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Option Strategies to Consider for 2023

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Option Strategies for 2023

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A copy is also available at: http://www.optionsclearing.com/publications/risks/riskstoc.pdf

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Host Profile
(Gareth Ryan)

- Founded IUR Capital Ltd in 2007, IUR Capital LLC in 2010
- IUR Capital is an investment advisor for institutional and retail investors
- Focused in exchange-traded option strategies

“Bear markets are the true test of every investor.”

(Me. December 2022)

Market Update…how was your 2022?

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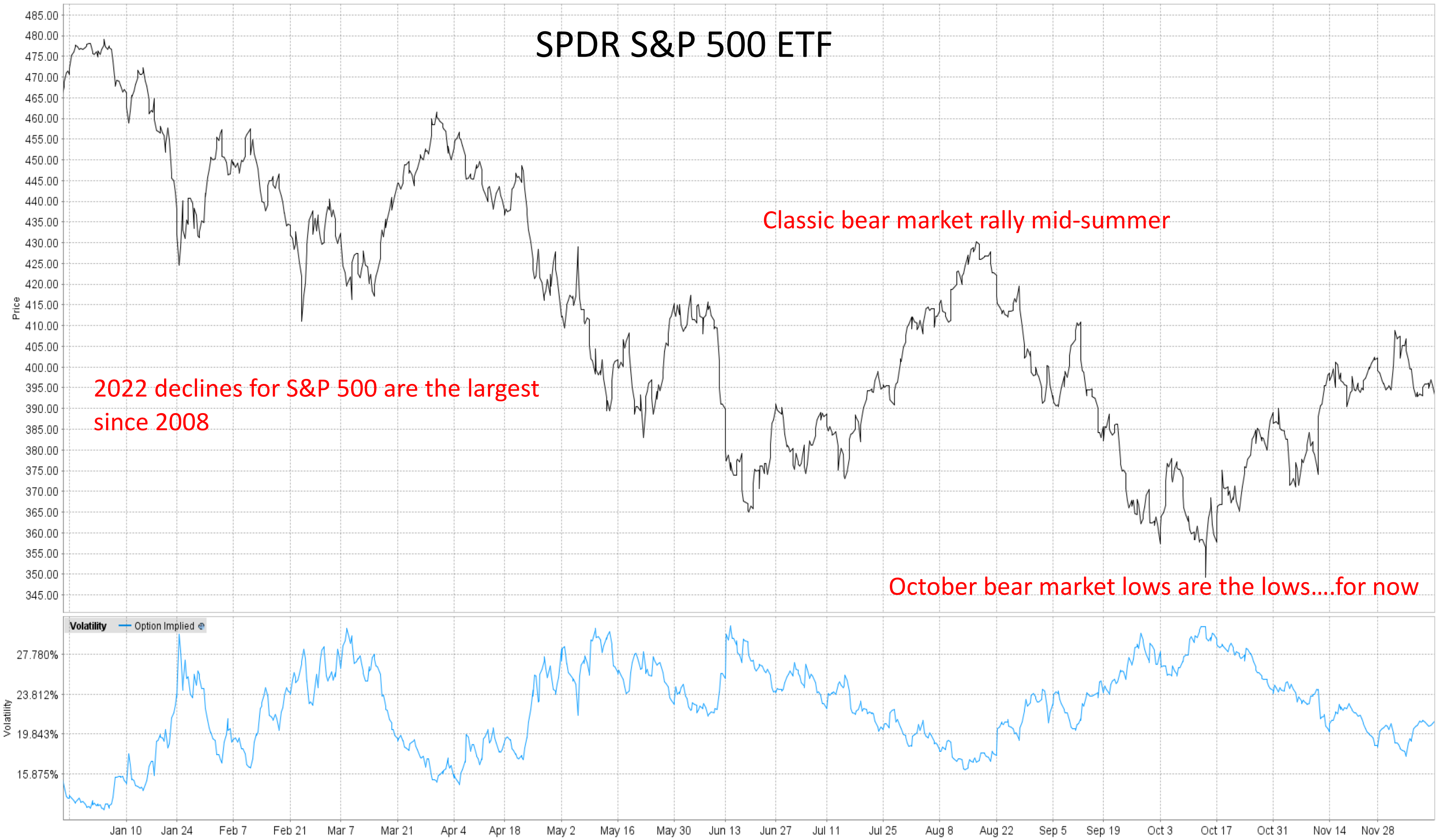
- SPX -17% YTD / Nasdaq -30% YTD
- 10Y Treasury Yields peaked above 4%
- Growth names down >50% this year
- Energy the lone outperformer in 2022
- Fastest change in rate environment in 40 years
- VIX peaked at 38 in 2022….have we underestimated this bear market?
- Expect 3-4% market move this week, post CPI/Fed meeting

Source: Bloomberg/IBKR

(As of December 7, 2022)

S&P 500 YTD….it's been a tough year for US equity markets



Source: IBKR TWS

Bear market in tech has been brutal in 2022...software/internet stocks -50%

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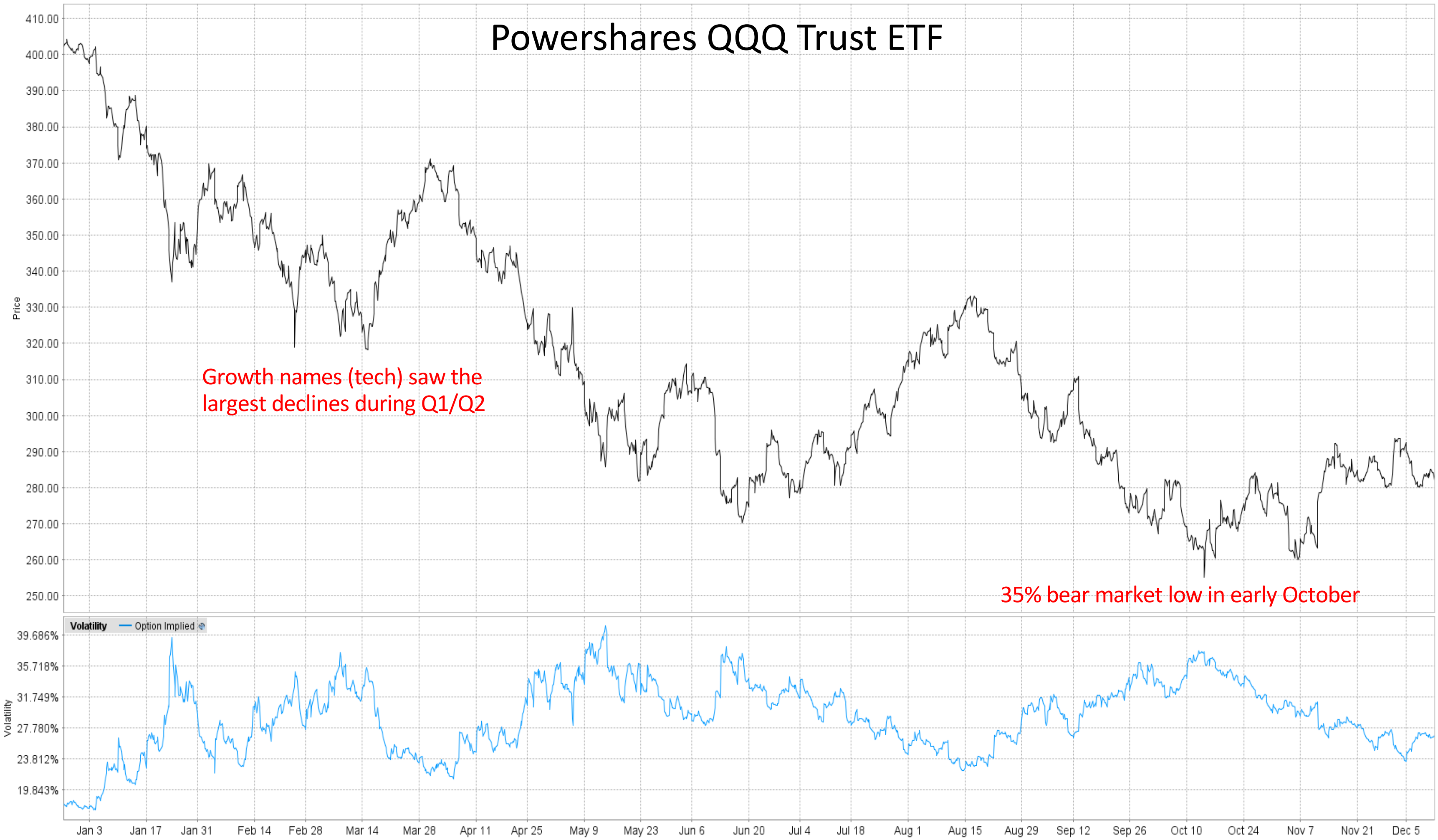

Source: IBKR TWS

Everyone becomes concerned about the VIX during market sell-offs…

Source: IBKR TWS

Question of the day….

Will the S&P 500 close above 4000 on December 31st?

Answers please in the Q&A Panel

What causes volatility, and why is volatility important?

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- The March 2020 market meltdown saw historic moves in x-asset volatility:
- *1: Fastest ever correction for S&P 500*
  2: Fastest ever bear market for S&P 500
  3: Record VIX print of 84
  4: Dow has two of its largest ever daily points declines in the same week
  5: US equity options volume breaks new daily records
- High volatility = High option pricing
- Fed talk / Fed action
- Economic reports (jobs reports / inflation data / manufacturing data)
- Investor sentiment
- Why did we see a smaller move in volatility in 2022 relative to March 2020?

Scenario 1:
$5m portfolio

- You are middle-aged, married with 0 / 1 dependent
- You are looking to supplement income from employment through your current portfolio
- Currently invested in bonds, mutual fund, dividend-paying stocks
- You need to generate consistent income in the portfolio BUT with a focus on capital preservation
- You are willing to allocate 15-20% of the overall portfolio to a conservative options strategy to generate regular premium
- You want to achieve regular premium even if the market remains flat

Scenario 2:
$500k retirement account

- You are nearing retirement or already retired, with no dependents
- Your income has dropped, but you are wary that you will still have living costs for you and your spouse
- Mostly invested in bonds with a small element of stocks, but your dividend income is not sufficient for regular drawdowns
- Preserving your capital in your retirement accounts is a priority
- But you are willing to look at an income strategy using options that does not require a rising market
- You want to achieve regular premium even if the market remains flat

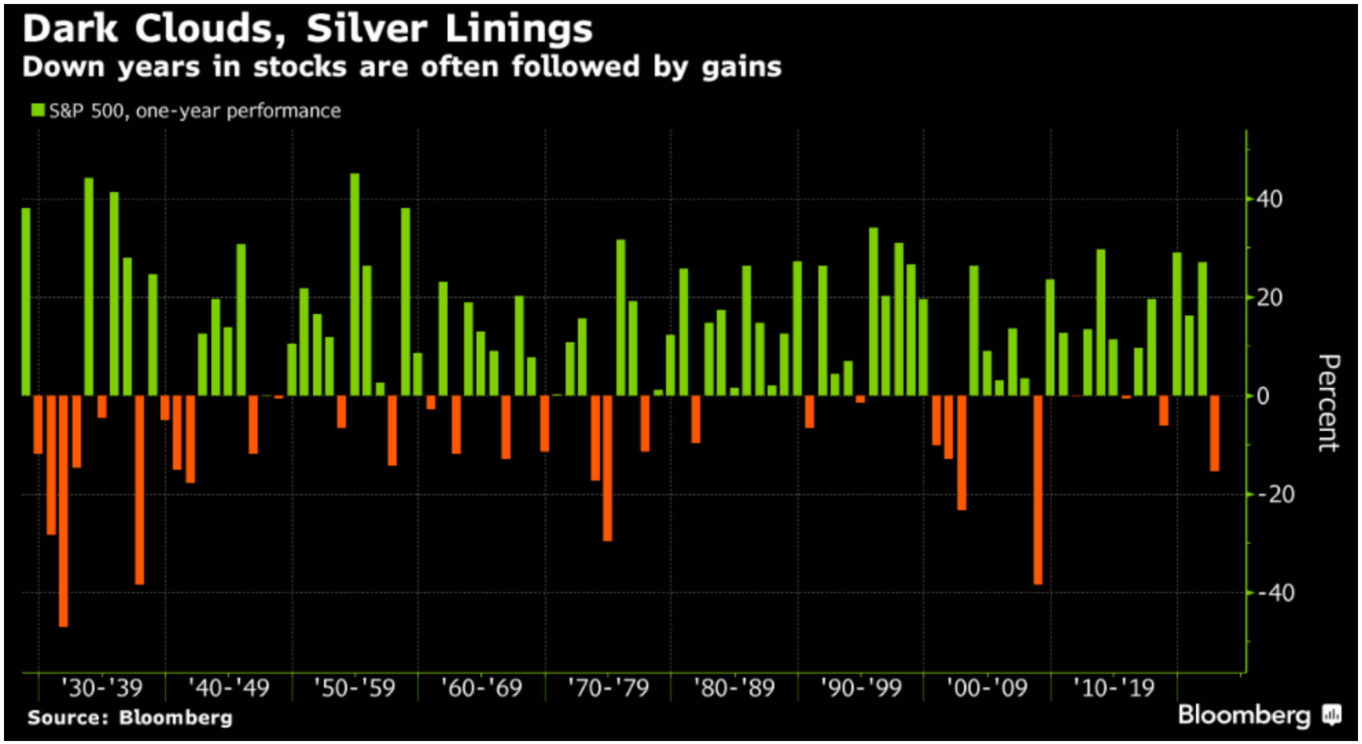
Some common themes we have saw with self-directed investors this year

- Portfolio was heavily tech-driven in 2021 (software/internet stocks)
- Significant unrealized gains carried into 2022
- Little (if any) hedging taken on these single names (ie; collar strategy), lack of knowledge in option strategies
- Portfolio has given back >50% of these unrealized gains since January
- Growth names in the portfolio having the largest impact from change in rate environment
- What should the approach be in the coming 12 months?

Source: IUR Capital

And now the good news….

- Stocks don't often fall two years in a row - Red years are *usually* followed by green ones
- In fact, a down-year is almost three times as likely to be followed by an up-year as by another down year*



*Based on data series going back to 1928

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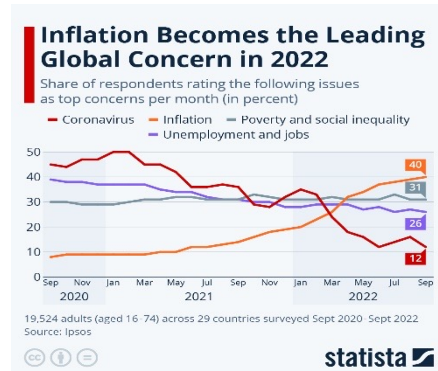
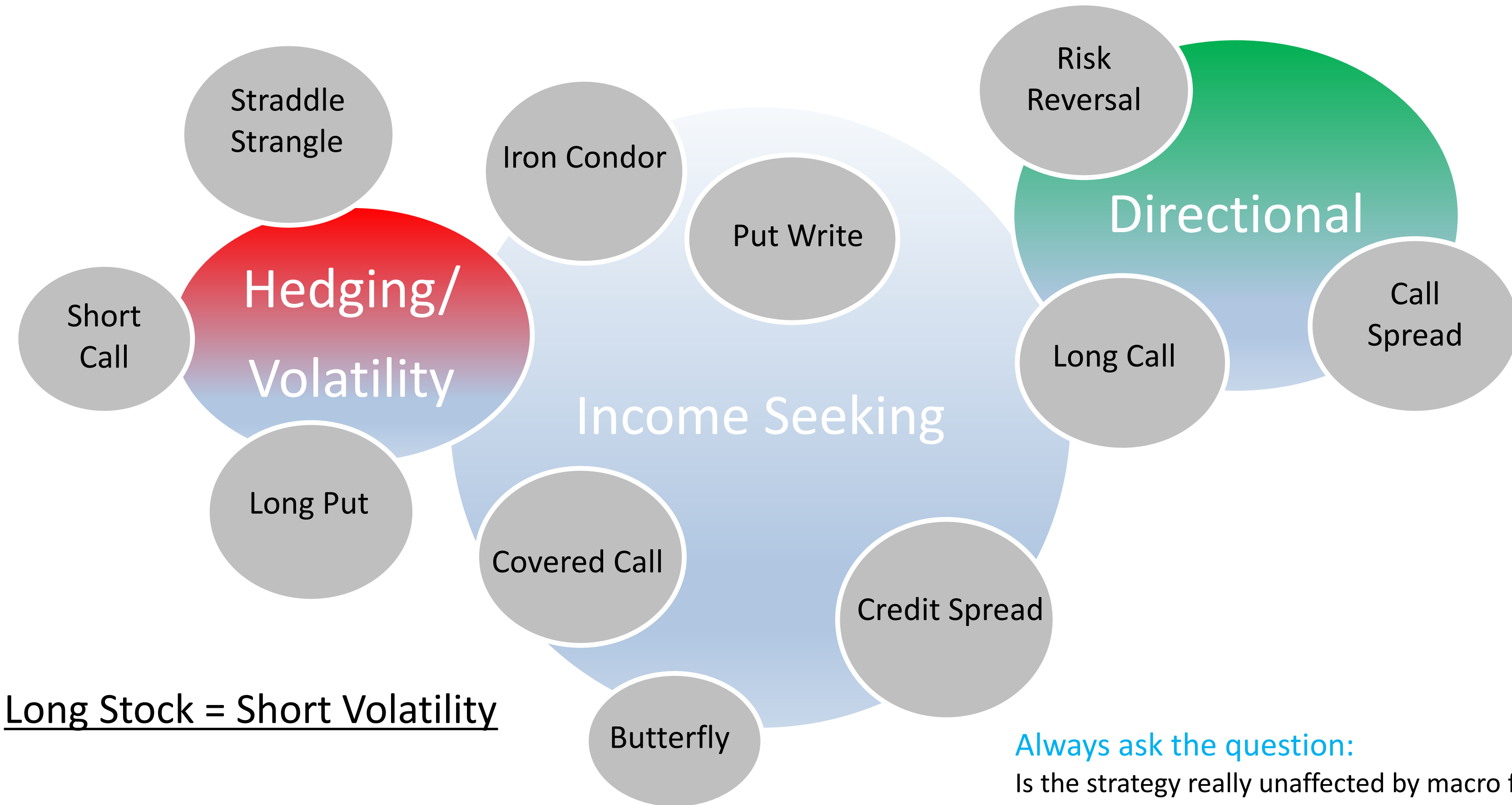
What we need to watch in early 2023:



Questions to ask about option strategies for 2023:

- What are the objectives for an equity/fixed income portfolio?
- How can option strategies achieve a "*net benefit*"?
- If **seeking income** with options, what risk/return profile is appropriate?
- If taking **directional positioning** with options, what strategies can we use?
- For **hedging** an equity portfolio with options, how can we justify costs?
- Do we have sufficient knowledge of the various strategies available?

Strategy Suite for 2023



<u>Long Stock = Short Volatility</u>

Always ask the question:
Is the strategy really unaffected by macro forces (growth, inflation, monetary policy)?
How to react if the sensitivity changes over time?
Adapt the strategy / Lower expected potential

Options involve risk and are not suitable for all investors. Multiple leg strategies, including spreads, will incur multiple transaction costs

Systematic vs Discretionary….

Systematic

Creates an "auto-pilot"

Options rolled at expiry each month

Strike selection pre-defined

Fixed time horizon

Minimal variation in market timing

Involves continuous market exposure

Seeks to perform consistently in low volatility

Avoid over-trading

Discretionary/Opportunistic

Option Strategy / Market Bias can vary

Positions rolled only when appropriate

Strike selection may change each month

Time horizon to vary based on market conditions

Does not seek on-going exposure to volatility / market moves

Seeks to benefit from extreme market moves

Avoid missing opportunities

Income-seeking strategies… an overview

Objective	To generate regular premium to portfolio / generate income	
Setup	Selling of put / call options for premium on underlying security Carries inherent market exposure	
Covered Call	Credit Spread	Iron Condor / Iron Butterfly
When it works:	Moderately trending market Sideways market	
Risks:	Sharp market moves with no hedge Realized volatility is higher than implied volatility	

Using index options as a vehicle for income

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- Vertical Spreads
- Creates defined-risk, defined-reward scenario
- Buy one option, sell another
- Same underlying
- Same expiration
- Different strike prices
- Established as a credit spread
  (premium received on opening transaction)

Stock Repair Strategy

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- Multi-leg option strategy used to help recover losses from tech holdings
- Limited profit potential, seeks to lower the break-even price of our long stock position
- Reduces our upside participation, can be used as alternative to waiting for stock price to recover to repair loss
- Best outcome is break even on the original long stock position

Let's look at the setup…

- Call ratio spread combined with our long stock position
- Buying ATM call + Selling two OTM calls at higher strike
- Established at either a credit or at zero
- Best outcome is break even on the original long stock position

What else do we need to think about?

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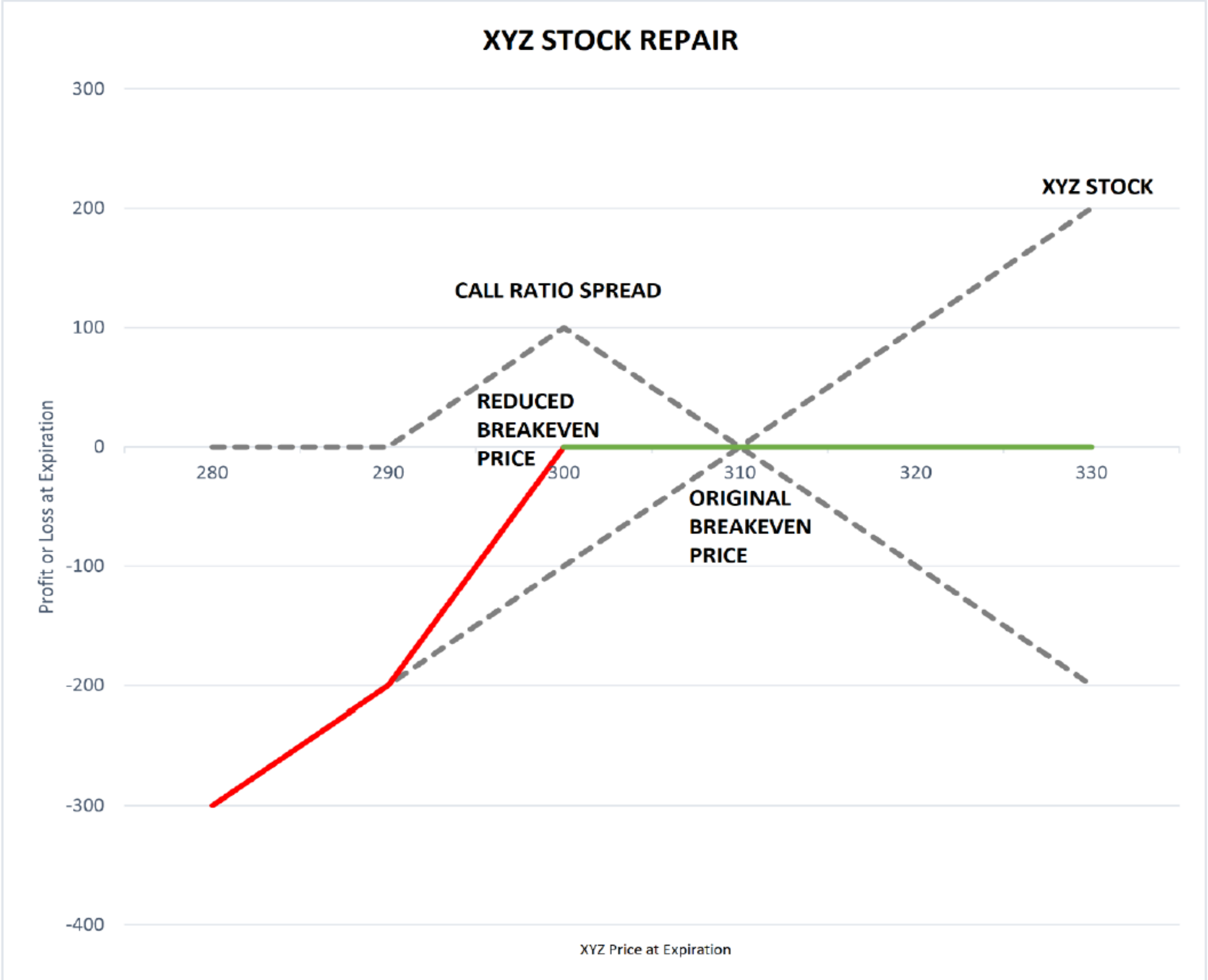
- **Adjusting a stock repair** – if we no longer want to break-even and are looking for more upside on our long stock
- **Rolling our stock repair** – if our long stock is above the long call at expiry and we want to extend our time horizon
- **What about hedging**? Stock repair seeks to lower our break-even on our long stock position, so hedging the stock repair would not be an objective

And our payoff…



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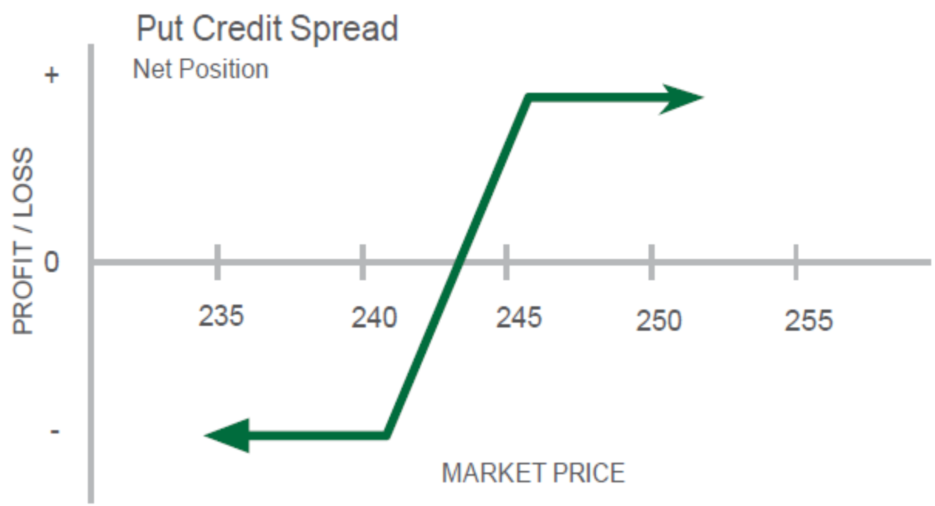
S&P 500 Index
Credit Spread Strategy

- Seeks to harvest premium on a continuous basis to the portfolio using both put spread and call spread premium S&P 500 index.
- Makes use of short-dated and long-dated options
- Can be used on any equity index or index ETF.

2023 Approach

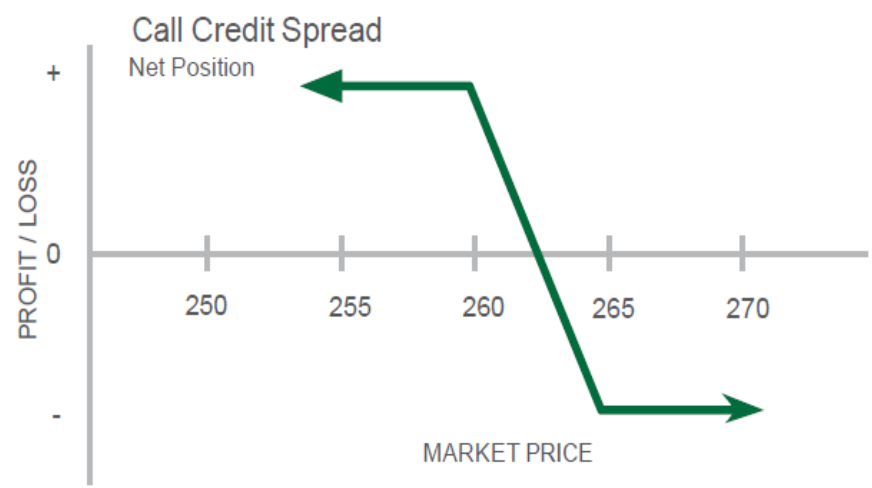
- Combine weeklies and traditional monthlies to harvest premium
- Weeklies setup could be as short as 14 days
- Consider an outright hedge

Credit Spread Strategy for income



Defined risk

Defined return



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Risk Management

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- Both maximum gain and maximum loss are defined
- Best case scenario is both legs of the credit spread expire OTM at zero
- Worst case scenario is for the index ETF to fall below the lower strike at expiry (put credit spread) or above the higher strike (call credit spread)
- Adjustment points determined at the outset to avoid assignment
- Credit Spread Strategy can also be hedged to reduce directional exposure
- **This requires active management of the position…**

Reasons to hedge with options…

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"Everybody's got plans…until they get hit."

Mike Tyson

- **Economic**
- Correct for "wrong-way market bias"
- Reduce portfolio volatility at appropriate cost

- **Behavioural**
- Hedging should be a mouthguard, helps to avoid big psychological hits during major market events…like earnings
- Also helps us to stay the course…are you short-term or long-term with your horizon?

Reasons to hedge with options…cont'd

- **By having an explicit approach to hedging in place, we can more accurately determine the "lay of the land" during sharp market selloffs**

- We planned for this

- We hedged in anticipation

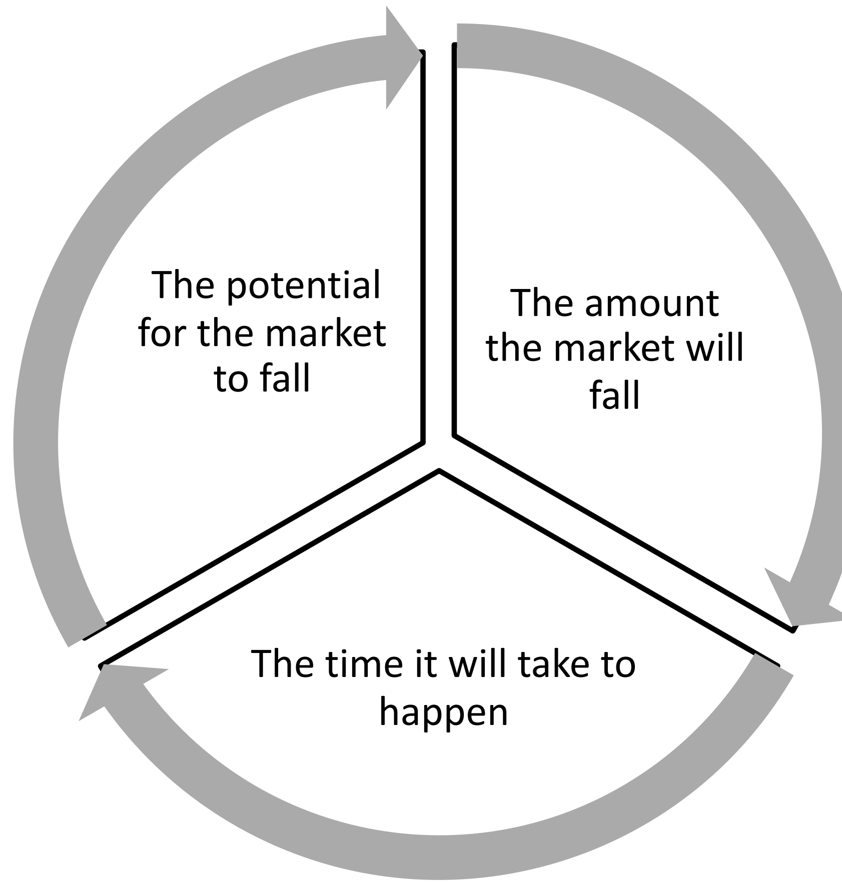
- We are better positioned for this situation than we were previously

- If the portfolio is heavily exposed to tech, the recent correction necessitates at least partially reducing your risk with puts

Protection is cheaper than you think…

To be successful with hedging using put options, we need to be right about three things:

- **Fixed costs** – what will we spend on premium?
- **Standalone** – expected return of the protection element of the portfolio?
- **Portfolio cost** – What is the marginal effect on the portfolio from continually hedging with puts?



Making option-based strategies work in a portfolio…..

Look at Market Conditions

What strikes should you use?

What underlying security?

What about time horizon?

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Let's talk…

Email me gryan@iurcapital.com to request the slides or to have a chat….