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Volatility Strategies for a Volatile Market

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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 on exchange-traded option strategies

A recent discussion with a retail investor…..

Client: "*Buying puts is an expensive way to hedge my portfolio*".

IUR: "*Big losses as a result of no hedge will be even more expensive!".*

Market Update

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- SPX / Nasdaq both 20% YTD
- Tech continues to drive broader market sentiment, lack of headwinds
- VIX trending lower and now below January 2020 levels
- Risk assets continue to see inflows with an accommodative Fed
- The retail investor is now a central part of daily volumes
- Are you back in the office yet?

(As of August 30, 2021)

“Mean reversion” Volatility

- The events of early 2020 have set a permanent mark on cross-asset volatility and how it is priced
- High volatility = High option pricing
- Implied volatility tells us what the options market is *implying* in terms of market moves
- The reversion to a pre-Covid volatility environment continues into Q4
- For as long as volatility continues to decline, the cost of insurance (puts) will be significantly lower than March 2020…time to buy a cheap hedge?

The VIX tells its own story about *implied* market moves…

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CBOE VIX 5 YEAR

Source: Bloomberg

Question of the day….

Should we be a BUYER or SELLER of volatility at current levels?

Answers please in the Q&A Panel

Buying Puts =
Buying Volatility

Selling Puts =
Selling Volatility

Questions to ask about option strategies:

- 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 position with options, how can we justify costs?
- Do we have sufficient knowledge of the various strategies available?

Strategy Suite

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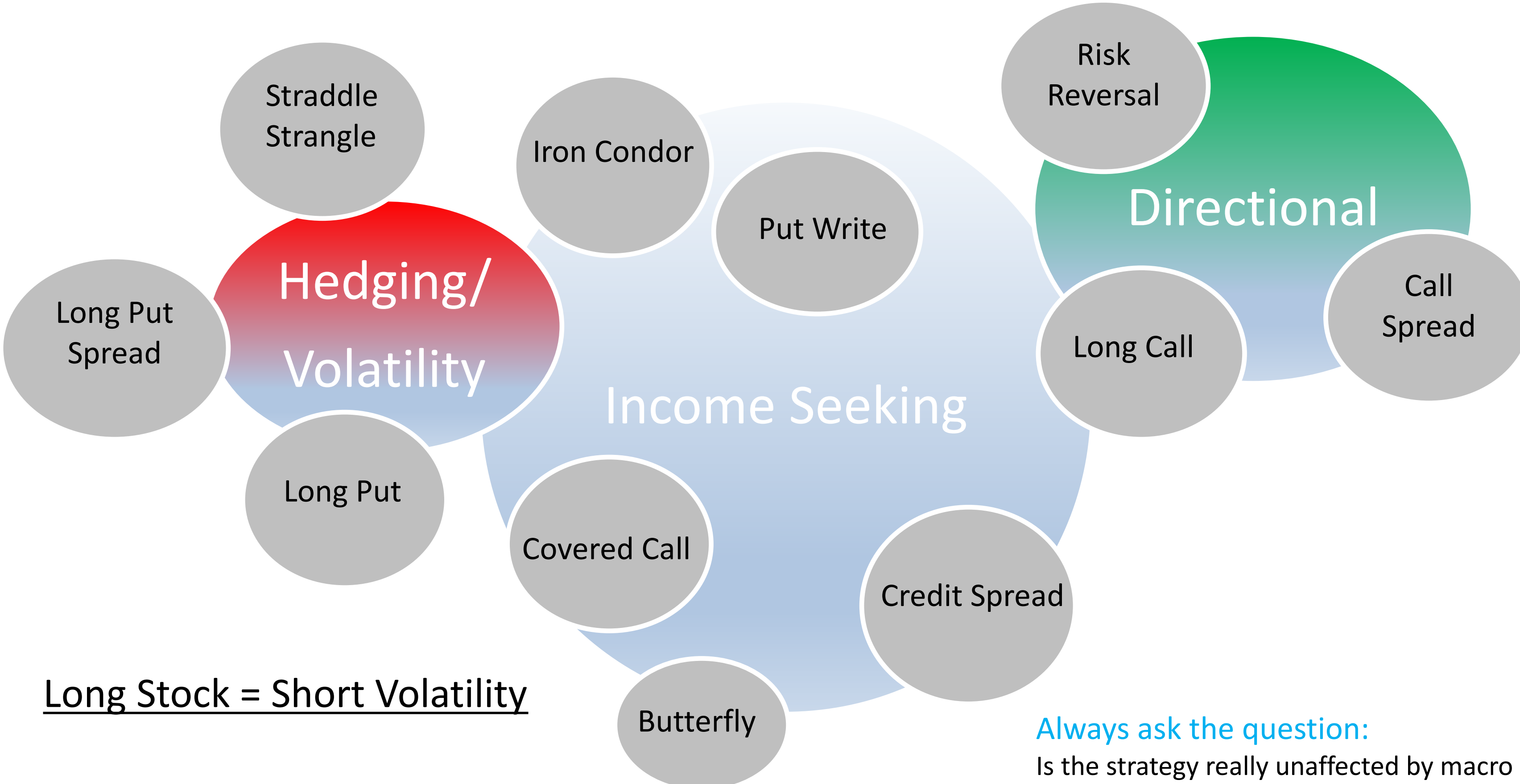

<u>Long Stock = Short Volatility</u>

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

Am I long vol or short vol? (Spreads)

Strategy	Vega	Rise in IV	Fall in IV
Long Strangle	Positive / Long	Gain	Loss
Long Straddle	Positive / Long	Gain	Loss
Credit Spread	Negative / Short	Loss	Gain
Debit Spread	Positive / Long	Gain	Loss
Butterfly Spread	Negative / Short	Loss	Gain
Calendar Spread	Positive / Long	Loss	Gain

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Potential Volatility Strategies

- Why the straddle or strangle?
- Speculating volatility of the stock
- Straddle BUYERS expect higher volatility
- Straddle SELLERS expect lower volatility
- Stranglers expect a similar movement, BUT with a different risk/return scenario

The Long Straddle

- Purchase of one call
- Purchase of one put
- Same strike price, underlying and expiry date.
- Risk Profile
- Maximum Risk – Net Debit
- Maximum Reward – Unlimited
- Downside Breakeven – Strike less net debit
- Upside Breakeven – Strike plus net debit

The Long Straddle Example

- With XYZ stock trading at $50.00
- Buy 1 XYZ 50 Call at $3.20
- Buy 1 XYZ 50 Put at $3.00
- Net Cost $6.20 * 100 = $620.00
- The “50 straddle” is purchased for a total cost of $620 plus commissions.

Long Straddle P&L

Stock price	50 Call Profit/Loss	50 Put Profit/Loss	Net Profit/Loss
$60.00	$680	($300)	$380
$55.00	$180	($300)	($120)
$50.00	($320)	($300)	($620)
$45.00	($320)	$200	($120)
$40.00	($320)	$700	$380

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Long Straddle P&L

	50 Call Profit/Loss	50 Put Profit/Loss	Net Profit/Loss
Stock Price	$50.00	$60.00	20%
Days to Expiration	60	32	
50 Call	$320	$1020	220%
50 Put	$300	$15	(95%)
50 Straddle	$620	$1035	67%

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The Long Strangle Example

- XYZ stock trading at $50.00
- Buy 1 XYZ 55 Call at $1.40
- Buy 1 XYZ 45 Put for $1.05
- Net Cost $2.45
- The “45-55 Strangle” is purchased for a total of $245 plus commissions.

Long Strangle P&L

Stock price	55 Call Profit/Loss	45 Put Profit/Loss	Net Profit/Loss
$60.00	$360	($105)	$255
$55.00	($140)	($105)	($245)
$50.00	($140)	($105)	($245)
$45.00	($140)	($105)	($245)
$40.00	($140)	$395	$255

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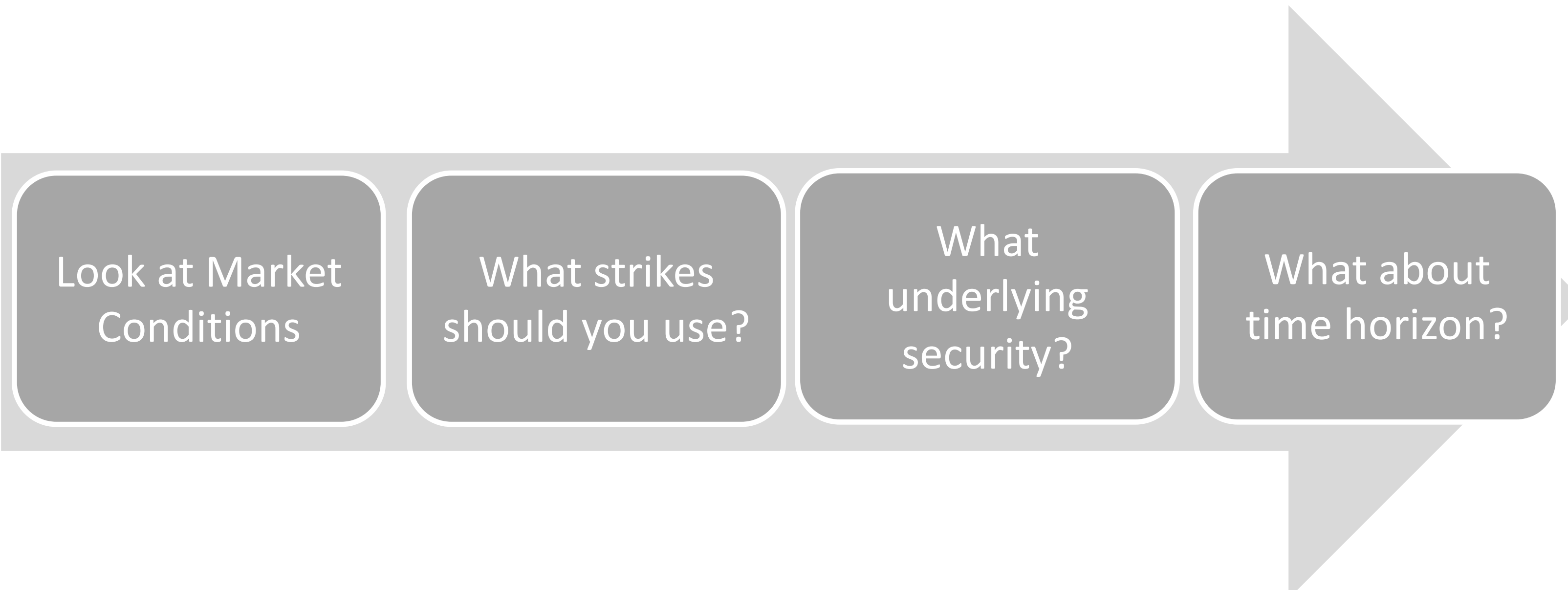
Straddles vs Strangles

- Strangle – Maximum loss possible over wider range than straddle
- Straddle – Maximum loss only if stock = strike price at expiry
- Combination (strangle) – Maximum loss anywhere between two strikes at expiry

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



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Let’s talk…

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