Making Money With Options

CIBC Wood Gundy

Friedman Investment Group

In a recent letter to our CIBC Enhanced Equity Fund shareholders we explained how options can be used to earn a return. Because it's not a particularly well-understood strategy we thought it deserved repeating here:

Recently, an investor asked us to explain how our Fund uses option writing to achieve its returns while, at the same time, reducing volatility. While the Fund is similar to an actively-managed, long-only equity portfolio, there are several differences in the way it's managed and returns are earned.

Everyone understands an actively-managed, long-only equity portfolio where performance depends primarily on stock selection plus some dividend yield. Money is made if the chosen stocks go up in price and there are losses if those stock prices go down. Holdings take time to realize their various price targets, so usually, the intention is to keep positions for several years in order to achieve expected capital gains.

Our Fund is similar in that stock selection is important and there is some return from dividends. However, the largest part of returns are realized through premiums received from writing puts and calls.

Since the duration of an option is generally not more than four months, this means positions may not be held for very long and portfolio turnover is, therefore, higher. This is a disadvantage because it means more work for the Portfolio Manager and also more transactions, which can potentially result in higher costs. The main criticism of writing covered calls is that upside potential is capped, which means opportunity is lost if a given holding keeps on rising well beyond the strike price of a call option that has been written on it.

However, there are offsetting advantages. For example, an advantage of high turnover is holdings are reduced when the market rises (as puts expire and calls are assigned), and cash naturally builds. And then the Portfolio Manager can to take advantage of lower prices when the market eventually corrects.

While turnover is high, the same stocks often return to the portfolio after their share price has corrected, so there is an ongoing list of "core" holdings, similar to a long-only portfolio. Turnover also forces the Portfolio Manager to constantly search for stocks that are more attractively priced than those being eliminated from the portfolio, thus improving the "margin of safety."

Another key advantage to options is the premiums received tend to rise sharply during major market corrections, which offsets some of the downside risk of holding equities over the long term. What's more, premium returns are predictable because they are received up-front and are retained no matter what may happen to the underlying share price down the road. All else being equal, this reduces volatility.

For puts, and for any calls that expire without being exercised, the cost of a given position is reduced, meaning less capital is at risk for the same number of shares. It is possible to eventually work down the cost of a given position to zero through ongoing option writing.

While a position may be lost due to assignment of a call, the price received together with the original call premium will meet the Fund's return on capital target, even though further upside may be lost if the stock keeps rising. And while puts are used as a way to enter new positions at prices below the current market, the premiums received represent an attractive return on capital — even if puts expire unexercised. Meanwhile, cash held to cover potential put assignments will earn interest and, being held in US dollars, enables the Fund to benefit from further weakness in the Canadian dollar.

In short, we consider the option writing Fund as another equity-related asset class that can offer further diversification to client portfolios. If you'd like to know more we're happy to elaborate on the merits of the strategy.