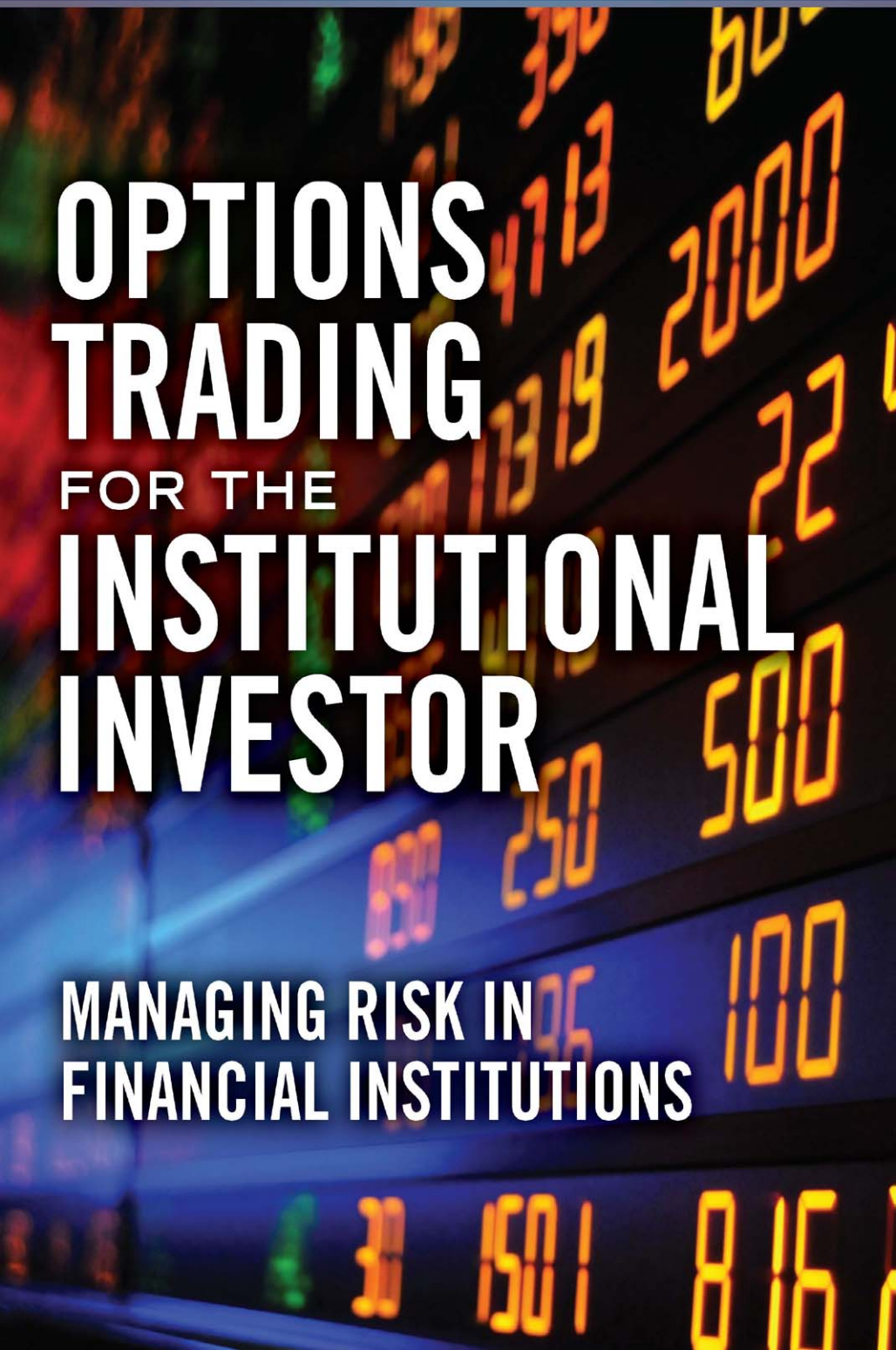
MICHAEL C. THOMSETT



OPTIONS TRADING FOR THE INSTITUTIONAL INVESTOR

MANAGING RISK IN FINANCIAL INSTITUTIONS

Options Trading for the Institutional Investor

Managing Risk in Financial Institutions

Michael C. Thomsett

Associate Publisher: Amy Neidlinger
Executive Editor: Jeanne Glasser Levine
Operations Specialist: Jodi Kemper
Cover Designer: Alan Clements
Managing Editor: Kristy Hart
Project Editor: Elaine Wiley
Copy Editor: Krista Hansing Editorial Services, Inc.
Proofreader: Jess DeGabriele
Senior Compositor: Gloria Schurick
Manufacturing Buyer: Dan Uhrig

Upper Saddle River, New Jersey 07458

Printed in the United States of America

First Printing April 2014

ISBN-10: 0-13-381166-2
ISBN-13: 978-0-13-381166-7

Pearson Education LTD.
Pearson Education Australia PTY, Limited.
Pearson Education Singapore, Pte. Ltd.
Pearson Education Asia, Ltd.
Pearson Education Canada, Ltd.
Pearson Educación de Mexico, S.A. de C.V.
Pearson Education—Japan
Pearson Education Malaysia, Pte. Ltd.

Library of Congress Control Number: 2014930527

Contents

Acknowledgments

Many thanks to the readers who let me know their thoughts about my previous books. Thanks also to Jeanne Glasser Levine, Executive Editor at Pearson/FT Press, and Elaine Wiley, Project Editor; also to Michael Stoppa, my webmaster and partner at ThomsettOptions.com, for his guidance and support throughout the process of developing new strategies in the options market. My son, Eric J. Thomsett, also deserves special recognition for insights, advice, and participation in developing sensible, working options strategies.

About the Author

Michael C. Thomsett has published more than 80 books on investing and business topics, including several other FT/Prentice Hall projects (*The Options Stock Profits: Getting to the Core, Put Option Strategies, The Options Trading Body of Knowledge,* and *Trading with Candlesticks*), and many other books concerning options and stock market investing. His best-selling book *Getting Started in Options* is in its ninth edition and has sold more than 300,000 copies. Thomsett is also the cofounder of the education sites *ThomsettOptions.com* and *ThomsettStocks.com*. He lives in Nashville, Tennessee.

This page intentionally left blank

Preface

The Elusive Goal: Low Risk and High Yield

The market invariably brings you both good news and bad news. The bad news: Markets are volatile and risky, and any capital placed at risk could result in losses—sometimes catastrophic losses. The good news: These market risks can be hedged effectively using *conservative* options strategies.

Coupling the words *conservative* and *options* might seem surprising. After all, the long-standing reputation of the options market has been exotic, high risk, and inappropriate for many (if not most) investors—both institutional and retail.

This does not have to be the case.

The options market is becoming increasingly recognized as much more than a form of pure speculation. Growing numbers of investors are recognizing that options are most effective as tools for managing a portfolio, reducing and eliminating its risks, and improving its profits.

This book demonstrates how a conservative portfolio can be made safer and more secure while increasing income. This is accomplished through combining equity positions with specific and conservative options strategies. The intention is not merely to augment net profits, but to protect the profitability of the equity side of the portfolio as well. This idea is dramatic in the positive effect it has on an institutional portfolio.

Every investment officer faces a twofold problem: First and foremost, investment decisions have to be conservative enough to protect against losses. This means that many opportunities have to be passed up because

the risks are perceived as too great. Second, the goal must be to match and beat inflation and taxes, the double impact that demands seeking higher returns.

How can you seek higher returns in this portfolio while continuing to observe the essential demand for conservative strategic management?

Many market insiders and experts are pessimists on this question. They point out that your only chance is through broad diversification of risk and complex asset allocation. Both of these ideas present profound problems for every investment officer and for every portfolio. Broad diversification means trying to attain the "vanilla" medium return of the market. A majority of mutual funds, for example, are broadly diversified, but they underperform the market average. In fact, according to one source, "The average actively managed stock mutual fund returns approximately 2% less per year to its shareholders than the stock market returns in general."[1]

Making matters worse, even beyond the average outcome, most funds perform beneath the average of the market. In other words, most funds do not even match the broader market. One study concluded: "In 2012, 66.08 percent of all domestic equity mutual funds underperformed when matched against the S&P 1500. In 2011 a swollen 84.07 percent were laggards, while in 2010 'only' 57.63 did worse than the averages."[2]

Why is this so? The answer is at the crux of the message in this book. Any observer of the mutual fund performance phenomenon would wonder why the average mutual fund underperforms market averages *and* why most funds perform under market averages.

The three disadvantages mutual funds have over other institutions (insurance companies, banks, pension plans, and specialized advisory service providers, for example) include over-diversification, fees, and cash on hand. Mutual funds (especially large ones) might simply hold positions in too many segments of the market, so their returns are average at best. Returns are further diminished by fees that mutual funds charge (1.44%, on average). Finally, funds hold between 3% and 7% in cash to meet obligations, and this "dead money" is not earning.

Other institutions that are less concerned with competition or performance reporting are not as likely to suffer from this dismal outcome. However, an underlying problem is that every investment officer has to contend with the desire for better returns without higher risks. This is a daunting task. However, the options market addresses these concerns and improves investors' chances of meeting both of these otherwise conflicting goals.

A central theme is this book is that investors must analyze the possibility of matching acceptable risks with better than average yields. Most experts question the idea that risk-averse investors can outperform the market averages. However, this book challenges the conventional wisdom by demonstrating how conservative investors can exploit a narrow band of potential strategies, dramatically increase yields, and, at the same time, manage risks within their self-defined risk limitations.

Risk is at the core of all ideas for portfolio management. If a range of strategies contains too many pitfalls, it is not worth pursuing. But a basic premise in this book is that a conservative investor is not necessarily someone who does not want to expand beyond a well-understood and short list of investment possibilities. Being a conservative investor does not necessarily mean that you are unwilling to examine new ideas, expand your portfolio, or take acceptable risks. It just means that you are not interested in speculation or in exposing yourself to the possibilities of high risk. This applies to personal comfort levels or preferences, as well as to internally imposed standards and limits. Institutions attempt to carefully define acceptable risks, with the intention of avoiding unacceptable losses. To many investors, this translates to a complete ban on options trading—and for good reason.

In recent years, abuses of derivatives trading created many losses and prompted a troubling question on whether individuals making portfolio decisions represented the investment policies of the institution. In the U.S. alone, many options-based institutional trades resulted in massive losses, including Morgan Stanley, in 2008 ($0.12 billion); Proctor & Gamble, in 2004 ($0.16 billion); Deutsche Bank, in 2008 ($1.8 billion); and, the largest options loss of all, Long Term Capital Management (a hedge fund management firm), in 1998 ($4.6 billion).[3]

This list does not include losses in futures or credit default swaps, which, in many cases, have been even larger. Even so, the options market has received the worst press and has been characterized as overly risky, often abused, and far too speculative for conservative investment managers or institutional investment officers. True, a lack of experience or awareness of risks is most likely to lead to large losses. It is not enough for an institution to rely on an individual who has studied options and passed the FINRA Series 4 exam (Registered Options Principal); that person also must have experience in trading and must be aware of the range of risks in speculative trading practices.

Conservative practices are normally aimed at achieving three goals: preserve spending power after both inflation and taxes, avoid unacceptable level of market liquidity and diversification risks, and protect profits without loss of desirable equity positions with hedges against potential losses. These goals are typical for both conservative and moderate investors. They demand the use of strategies for avoiding loss. As a conservative investor, you are not averse to risk in any and every form; essentially, you are averse to unexpected surprises. This is perhaps the most important distinguishing characteristic between you and other investors. Many investors are surprised when they lose money in the market—but in retrospect, should they have been surprised? If they operate on certain assumptions concerning potential profits but are unaware of the related risk or the degree of risk exposure, they are making decisions with a blind eye.

With this in mind, this book offers a more realistic definition of conservative investors: those who are experienced enough to be aware of both yield and risk and who make decisions based on that level of awareness. Conservative investors are not as likely as other investors to be taken by surprise when they lose money in the market. Another aspect of this expanded definition distinguishes between risk profile and the willingness to use creative and alternative strategies. Conservative investors are not closed-minded and do not reject exotic instruments such as options merely because of their reputation as being high risk. Instead, well-informed conservative investors are likely to examine claims about high-yield potential with an open mind. You can be skeptical and, at the same time, willing to listen to the suggestion that the combination is at least possible. In fact, a limited number of strategies do offer the

potential of using various conservative applications to meet the three goals common to conservative investors: preserving capital, avoiding unacceptable risk, and protecting profits.

This book does not suggest that you have to become an expert in a broad range of complex or exotic options strategies. Instead, it proposes a rather limited number of strategies appropriate for conservative investors. This approach respects the risk limitations in the conservative strategy while showing how experienced stock market investors can expand their yield levels significantly, protect existing positions, and come through market down cycles intact.

Endnotes

1 Bill Barker, "The Performance of Mutual Funds," *The Motley Fool*, www.fool.com, accessed 24 September 2013.

2 Richard Finger, "Five Reasons Your Mutual Fund Probably Underperforms the Market," *Forbes*, 15 April 2013.

3 Peter Coy and Suzanne Woolley, "Failed Wizards of Wall Street," *BusinessWeek*, 10 September 1998.

This page intentionally left blank

1

Setting the Ground Rules

In any discussion of an investment strategy, you begin with a series of assumptions. Your assumptions tie into your conservative profile: You have prequalified the stock of a limited number of companies on the basis of a short list of solid fundamentals, essential in stock selection; you believe these stocks will rise in value over time; you would be happy to buy more shares; and a finite number of companies meet your standards. We have identified ten companies that make up a model portfolio, to illustrate the options strategies in this book. These serve as examples of companies that meet a few basic criteria for picking companies and their stocks, as candidates for conservative options trading.

This book explains how conservative investors can employ options strategies to (a) enhance current income without increasing market risks, (b) protect long positions through options used for insurance, and (c) create a form of contingency to survive in volatile market conditions.

The Ground Rules

Because you are a *conservative* investor, the arguments in this book are based on a series of underlying assumptions. Always keep these ground rules in mind because they relate to your risk profile and your investing philosophy. This book follows five underlying assumptions:

1. **You will limit options activities to stocks you have prequalified.** This is a necessary starting point, as long as your portfolio and the stocks you use for options strategies include stocks you believe in as long-term-hold positions and you consider these stocks permanent parts of your portfolio (as long as the fundamentals remain strong). This is an important attribute because it is not conservative to buy stocks solely to use for options strategies. A conservative approach to options must include the premise that your activities will be limited to the strongest possible stocks you can find.

2. **You believe that your stocks will rise in value.** A conservative investor naturally expects stocks to rise in value; otherwise, why keep them? But this seemingly obvious point has relevance in the underlying assumptions of this book. Many of the discussions of strategies are premised on a belief that, over the long term, the subject stock's market value will rise. However, many options strategies work best when stocks do *not* rise, such as in bearish combinations or long put strategies. Covered call writing (a very conservative strategy) is most profitable when stock values remain steady or even fall slightly. This means that you may need to time a strategy to produce profits resulting from short-term

stability in prices, hoping for longer-term growth. So a second underlying assumption is in line with the conservative approach. This means you want to accumulate shares of value investments, you expect prices to rise over time, and you will change a *hold* to a *sell* when the fundamentals change. However, at the same time, some options strategies are designed to take advantage of short-term price volatility. When marketwide volatility affects short-term prices of your stocks, you have an opportunity to pick up discounted shares, take profits (without having to sell stock), or average down your overall basis. Of course, the proposal that you should average down is conservative only if the basic stock selection assumptions remain valid. You want to employ such a strategy only for stocks in which you have a strong belief as long-term value investments.

3. **You accept the premise that fundamental analysis of stocks is an essential first step in the process of examining option opportunities.** Options have no fundamental attributes. These are intangible contractual instruments, and they have no value on their own; thus, you can judge the tangible value of stock only as a means for selecting appropriate options strategies. Many first-time options traders make the mistake of overlooking this basic reality. They select options (and stocks) based on the immediate return potential, but they ignore the real market risks of the underlying stocks. This violates the conservative tenet that stocks should be chosen for their fundamental strength and growth potential.

4. **In the event of a temporary downward movement in a stock's price, you would be happy to buy more shares.** Some investors might be unwilling to pick up more shares of a particular stock, even when the opportunity to buy discounted shares is presented. This book introduces several strategies proposing that additional shares be purchased (or exposed to contingent purchase) using options. If this is not the case in a particular situation, you should simply pass over those suggestions. You might use a strict formula for diversification or asset allocation to limit risks in particular stocks, for example, so strategies aimed at increasing your holdings in one stock might contradict your portfolio management standards in such an instance. Strategies proposing that

you pick up more shares work *only* if that suggestion conforms to your overall portfolio plan.

5. **You believe that an adequate number of available stocks meet your criteria.** Some investors become convinced that their short list of stocks is the only list available to them. Thus, if they sold shares of stock from their portfolio, they would be unable to reinvest profits in equally acceptable stocks. If you do not believe this, you are probably aware that dozens of stocks meet your criteria in terms of price level, P/E ratio, volatility, dividend payment history, and a range of other analytical tests. Accordingly, if you sell a particular stock from your portfolio, you recognize that you could (and would) purchase a number of other stocks that also conform to your criteria.

Incidentally, this practice makes sense whether you trade options or not. The fundamentals can change for any company, so if a hold stock changes to a sell, you need to reinvest funds. As a matter of basic portfolio management, every investor needs a secondary list of stocks for replacing sold stocks from the current portfolio. The need for maintaining this list relates to options trading because some strategies result in selling shares of stock. In those cases, you want to reinvest capital in a new issue on your list of qualified stocks.

A Model Portfolio

In the examples in the following chapters, these five underlying assumptions demonstrate how options work within the conservative framework. These criteria are applied to a model portfolio of ten stocks in various combinations throughout. This helps tie together the various examples and range of possible outcomes. This model portfolio is by no means a recommendation of stocks you should own; it was selected to include stocks with some common attributes. These stocks have increased dividends every year for the past seven to ten years (or more) and have reported low volatility in trading. Dividend yields are higher than average, between 2.7% and 5.3%. Some issues have exhibited rising market value in recent years. All these stocks have available both listed options and long-term options (LEAPS), enabling you to look at a variety of scenarios for each conservative strategy. Analysis includes a study of options expiring in 1, 2, 4, and 16 months.

Employing a single portfolio throughout the book is helpful in another way. Not every strategy works well for each stock in the model portfolio, so you can walk through the selection process to demonstrate how a particular strategic decision is made. Although your portfolio might contain a number of excellent value investments, some strategies simply do not work at all times or in all cases. You can compare the different potentials for strategies across a range of stocks by following the model portfolio throughout the explanations in each chapter.

The values of each stock, current bid, and ask value of every option in this book are based on the last traded closing prices reported by the Chicago Board of Exchange (CBOE) on September 25, 2013. Table 1-1 summarizes this model portfolio. The portfolio's overall value is estimated at $1 million, split as equally as possible among the ten stocks.

Table 1-1 Model Portfolio

Stock Name	Trading Symbol	Closing Price*	Shares Held	Total Value	%
Kimberly Clark	KMB	$94.69	1,100	$104,159	10.4%
Coca-Cola	KO	38.33	2,600	99,658	10.0
McDonald's	MCD	97.60	1,000	97,600	9.7
Microsoft	MSFT	32.51	3,100	100,781	10.1
Occidental Petroleum	OXY	92.91	1,100	102,201	10.2
Reynolds Aluminum	RAI	49.09	2,000	98,180	9.8
Southern Company	SO	41.72	2,400	100,128	10.0
AT&T	T	34.05	2,900	98,745	9.9
Target	TGT	63.24	1,600	101,184	10.1
Verizon	VZ	46.95	2,100	98,595	9.8
			Total	**$1,001,231**	**100.0%**

* Closing prices as of September 25, 2013

This portfolio is split equally among the ten issues, a modest but effective level of diversification. An individual portfolio would likely select an entirely different list of stocks, perhaps more than ten, and perhaps

split in a different manner. This is only one example of how a $1 million portfolio might be diversified among ten value investments (*value,* in this sense, is defined as having a consistent record of increasing dividends, higher than average dividend yield, a medium level of debt ratio, and a preference for increasing revenues and earnings).

This raises a question every portfolio manager faces: Is this a "conservative" portfolio? That is a matter of opinion and one that depends on the timing of purchase, long-term goals, and your opinion about the fundamentals for each corporation. These ten stocks provide a cross-section of stocks that illustrate where strategies work well and where they do not work at all. The actual definition of a conservative portfolio is (and should be) always evolving based on changes in the market, in a stock's market price and volatility, and, of course, in emerging information concerning fundamental strength or weakness of a particular company.

Is this information outdated? The data gathered on the closing date of September 25, 2013, is dated, but it would be impossible to perpetually update ten stocks and still meet the publication date of this book. However, all the information is relative. The values of options for a particular stock will probably be consistent from one period to the next, assuming that the proximity between closing price and option strike price is about the same and that months to go until expiration are the same as well. Although these relationships can and do vary based on ever-changing perceptions about a particular company, the data is valid for the purpose of illustrating strategies. The use of some measurement in time is necessary, and all these stocks were selected and summarized on the same date. Given all these qualifications, these closing prices (and the options values used in this book) are fair and reasonable. Thousands of stocks have options available to trade, and this translates into many choices for conservative investors.

Throughout this book, the ten portfolio companies compare options trades for a series of different strikes and expiration dates. The purpose of using so many different versions of an options trade is to accommodate many different strategies employing calls or puts (or both); in-the-money (ITM), at-the-money (ATM), or out-of-the-money (OTM) options; and a variety of expiration dates. The following chart summarizes the strikes and expirations for each.

Trading Symbol	Strikes	Closing Price	Option Premium 1 Month (24 Days)	2 Months (52 Days)	4 Months (115 Days)	16 Months (479 Days)
KMB		*$94.69*				
C	85		8.70	11.50	9.90	13.90
	90		5.80	5.80	6.90	9.90
	95		1.30	2.35	3.40	7.80
	100		0.16	0.60	1.29	4.80
	105		0.03	0.25	0.45	3.30
P	85		0.09	0.26	0.90	5.12
	90		0.25	0.90	1.90	7.21
	95		1.55	2.55	3.40	9.70
	100		3.46	5.20	6.16	12.30
	105		8.50	10.60	11.50	15.60

Trading Symbol	Strikes	Closing Price	Option Premium 1 Month (24 Days)	2 Months (52 Days)	4 Months (115 Days)	16 Months (479 Days)
KO		*$38.33*				
C	36		2.65	2.83	—	—
	37		1.60	1.84	—	—
	38		0.88	1.15	—	—
	39		0.37	0.62	—	—
	40		0.13	0.32	0.67	2.20
P	36		0.09	0.23	—	—
	37		0.20	0.41	—	—
	38		0.49	0.75	—	—
	39		0.97	1.23	—	—
	40		1.72	1.65	2.47	4.71
MCD		*$97.60*				
C	92.50		5.40	5.85	6.30	8.85
	95		3.00	3.95	4.26	6.91
	97.50		1.28	2.10	2.70	6.10
	100		0.30	1.03	1.75	5.00
	105		0.02	0.16	0.52	3.20

Trading Symbol	Strikes	Closing Price	Option Premium 1 Month (24 Days)	2 Months (52 Days)	4 Months (115 Days)	16 Months (479 Days)
P	92.50		0.14	0.53	1.39	6.25
	95		0.35	1.01	2.16	7.45
	97.50		1.02	1.89	3.25	9.00
	100		2.70	3.19	4.70	10.50
	105		7.95	8.30	8.00	13.65
MSFT		*$32.51*				
C	30		2.64	2.86	3.00	4.39
	31		1.76	2.02	2.42	—
	32		0.97	1.38	1.75	3.30
	33		0.43	0.87	1.25	—
	35		0.08	0.28	0.58	2.10
P	30		0.07	0.27	0.70	2.76
	31		0.17	0.49	1.00	—
	32		0.42	0.84	1.45	3.78
	33		0.90	1.31	1.89	—
	35		2.51	2.70	3.40	5.70

Trading Symbol	Strikes	Closing Price	Option Premium 1 Month (24 Days)	2 Months (52 Days)	4 Months (115 Days)	16 Months (479 Days)
OXY		*$92.91*				
C	87.50		5.80	6.70	7.70	12.10
	90		3.65	4.90	6.00	10.39
	92.50		2.05	3.40	4.51	9.38
	95		0.95	2.15	3.20	8.05
	97.50		0.41	1.30	2.34	5.83
P	87.50		0.34	1.08	2.48	8.70
	90		0.76	1.82	3.30	9.90
	92.50		1.59	2.65	4.30	11.35
	95		2.90	3.95	5.80	13.05
	97.50		5.00	6.55	7.25	14.80
RAI		*$49.09*				
C	47		1.65	3.90	3.40	4.91
	48		1.55	1.92	1.75	—
	49		1.13	1.30	1.68	—
	50		0.35	0.80	1.25	3.30
	52.50		0.05	—	0.42	—

			Option Premium			
Trading Symbol	**Strikes**	**Closing Price**	**1 Month (24 Days)**	**2 Months (52 Days)**	**4 Months (115 Days)**	**16 Months (479 Days)**
P	47		0.15	0.51	1.20	5.72
	48		0.35	0.85	1.65	—
	49		0.55	1.20	2.15	—
	50		1.08	1.50	2.20	5.70
	52.50		3.22	—	6.17	—
SO		*$41.72*				
C	40		1.94	2.23	2.85	3.45
	41		1.09	1.26	1.79	—
	42		0.45	0.67	1.11	—
	43		0.12	0.28	0.63	1.90
	44		0.05	0.12	0.37	—
P	40		0.10	0.41	0.75	3.24
	41		0.27	0.73	1.15	—
	42		0.65	1.22	1.56	—
	43		1.21	1.92	1.95	4.89
	44		1.82	2.46	2.85	—

Trading Symbol	Strikes	Closing Price	Option Premium 1 Month (24 Days)	2 Months (52 Days)	4 Months (115 Days)	16 Months (479 Days)
T		*$34.05*				
C	32		2.01	2.15	2.28	—
	33		1.15	1.28	1.56	2.50
	34		0.42	0.64	0.98	—
	35		0.10	0.28	0.58	1.60
	36		0.02	0.11	0.31	—
P	32		0.11	0.29	0.72	—
	33		0.28	0.56	1.02	3.50
	34		0.72	0.97	1.49	—
	35		1.43	1.59	2.25	4.75
	36		2.33	2.45	3.02	—
TGT		*$63.24*				
C	60		3.40	3.70	4.10	6.70
	62.50		1.78	2.20	2.94	5.90
	65		0.39	0.90	1.61	5.26
	67.50		0.07	0.30	0.82	4.10
	70		0.02	0.14	0.39	2.55

			Option Premium			
Trading Symbol	**Strikes**	**Closing Price**	**1 Month (24 Days)**	**2 Months (52 Days)**	**4 Months (115 Days)**	**16 Months (479 Days)**
P	60		0.25	0.53	1.35	5.00
	62.50		0.74	1.17	2.22	6.00
	65		2.05	2.56	3.45	7.60
	67.50		4.13	4.55	5.10	9.30
	70		6.55	7.50	7.22	10.59
VZ		*$46.95*				
C	45		2.14	2.50	2.66	4.40
	46		1.28	1.55	2.09	—
	47		0.68	0.98	1.54	3.25
	48		0.30	0.59	1.81	—
	49		0.12	0.34	0.75	—
P	45		0.42	0.75	1.56	4.88
	46		0.72	1.12	1.98	—
	47		1.28	1.60	2.45	6.10
	48		1.93	2.29	2.89	—
	49		2.74	2.94	3.21	—

The wide range of premium values is affected by both time remaining until expiration and the proximity between the strike and the current underlying stock's price. All these values are fixed in time as of the close of business on September 25, 2013, so that comparisons among any of the ten are valid. However, even though these premium levels and stock prices are outdated, the relative values, given specific time and proximity, are accurate and apply in any period.

This page intentionally left blank

Index

P

Q

R

S

T

U

V

W–Z