of their planners—even when they do have advisers—according to a recent study of individual investors by the Options Industry Council. The study found that 72% of options users don't rely on financial advisers for investment advice, and only 2% of survey respondents listed advisers as an "important source" for data and information about their options investments.

That could be a big loss for financial planners because the study reports that the average options investor has a higher income, higher level of education, more financial experience, and more liquid assets than a non-options investor. In short, they are ideal clients, but many financial planners are ignoring them.

"Many planners are busy servicing their clients, so they don't have the time or inclination to get into options," says George S. Middleton, a planner with Limoges Investment Management in Vancouver, Wash. "Most financial planners aren't CFAs, so they don't have the knowledge or background to understand the options markets."

While the O-word may be anathema to many advisers—who spend years teaching their clients to diversify and manage risk through asset allocation—there are times when an options strategy may be not only appropriate, but the best option for managing risk or raising income. Advisers need at least to be familiar with the safest and most commonly used options strategies, and to know when and how to use them.

For those who haven't cracked a textbook since their Series 7 or 63 exams, here's a brief refresher course. Options come in two flavors: calls and puts. Calls give you the right to buy a security at a specified price, by a specified time. Puts give you the right to sell a security at a specified price, by a specified time. In a nutshell, calls make money when the market goes up and puts make money when the markets go down (See "How Options Work" on page 172).

For planners, the most important use of options, perhaps, is in protecting a portfolio against market downdrafts. "Most planners who are using options are more focused on risk management than on trading strategies," says Bryan Kelly, a planner and principal of Kelly Financial Group in Bel Air, Md.

Certainly, options can be dangerous if they are used to gamble on the direction of an asset or market. "I do not recommend naked option positions to my clients simply because that is too aggressive from a wealth management standpoint," explains Scott Noyes of Noyes Capital Management in New Vernon, N.J. "I'm not paid to gamble on the market for people or to leverage up a single position." But Noyes does use options to hedge his clients' positions. "I'm paid to diversify and manage risk," he says. "Options help me do that."

PUTTING ON THE PUTS

There's a good reason that puts are also called "portfolio insurance." They start appreciating as soon as an asset or index drops below a certain strike price. As such, they can be used to lock in a client's gains for any number of reasons.

For example, toward the end of the year, a client whose position has appreciated may want to protect those gains until she has held them for a year and can get favorable long-term capital gains

How Options Work

CALL OPTIONS give you the right to buy a stock at a specified price by a specified time. They gain in value as the stock price rises.

For example: XYZ stock is trading at 100 at the end of June. You think the stock will rally to 110 in a few weeks, but you don't have enough money to buy the stock. Instead, you buy five July 100 calls for $1 each, giving you the right to buy 500 shares of XYZ stock at $100, but they expire in the third week of July.

The net cost: $500 (5 x $1 x equity option multiplier of 100), versus $50,000 to purchase 500 shares at the current market price.

On the date the options expire, if the stock is trading at $110, you can buy the stock at $10 below the market price. You can sell the calls for $5,000 (5 x $10 x equity option multiplier of 100), giving you a net gain of $4,500. You could also exercise your option to buy 500 shares of the stock at $100. If the stock is trading below $100 at the expiration date, then your calls will expire, worthless, and your $500 investment will be lost.

PUT OPTIONS give you the right to sell a stock at a specified price by a specified time. They gain in value as the stock price drops.

For example: XYZ stock is trading at $110 at the end of June. You think the price will drop to $100 in a few weeks. You buy 5 July 110 puts for $1 each, giving you the right to sell 500 shares of XYZ stock at $110, but they expire in the third week of July.

The net cost: $500 (5 x $1 x equity option multiplier of 100), versus $27,500 in margin funds that it would require to short 500 shares of the stock.

On the expiration date, the stock is trading at $100. Since the puts give you the right to sell the stock at $10 above the market price, they are now worth $10 each ($110 – $100). You can sell the puts for $5,000 (5 x $10 x equity option multiplier of 100), giving you a net gain of $4,500. If the stock is trading above $110, then your puts will expire, worthless, and your $500 investment will be lost. *–ML*

tax treatment. You can protect that appreciation until the holding period is up by purchasing a put on it.

These puts must be bought and rolled forward on a regular basis to provide continual coverage. But like any insurance, puts come at a price, which varies depending on the situation. Even though your clients' portfolios may need the protection, many of them will balk at paying for it.

"Clients do have a difficult time paying for insurance," says Kevin Connellan, director of equity trading for Northern Trust in Chicago. "It's hard to get it through a client's head that sometimes it's smarter to pay for that insurance."

Planners can reduce or even eliminate the price of portfolio insurance by using a "collar," which uses the income generated from selling covered calls to offset the price of the puts. This strategy is particularly suitable for clients who have concentrated equity holdings that they can't liquidate.

"Collars are very popular with clients who have positions that cannot be sold due to regulatory or other prohibitions," Noyes says. "These are typically CEOs and other high-level executives who are forced to own stock in their company. Collars can provide long-term downside protection for these individuals at a very reasonable price."

COVERING YOUR CALLS

In today's environment of low fixed-income returns, another options strategy, selling covered calls, can help generate immediate income—for a retiree, for example. Selling covered calls also provides clients with a small amount of downside protection.

Call options give you the right to buy a stock at a specified price by a specified date. When your client sells calls against his stock position, he is essentially selling someone the right to buy his stock if the price rises to a certain level (in this case, the strike price of the options). In order to sell covered calls, you must determine the price at which your client is willing to part with his shares. As a rule, calls that are closer to the at-the-money strike price, or where the stock is currently trading, will generate more income for your client, but they will also increase the probability that his stock will be bought or "called away."

You should also discuss how long your client wishes to employ this strategy. Options that have a longer time until expiration will typically generate more immediate income, but they also increase the chances that the stock will be called away.

Let's say that your client owns 1,000 shares of Boffo Corp., which she purchased at 40, but are currently trading at 50. She is thinking about taking profits, but you suggest that she sell covered calls against her position instead. She has 1,000 shares, so you will sell 10 calls to cover her position (each equity option gives you the right to buy or sell 100 shares of the underlying stock).

Since she's still tentative about selling her shares, you choose to sell calls on the 55 strike, making them 10% out of the money. That way, the stock has to rally a lot to reach or surpass 55 before it is called away. Since your client has a short-term time horizon for this investment, you sell calls that will expire in two months.

If the calls expire worthless, your client can choose whether she wants to continue the strategy or sell the stock outright. You decide to sell 10 August 55 calls for the price of $1, generating an immediate gain of $1,000 ($1 x 10 x the equity option multiplier of 100), or 2.5% of your client's initial investment.

If the stock rallies to $55 or more during the two-month period, the calls that you sold are now in the money and will be exercised. Your client will sell her stock at $55. Because you sold calls on the 55 strike instead of selling outright at 50, your client participated in a 10% run-up *and* received an initial profit of $1,000. Her net gain: $6,000, or 15% of her initial investment.

Alternatively, the stock could remain below the 55 strike price for two months, and thus the options won't be exercised. Instead, they will expire worthless, and your client will keep the stock and the revenue generated from the sale of the call. Any price that the stock reaches between 50 and 55 will be appreciation

that your client keeps, in addition to the initial $1,000 she received for the sale of the options. And that $1,000 gives her some downside protection: If the stock falls to $49, she will break even. If the stock falls below that, though, she will begin to lose money.

The ideal scenario would be for the stock to rally close to 55 without reaching it. Then your client would receive the profits from her stock position along with the profits from the options. You could then sell more calls against her stock, generating more immediate revenue. By repeating these trades several times, you can boost a client's income on a regular basis.

Bear in mind that your client has to be comfortable parting with her stock at the option strike price. And make sure that your client understands that selling calls is not the same thing as selling outright. She could still lose money if the stock drops significantly.

"We use covered calls to produce additional income and unwind positions," Kelly says. "For example, I have a client with a large position in UPS. I recently sold calls against that position and earned a 10% return in a very short period of time."

An often-overlooked benefit of selling covered calls is their ability to defer or reduce capital gains taxes. "If we have clients with a position that has gone up significantly in the past nine months, we might write an option that will roll that gain into a 12-month gain, thus reducing their tax liability," says Robert K. O'Dell of LVM Capital Management in Kalamazoo, Mich. "Sometimes we write calls that will roll clients' capital gains taxes from one calendar year into the next, if they wish to spread out their gains over several years." By selling covered calls in this manner, you can defer your client's stock sale until the expiration date of the options—unless the stock is called away, of course.

NEW KID ON THE BLOCK

Clients who are holding SPDR ("spider") exchange-traded funds (ETFs) as a proxy for the broad market can use a new product that makes hedging a large-cap, S&P-like portfolio much cheaper and easier. In the past, investors had to buy expensive and unwieldy S&P 500 index options, which are so expensive that only the wealthiest can afford them. Many interested advisers and clients have been priced out of the market.

The new SPDR ETF options (SPY), which were introduced in January, represent shares of a security designed to track the value of the S&P 500, but at one-tenth of the size and price of an S&P 500 (SPX) index option. For example, in 2004, the year-end prices were 120.87 for SPDRs and 1211.92 for an S&P 500 index option.

"There are many times when we have considered using index options to hedge our client's portfolios," Middleton explains. "However, we usually find that they are price-prohibitive. Index options are too large, expensive, and cumbersome to use with most of our clients' portfolios."

SPDR options are a great way to capture the same returns without the price and hassle of large index options.

SPDR options are so new that not that many planners are using them yet, but many are considering them. "The SPDR options are a much more practical way to participate in long-term index option contracts, particularly with your smaller clients," Kelly says. "They are a great way for us to capture the same returns without the price and hassle of large index options."

The most important first step in using SPDR options is determining which month and strike price to incorporate into your hedging strategy. If you buy puts to hedge your overall portfolio, you'll have to balance your client's protection needs with the overall cost of that protection.

Say your client has made significant gains in his SPDR portfolio in the past year. However, he is worried about a short-term market pullback. He doesn't want to sell his SPDRs, so you need a hedge. The S&P 500 was valued at 1,170 (in early May). Since your client is worried about an immediate short-term correction, you decide to buy the June 117 puts (SPDRs options are quoted in strike prices that are one-tenth the value of the full S&P 500) to protect his portfolio. This gives you immediate downside protection that will expire in the third week of June.

Your client owns 1,000 SPDRs, so you need to purchase 10 SPDR puts (10 x SPDR option multiplier of 100). The June 117 SPY puts are trading at 1.65, so the entire trade will cost your client $1,650 ($1.65 x 10 x SPDR option multiplier of 100), or 1.4% of the value of his portfolio. By the end of the third week in June, the S&P 500 is trading at 1,100.

Your client's June 117 SPY puts are now trading at $7 ((1,170-1,100)/10) for a total value of $7,000 ($7 x 10 x SPDR option multiplier of 100). Although the puts were expensive, they prevented an even more costly loss.

If your client already holds SPDR ETFs, for every 100 ETFs you own you need to buy one option. For diversified equity portfolios or equity index funds, it can be much trickier to figure out how many options you need because these portfolios aren't necessarily correlated that well with the S&P index. Luckily, there are quite a few software programs to assist you with this calculation. The most popular is Microhedge from Brass/Sungard, although there are other programs available. Ask your options broker for more details.

Because clients, especially wealthier ones, are becoming more knowledgeable—and are demanding more of their financial planners—it makes sense to get up to speed on several options strategies. They simply add another arrow to your quiver. **FP**

Mark S. Longo is a freelance financial writer and former member of the Chicago Board Options Exchange. You can read more of his work at www.marklongo.com.

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