Know What You Own: Options Income Strategies

Understanding the Diversity of Options Strategies

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While Morningstar's addition of the Options-Based Fund category is welcomed, it would benefit from further division into distinct subcategories. We would classify these subcategories as,

1. Hedging Strategies
2. Income strategies
3. Alpha/trading strategies

Our last post covered hedging strategies, so now we turn to income strategies, their primary objectives, variations, when they work, and their risks.

Options-Based Income Strategies

Like hedging strategies, income strategies typically have traditional, long holdings at the core of their portfolio. However, such strategies seek to supplement the returns of their portfolio by trading options. These trades typically involve the writing of short-term calls and/or puts. The compensation or "premiums" collected from this option writing can be an additional income stream to the return of the core holdings.

Variations within the Category

There are a few different types of approaches managers can take to generate income. Covered call strategies are one approach, and they typically hold a portfolio of equities and write calls on the portfolio. Another approach is with put-write strategies that typically hold cash or fixed income securities and write puts using cash as collateral. There are other trades that can generate income with varying levels of return and risk, but these two strategies are the most popular.

It is important to remember that income strategies do not explicitly hedge the market. While they might have lower overall risk and can help diversify a portfolio, by definition the purpose isn't to mitigate downside risk but to generate income.

When It Works

Income strategies typically work best in a gently rising market. A covered call strategy does well if the value of the long portfolio edges upward, but not so much that the short calls go in the money and further gains are called away. A put write strategy does well if markets go up, since the cash position will earn interest and the written puts expire worthless, leaving the writer with all of the premium. In calm markets, income-based strategies can make a lot of sense.

Possible Risks and Drawbacks

If income strategies do well in calm markets, it stands to reason that they will do poorly if markets make a big move, either up or down.

Opportunity Cost

If markets are trending strongly upwards, a covered call strategy could see a good portion of its market gains disappear. If a call is written, say, 2% out of the money and the market goes up 6%, the strategy will not enjoy the full upward move in the market. The gains to the strategy will be capped. The strategy essentially sold off the unknown potential for gains for the known gain of the option premium. This should be viewed as an opportunity cost.

Inability to Hedge Large Drawdowns

But the bigger risk to most income strategies happens when markets sell off. A covered call strategy consists of two parts: a traditional long position and some short calls. If markets sell off significantly, the premium collection from the short calls might offset a bit of the downward move in the long portfolio. However, in the face of a significant sell off the long portfolio is unhedged and premium from selling calls is unlikely to fully offset losses.

A put-write strategy has a similar risk-return profile. The cash position will help insulate against a market sell-off, but the short puts expose the strategy to losses the more the market goes down.

Leverage

Finally, one of the biggest risks to any strategy that writes options is leverage. If a strategy opts to write two, three, four, or more options against their collateral positions, the potential for losses can accelerate quickly. Many of the well-publicized blow-ups in derivative strategies can be blamed on leverage more than anything else.

Every Strategy Has a Purpose/Objective

Options-based strategies can be quite different from each other. This is why it's important to be able to differentiate between them. One of the more important steps is to figure out what the strategy's main objective is and see if it aligns with what you're looking for in an options strategy, whether it's hedging, income, or alpha.

With that in mind, delve into how it accomplishes its objective and compare risks among strategies and determine which one is best suited for each of your clients.

In the next post, I discuss the last of the three subcategories: alpha/trading strategies.

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