A Strategy for Reducing Volatility While Increasing Returns

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The product on every advisor’s wish list would have the low volatility of fixed income while providing equity-like returns. Although such a product does not exist, equity options, when used properly, will give you the ability to achieve pre-defined goals and objectives.

During a press conference on June 19th, Federal Reserve Chairman Ben Bernanke presented a tentative timeline for the winding down the Fed’s $85 billion-per-month bond-buying program, and initiated a violent sell off in the US equity market. With the stage set for interest rates to rise, investors are beginning to realize that they have to look beyond fixed income and find new ways to lower the volatility of their portfolios and generate yield.

Generations of investors and financial advisers have relied on the 60/40 asset allocation model which calls for a portfolio with 60% invested in stocks and 40% in high-quality bonds with regular rebalancing to keep the portfolio properly weighted. In a rising interest rate environment, it is unlikely that this asset allocation will produce the same historical returns we have seen in the last three decades.

A growing number of advisers are adding options strategies to their clients’ portfolios with the goal of lowering volatility and generating income. One of the easiest ways to introduce your clients to options is through covered-call writing – selling call options against long positions held in one’s portfolio. This strategy provides your client with a steady flow of income while reducing some of their downside risk. The amount of upside you forfeit using this strategy will depend on the strike price of the option you choose to sell.

To determine whether covered-call writing is appropriate, it is important to understand what your client is trying to achieve. A client that falls on the low-risk end of the spectrum and whose main objective is income generation is probably comfortable with giving up the majority of the upside in exchange for generating greater yield. On the other hand, a growth-oriented investor who has a more bullish outlook would likely be more comfortable in generating lower yield in exchange for the ability to participate in more of the upside.
Once you have chosen your strike price, the next big decision is which expiration to choose. In making this decision, consider the historical volatility of the underlying equity as well as its implied volatility. Generally speaking, the higher the volatility, the larger the premium. When considering a call-writing strategy on a volatile stock, you can probably collect a meaningful premium income by selling the front-month calls, which are the next series of calls set to expire on the third Friday of the month.

In order to clearly illustrate this point, let’s look at two stocks that are on opposite ends of the implied volatility spectrum: Facebook and Cisco.

With Facebook, which is currently trading at $25.97 and has an implied volatility of 43, you can collect a meaningful amount of premium by selling the front-month August 17 $26 in-the-money calls, which are currently trading at $1.14. In comparison, for Cisco, which is currently trading at $25.68, the August 17 $26 in-the-money calls are trading at $0.75. As you can see, the premium that you collect on a similar in-the-money call on Cisco is much lower because the implied volatility is currently only 29.

Finally, after you have decided on your strike price and options series, the final component is deciding on how often you will roll your position. When making this decision, you will once again have to consider the volatility of the stock. In our Cisco example, since the premiums are generally lower that for Facebook, it makes sense to sell options in further out months. For example, the front-month option in Facebook would generate the same premium as the two-month-away option in Cisco. When using this strategy, it makes sense to roll your options every 60 days in order to capture the optimal amount of premium.

Another strategy is to sell calls against an existing ETF position. For example, if you have a client who is looking for yield and already owns the iShares Dow Jones Select Dividend index, which is currently yielding 3.4%, initiating a call writing strategy which rolled the 3% out-of-the-money calls every 90 days would add an additional 200 basis points of yield based on current prices.

Clients who may benefit from including a call-writing program in their portfolios include corporate executives who have a concentrated position in the company for which they work for or have retired from and would like to lower the volatility of the holding, generate some income and avoid triggering a taxable event. Another target group would be individuals who are looking for a monthly or bimonthly income stream, and clients who are looking for yield, but are scared to go into fixed income right now.

In conclusion, initiating a discussion with your clients about the benefits of using options to generate yield and adding some downside protection to their portfolios will distinguish yourself from your competitors. It will also show your clients that you are thinking of creative ways to address the ever-changing market environment.

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