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WEALTH MANAGEMENT

The View

November 2011

Investing and Wealth Management Insights

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Use Market Volatility to Your Advantage

Options are not to be feared

Contrary to popular belief, options are not exotic, overly complex, excessively risky instruments. In reality, options are a critical part of financial markets and absolutely essential to managing risk for most institutional investors. In fact, using options can significantly REDUCE the risk of one's portfolio. The key to understanding options lies in knowing that the value of options is determined, largely, by volatility.

Indeed, the fundamental tenet of investing with options is that options increase in value as volatility increases. This is logical because investors are willing to pay more to reduce the uncertainty that accompanies volatility. An option that allows one to buy or sell a given stock in the future at a pre-established price, regardless of what happens to the market or the price of the stock, is worth more when volatility is high. Volatility increases uncertainty and when uncertainty is high, investors will pay more for certainty. Understanding this concept is central to developing any options strategy and is essential for knowing how to use the maddening market volatility to your advantage.



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Embrace market volatility

Market volatility is unnerving and can cause investors to make emotional decisions they may eventually regret. The violent, up and down swings in stocks, exacerbated by heightened media focus, erode investor confidence and undermine sound investing principles. It is human nature to be worried by frequent drops in the value of stocks, sometimes for no apparent reason, and many individuals have virtually given up on investing in equities.

Unfortunately, volatility is likely here to stay. The global de-leveraging process will restrain economic growth. As governments seek ways to get out from under enormous debt, they will cut programs and spending. While this is healthy for the long-term, declines in government spending will, at least initially, dampen growth. Historically, volatility is higher during times of slower economic growth. Intuitively, this makes sense as slower growth means there is less room for economies to absorb problems. Therefore, markets are more susceptible to shock. Indeed, Fidelity Research notes that market volatility is nearly **twice as high** when nominal economic growth is less than 4% vs. a more normal range of growth of 4% to 8%.

Use options to capitalize on market volatility

While abandoning equities may be tempting and seem like the “safe” thing to do given the extreme volatility, it is not optimal for investors due to the significant loss of potential return. Fortunately, there are strategies one can use to weather through market volatility, and, at times, actually benefit from it.

One of the simplest, most popular strategies is selling call options on stocks one owns, also known as selling or writing “covered calls.” A call option gives the owner the right to purchase a stock at a set price for a set length of time. If one owns stock and sells options on that stock, this is called “covered.” If one does not own stock and sells options on that stock, this is called “uncovered” or “naked.” Buying and selling options on an uncovered or naked basis involves much greater risk and uncertainty than employing covered strategies. Covered calls, on the other hand, are fairly simple, essentially risk-free, and can be quite effective.

Please review the last section of this newsletter to see a specific example of covered calls and an overview of the advantages of using options.



The Current View

What recession?

The long-term structural challenges facing the global economy are many and serious; including working through a de-leveraging of the excess debt accumulated the past two decades. This healing process – austerity, etc – will inhibit growth and likely restrain asset values. However, *growth*, albeit below normal, still seems the more probable scenario than contraction. Markets see things differently. Indeed, it appears that markets are assuming the U.S. has either already fallen into a recession or that it will soon. Aside from a robust bounce back in October, bond yields, commodity prices, and stock prices have all moved lower the past few months, a clear indication investors think the economy is contracting. What do the data tell us about the economy?

Contrary to popular opinion, recent data have been fairly strong, not only revealing that we are not in a recession, but also indicating many sectors seem to be producing healthy levels of growth.

Retail sales are relatively strong. Government data are subject to revision, manipulation, etc and therefore warrant a healthy dose of skepticism, but retail same store sales data give us a near real-time look at consumer spending trends. Recently reported sales data were solid for many companies. Aggregate retail sales at U.S. chain stores in September came in better than expected, averaging a 5.1% gain vs. 4.6% estimate, and increased again by 3.4% in October. Gains ranged from upper single digits at higher end stores like Nordstrom, to low to mid-single digit increases at department and general merchandise stores like Kohl's, Dillard's, Target, and T.J. Maxx.

As we have noted many times, corporate America is, on the whole, in good shape. The ability of companies to squeeze more productivity out of existing resources is probably constrained, but their ability to increase dividends is not. The 500 companies in the S&P 500 are currently paying out just 27% of their earnings in dividends. This is well below average and clearly shows the potential for dividend rate increases is high, particularly when one considers that these companies are sitting on nearly \$3 trillion in cash.

Other data points, including ISM surveys, auto sales, industrial production, and the Chicago PMI all confirm we are not in a recession. To be sure, many Americans would beg to differ, and it certainly "feels" like we are in a recession. Yet this could be another example of negativity and pessimism rising to the surface, obfuscating the real situation.

Q3 Earnings Scorecard Update

Total S&P 500 earnings are expected to be another record at \$25.43 per share, + 18% vs. Q3 of last year. Thus far, of the 447 companies that have reported earnings, 292 or 65% have beat estimates, 110 or 25% missed estimates, and 45 or 10% met estimates.



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Covered calls

How do covered calls work and when would one use them? Let's use an example: suppose an investor owns 500 shares of Apple. The value of Apple stock has increased over 100% over the past couple of years and now sits at around \$400 per share. Apple is a great company, with great products and great earnings, and the stock has done well in spite of significant market volatility, yet the investor is concerned that the value of her stock may fall if market volatility persists, especially if the U.S. economy goes into another recession. However, she doesn't want to sell the stock outright at \$400 because she believes there is a chance it could move higher if the market increases and/or when the new iPhone is released. To satisfy the dual objectives of obtaining downside protection at no cost, while simultaneously preserving some upside, she could engage in a covered call strategy on Apple stock.

In the example where our investor has 500 shares of Apple, we have selected the April 2012 \$440 call options. This means that the call options give a purchaser the right to buy Apple stock from the seller at \$440 per share, or 10% above the current price, any time before April 20, 2012. These options currently sell for around \$20 each, thus when our investor sells 500 options she collects \$10,000. This \$10,000 is hers to keep forever, regardless of what happens to the price of Apple. Now, let's suppose that the stock rises and falls over the ensuing six months but never eclipses \$440 and closes on April 20, 2012 at \$425. In this case, the options that someone purchased for \$20 each would expire worthless and the investor would keep her Apple stock and of course her \$10,000 as well. On the other hand, if the stock increased to a level above \$440 before April 20, 2012, the purchaser of the options would likely exercise them and purchase the 500 shares of Apple at the pre-established price of \$440 per share. Therefore, our investor would be required to sell her 500 shares to the option purchaser for \$440 each and would collect \$220,000 for the sale of 500 shares in addition to the \$10,000 she already collected for selling the options. As a result, the total collected per share in this case would be \$460 (\$440 + \$20).

Advantages of covered call option strategies

The advantages of this transaction, and covered calls in general, are many and include:

- **Protection**: The \$10,000 received for selling the options, known as the "premium", essentially serves as a free 5% protective buffer (\$20 divided by \$400) against a decline in the value of the stock. In other, words, all other things equal, the price of Apple would have to decline more than 5% (i.e. fall below \$380) in order for the investor to lose money from the time of the sale through expiration (April 20, 2012).
- **A great return on investment at no cost**: If the stock increases to a level above \$440, the purchaser of the options will exercise them and purchase the stock from our investor at \$440. Thus, the total collected of \$460 (\$440 + \$20 call option) represents a 15% return in just six months or an annualized return of 30%. Aside from the minimal transaction costs there is no incremental cost for this strategy. By any measure, this is a very attractive return with virtually no risk.



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- **Tax advantages:** If the call option purchaser exercises the options and purchases the stock from our investor, the total collected proceeds would be \$230,000 (\$220,000 for the sale of the stock + \$10,000 for the sale of the options). The beauty of covered call strategies is that if the options are exercised, the option premiums collected (\$10,000 in our example) are treated for tax reasons the same way the sale of the stock is treated. Therefore, assuming our investor has held Apple stock for longer than one year, the \$10,000 in option premiums, AND the gains from the sale of the stock will both be treated as long-term capital gains and taxed at 15%. Conversely, if the options are not exercised and expire worthless, the option premium is considered to be ordinary income and taxed accordingly.
- **Flexibility:** Commencing a covered call strategy does not lock one in to seeing it through until expiration. Indeed, any call options that are sold can be closed out any time before expiration by simply buying back the options. The value of the options will of course vary with the change in value of the underlying security, market volatility, etc., so the option trade will be closed with a gain if the value has declined and a loss if the value has increased. Closing out a covered call option trade early “frees” the investor to do whatever she chooses with the underlying stock.
- **Managing concentrated positions:** Large, concentrated positions often contain significant embedded capital gains. Therefore, investors are reluctant to sell the position because they are unwilling to incur the associated capital gains tax. However, there are substantial risks to holding concentrated positions, regardless of how “safe” or solid the stock may seem (see Lehman Brothers, Wachovia, AIG, Bear Stearns, BP, etc). It is unwise to hold on to a substantial concentrated position in any stock, and covered calls can help investors manage their concentrated positions. The premiums collected from selling call options can cover meaningful portions of any tax due as a result of selling the underlying stock. Moreover, the premiums collected can help protect investors that may be restricted or otherwise prevented from selling a concentrated position from a decline in the underlying stock price. Finally, strategies can be constructed to generate premiums from selling calls where the “risk” of the stock being called away is low, thus investors can synthetically create their own dividends on a stock.

Advanced option strategies

There are a myriad of other option strategies that investors can use to help manage risk. You may have heard these terms: “collars”, “spreads”, “straddles”, “strangles”, etc. Each of these terms equates to one of many dozens of established option strategies investors can use to help insulate and protect their portfolios. By combining *call* options with *put* options (which give the purchaser the right to *sell* a stock at a set price for a set period of time), investors can create almost any desired payoff scenario and therefore customize their own risk management strategy.

Of course, there is a price for everything, and the more protection one desires the more expensive the strategy. Covered call strategies are about as close as one can get with option investing to a free lunch. In devising more advanced option strategies, there are frequently tradeoffs between upside participation and downside protection, and investors must carefully weigh the implications of emphasizing one vs. the other. More downside protection usually means investors must purchase more expensive options and/or be willing to give up more of the potential upside.



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The key to maximizing the alternatives available to you in optimizing portfolio performance is to not dismiss the notion of options. Fear of the unknown is powerful, but we urge you to have an open mind. The process of identifying the right strategy, which may or may not include using options, starts with honest, candid communication between you and your advisor. By understanding your needs, concerns, and goals, advisors can help articulate the risks and opportunities inherent in your portfolio and then explore how options can help address these to help you achieve your goals.

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What's Your View?

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