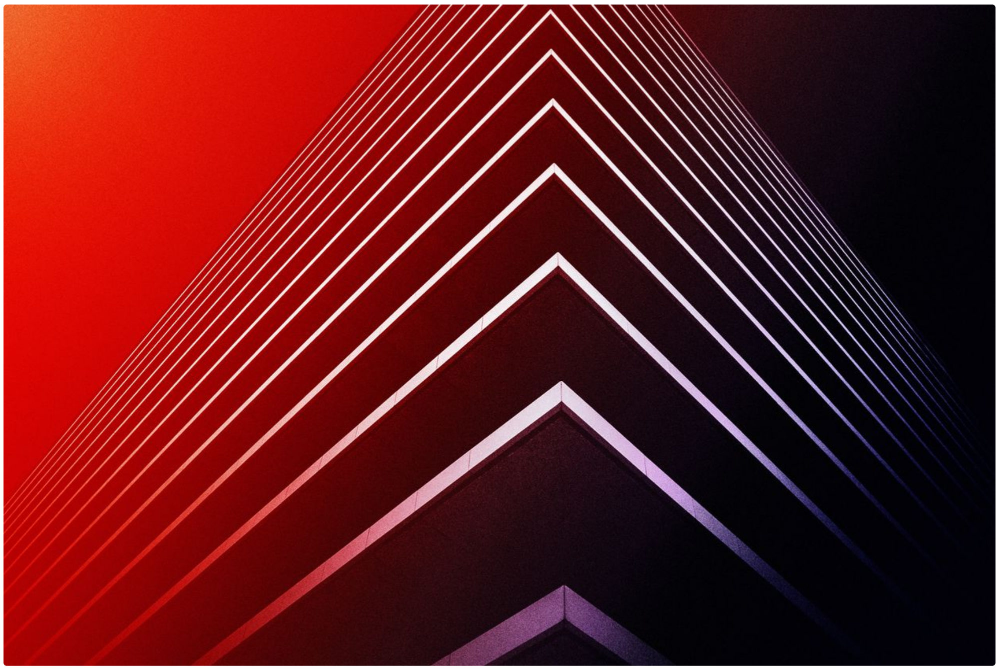
OPTIONS | STRIKING PRICE

How to Prevent Your Options Strategy From Backfiring

By Steven M. Sears Oct. 25, 2019 5:30 am ET



Photograph by Josh Rose

One of the great investing riddles is how to reduce portfolio risk without sacrificing profitability.

Many investors try diversifying portfolios with stocks and bonds. Others buy defensive put options that increase in value when associated security prices decline.

But such strategies are often ineffective. Stocks and bonds frequently behave like each other due to the interconnectedness of markets and the rise of passive investing. And many investors who buy puts find that profits elude them if they fail to perfectly time the stock market's declines.

Now, with stock prices near historic highs and many bonds also trading at stratospheric prices, investors are increasingly worried that slowing global economic growth will eventually push markets lower.

Those concerns are exacerbated by a popular investment strategy: selling call and put options in a wager that stock prices will keep rising and options premiums will keep declining. The strategy works great when stocks advance, but it can explode like a bomb if stock prices weaken.

It did so in February 2018, when the Cboe Volatility Index, or VIX, jumped 115% in one day as the S&P 500 index fell 4%. The selloff was triggered by exchange-traded products that made it easy for investors to sell options—effectively wagering that stock prices would keep advancing and the VIX would ebb ever lower. Since then, the S&P 500 has returned 18%, the VIX has plunged, and options-selling strategies have become even more popular.

Zem Sternberg, one of the options market's most respected traders, is using the low-volatility investing craze to power a strategy designed to produce returns that match the stock market's upside while outperforming when the market swoons. He does this by actively trading index options and futures to hedge portfolios. The moving parts of the strategy are complicated, but the essence is simple: creating hedges that are constantly curated to protect portfolios without paying so much money as to harm overall profitability.

As investors keep selling options, which suppresses implied volatility, Sternberg's investment firm, Lake Hill Capital Management, buys S&P 500 options and futures to create portfolio hedges at reduced prices. To further reduce the expense of continuous hedging, Lake Hill trades S&P 500 options and futures on a daily basis.

Over the past 20 years, the strategy's cumulative annual return is 7.4%, compared with 7.5% for the S&P 500 and 4.6% for the Cboe S&P 500 5% Put Protection index, Lake Hill reports. The strategy has also outperformed in market declines.

Sternberg's firm essentially trades hedges like any other options position, which requires a deep understanding of thousands of index options and futures contracts. Most investors treat hedges like insurance policies. Even when they can sell them for big profits, many do nothing because they're convinced that volatility will keep rising and increase the hedge's value.

"It's easy to just buy a put," Sternberg says. "The question is, when do you sell? When someone buys a $2 put and it goes to $80, and you ask what they did with the put, the answer is often nothing, as they had no process to sell."

Anyone concerned with maximizing returns and reducing risks can learn from Sternberg's approach.

For some time, investors have fretted that the traditional strategy of investing 60% of a portfolio in stocks and 40% in bonds has failed to produce optimal results. Blame it on the rising correlations between asset classes.

The growing awareness that old ways of managing money are no longer as effective may help answer another great investment question: How and where should investors use options in their portfolios?

The likely answer is that investors, big and small, should swap out some of their bonds for options strategies that reduce the risk of owning equities in ways that bonds should, but often fail to. In other words, diversification diversifies, but it doesn't necessarily reduce portfolio risk. Hedging does.

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