

In What Should One Invest and What Return to Demand?

by Mike Restivo

The easiest and most liquid asset class for investing and speculating alike is stock equities. Consider the performance and return provided by professional mutual fund managers as a benchmark of comparison to one's own investing efforts:

A recent, Feb. 2013, Restivo analysis of the performance of a sampling of a typical big bank family of mutual funds, indicates a maximum annualized capital gain of 4.5%. Also the maximum interest return was 4.4%. Noting inflation at approximately 3%, the real returned capital gain was 1.5% and the real returned interest was 1.4%. Given the average management expense ratio of the public funds at 2% gross, it can be understood that it is challenging for even professionals to make "serious" money. Privately managed portfolios under investment managers can earn substantially greater real returns for "high net worth" account holders (i.e. minimum C\$100,000.00 and preferably C\$1,000,000.00 under portfolio management).

The prospective investor can consider this mutual fund performance (a typical market example), as a comparable benchmark and then select equities whose capital and interest gains outperform it, using publicly available stock information from print or digital media. Doing this exercise on paper firstly for several months, in theory, gives real world practice in investing, without the losses that inevitably occur through trial and error, stock market risk, currency risk, macroeconomic event risk and microeconomic event risk. That is a lot of risks to endure, so thoughts of any strategies to "beat the market" through so-called "special situations" and "systems" must be understood as high risk gambling, not for the serious investor.

Profit from stocks follow the buy low then sell high dictum. This produces a one time monetization of the value gained by the equity. Now what is to be done with the cash profit after commissions and interest payable for loans for investment purposes? To take a new stock position immediately only re-capitalized the cash leaving zero net cash profit after trading commissions. What the investor optimally seeks is not capital gains alone, but steady cash income. Only stocks that pay cash income are suitable candidates for the investor is one proven investing principle: Debt equities (bonds, debentures mortgage back securities and preferred securities), dividend paying common stocks and preferred shares. The return on this asset class, is approximately 5% annually simple interest. The real return is then about 2%. This is marginally greater than the comparable benchmark but does not enjoy the professionally managed aspect of the portfolio, in lieu of self managed portfolio even requiring full-time attention. Thus the returns are roughly equal all things considered.

The challenge remains to outperform 5% per annum this typical mutual fund income benchmark, preferably through a steady cash stream on a monthly or quarterly basis. A solution is offered by the derivatives asset class, comprising especially, but not limited to: call options, put options, and futures. Restivo analysis will show the advantages needed and supplied by so-called writing covered call options on stocks that one already owns. Bear in mind that even the best risk management may not be sufficient to prevent gradual, if not sudden, loss of invested capital, so careful due diligence must precede the execution of any investment strategy.

Options Investing

A “call option” gives the purchaser the right, but not the obligation, to buy a stipulated stock at a previously agreed upon amount called the strike price and within a defined and limited time period at which time limit the option value and rights expire worthless. Consider stock XYZ trading at \$10.00 on the stock market and possessing call options (so-called call option chain) at various strikes. Strikes = \$10.00 are called “at the money”. Strikes < \$10.00 are called “in the money”. Strikes <<\$10.00 are called “deep in the money”. Strikes > \$10.00 are called “out of the money”. Strikes >> \$10.00 are called “deep out of the money”.

For example purposes, an XYZ call at \$12.00, 3 months in the future is trading at “.50” as indicated in the media. A call represents 100 shares, so the real price must be multiplied by 100 to show \$50.00 per call. The minimum stock purchase is called a “board lot” of 100 shares, irregular quantities of stocks, called odd lots, are much more difficult to buy and sell. To offset the cost of trading commissions 200 shares of XYZ will be bought, “at the market” price, on paper in this example. The cost excluding expenses involved is $200 \times \$10.00 = \$2,000.00$.

As soon as the trade is completed or “filled” as confirmed by the trader through your brokerage account, preferably a banking discount brokerage, 2 calls of XYZ at \$12.00 strike at such and such a month (i.e. 3 months to expiry in the future) are “written” that is sold at the “market”. The cash proceeds of sale are $2 \times \$0.50 \times 100 = \100.00 . Upon expiry in 3 months the call write can be repeated for another cash profit at prevailing call prices which can vary but can be compensated by taking a strike closer to the money or more out of the money.

Given that this particular stock, through due diligence prior research, showed a slow and steady growth over the previous year and preferably over 3 years, and that in general, equities’ up and down market performance are “statistically mean seeking”, that is, rides close to their so-called “200 day moving average”, the average call option cost for this stock will be about the same.

Performance for more volatile stocks and under the influences of financial risks mentioned previously, can and will affect the price. Option prices are calculated using a partial differential equation called the Black-Scholes equation and are influenced mostly by the price volatility of the underlying stock. Thus the optimum stock selection for covered call writing is one of steady if not slightly growing performance. This will ensure a consistent future expectancy with respect to writing covered call profits. What will be that gross rate of cash income return?

On average, Restivo analysis of performance determines that real world stock market option to stock ROI (i.e. return on investment) ranges from 12% to 25%+ simple interest per year, considering a wide range of suitable equity candidates. Many stocks to not have corresponding options and due to Restivo analysis of fundamental financial evaluation, are disqualified from stock ownership and/or option writing (either no option chain exists or the prices are comparatively too low).

Compared to the example mutual fund income benchmark of 4.4%, a self managed stock portfolio is capable of producing cash income consistently as much as 25% or more. In principle this is a preferable investment strategy, but more must be considered to make it worth while: portfolio risk management and techniques available to minimize the inevitable usual financial losses.

The day after an investor completes the previous theoretical example trade, the value of the stock slowly declines in a week and loses 10% of its value. What to do? Considering cash proceeds adjusting the cost base of stock acquisition, the net book value is then $\$2,000.00 - \$100.00 = \$1,800.00$. The 10% decline in stock value is $200 \times (0.90 \times \$10.00) = \$1,800.00$, which is break even at this price point.

Consider if the investor only owned the stock: This is a gross loss of 10% during the time period involved, that is, a loss of \$100.00 in theory. Only if and when the stock is actually sold at the market does this theoretical loss become realized. One may decide to hold and wait for the stock to rebound to increased capital value following its 200 day moving average, all things being equal, which they never are.

Consider if the investor determines from media information that further declines are possible. A “put” option at a corresponding strike as the call could be bought, which option will appreciate in value as the underlying equity declines, thus largely but not completely offsetting losses. Sale for cash of this option at the market may not return income sufficient to cover all declines after buying the put, due to commissions and prevailing option price bid ask spread difference, but most of the loss will be covered. This is loss minimization, not zero loss of fantasy.

Consider further at option expiry, the underlying has not declined further on average. Option writing can be done again for continued income. On average Restivo analysis indicates about 3 years duration required to return cash equal to a given initial outlay for the underlying stock. This performance encourages a buy and hold strategy even during price fluctuations or a 10% decline.

Consider a further decline of another 10% after the second call option is written. The income offsets the capital loss at zero gross profit if actualized upon the recommended sale of the stock. In 6 months at expiry of the second call option written, and underlying equity sale at the market, zero net income results, if not a slight negative income, due to commissions and inflation.

There exists the temptation to average down the cost base of the stock with additional at market buys, to return to a less of a loss position. What loss? “Opportunity cost” loss only: A relatively risk free investment in a typical monthly income paying bond mutual fund would have returned a 5% annually rate on average or 2.5% average during the 6 months duration in this example.

Advantages of Covered Call Writing

1. The additional periodic cash income contributes to the real interest rate of return over and above the cash from quarterly dividends, if any, received.
2. The cash income offsets stock value declines such that time is allowed to decide to keep the underlying equity or sell it at break even at option expiry. Buying put options is an additional loss minimization technique that may or may not be required.
3. Unless stock value declines 20% or more, holding the position, not accumulating or addition more, is practical, as one particular stock position, involving hundreds of shares perhaps, must be but one of a diversified stock portfolio whose business sectors are as little correlated as possible. This diversification helps minimize market or systemic risk, but cannot completely eliminate it.
4. Writing call options does not draw the writer into option market risk, as the cash premiums received can be taken “off the table”, as it were, with no liability whatever the direction of the option market. There is then no option market systemic risk in writing covered call options, however the terms of options contracts bind the writer not to sell the underlying stock during the option duration or equivalently cash secure it.

In the event of an unacceptable stock decline, the option could be re-purchased at prevailing option market prices. The underlying stock then could be sold at a realized loss. To avoid an impulsive panic sale during a short term transitory price gyration, relying on the compensatory income of the option premiums received is a risk minimization technique unavailable through stock ownership alone.

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