Physicians' Money Digest

Harnessing Volatility with a Long-Term Options Strategy

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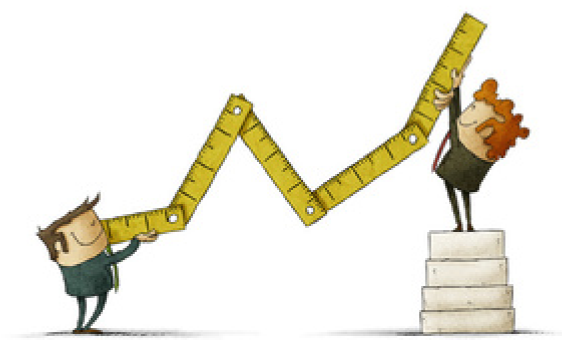
Ever notice the cold difference between the actual temperature and the wind chill temperature? Wind makes a big difference in the temperature we feel.

Just as there's almost always some degree of wind in the atmosphere, there's almost always some degree of volatility (short-term up or down movement) in the stock market. Although volatility is an inherent performance factor many people have an irrational fear of it, as though it weren't a constant.

Many in the investment industry equate volatility with risk, but it's really a natural part of the market, as is clear from data that illustrates the market's long history. Risk isn't what's always happening, but what might happen. So equating volatility with risk doesn't work.

Yet this isn't what they teach in business schools, where "volatility is almost universally used as a proxy for risk," Warren Buffet has explained. "Though this pedagogic assumption makes it easy for easy teaching, it is dead wrong: Volatility is far from synonymous with risk." Instead of being represented by volatility, true risk is the chance of permanent loss of capital.



Benefits of volatility

If your shares of P.J. Widget & Co. have a net gain of 50% for over five years—a period during which they fluctuated wildly in value—that's a pretty good long-term return. If you sold stock during an extreme dip during that period, this would be another matter entirely. But over the long term, these widgets were a good investment. Thus, volatility is really just a proxy for potential losses over the short term—but not for long-term risk.

For the long term, volatility can be an investing opportunity, so much so that some experts, including Goldman Sachs as early as 2007, have started to view it as a conceptual asset class. And like any other asset class, volatility can be leveraged for gain.

The best way to do this is to use something else that many individual investors irrationally fear: options, contracts that give the buyer the right to buy or sell the underlying stock at a price agreed to in advance within a certain period of time. Individuals think of options as too complicated and too risky. And sure, some high-flying professional traders use them largely for speculation. But they're also a way to profit incrementally over time from volatility.

Granted, understanding options requires individual investors to rearrange some mental furniture because many find them counter-intuitive. Most people's market orientations center on rising values, whereas options involve seeking gains from stocks that rise, fall in value, or stay the same price.

Options strategies can be likened to owning an insurance company. You probably spend several thousand dollars on insurance premiums for your home, knowing there's less than a 1% chance that you'll ever file a claim; this is how insurance companies profit. By selling options you can collect premium and seek profits over time.

A sensible way for individual investors to do this is to use options on volatility as a side-income producer, ancillary to returns from underlying assets, bringing limited return but with limited risk. This can involve exploiting the market as we have historically known it by systematically selling options to harness the volatility of a market index. This way, over the long term, you get the gains based on the fluctuations of that index. And, based on a century of market index performance, the longer this strategy is employed, the lower risk of permanent loss of capital becomes.

To get a real-world, objective look at the potential gains from this kind of investment over the long term, my firm conducted a comprehensive case study to examine the historical returns that would have resulted from an options overlay strategy—investing in a large-cap index fund and simultaneously employing an option overlay on that index's performance.

The test results showed that this strategy would have yielded significant benefits, producing a total hypothetical return of 1,183% over a 26-year period, versus about 782% from investing in the index fund, without using options.

Thus, strategic investments anticipating significant downward fluctuations in the index over the short term were more than compensated for by those anticipating upward spikes. During various short-term periods during the 26 years under examination, liquidating would have produced a significant loss, but staying invested for the long haul averaged out losses and gains to produce highly positive net result. As a long-term asset, volatility "paid off" handsomely.

The isn't a trading strategy—that is, it doesn't seek returns from attempting to predict the direction of the underlying index, so it doesn't involve speculation. Rather, it's a strategy designed to capture income from options by harnessing volatility -- exploiting its inevitable ups and downs over the long term, while simultaneously protecting against catastrophic loss from the index (with the market) cratering. So, it involves an insurance component.

To be successful, this strategy requires investors to have:

- An upward bias—an unwavering belief that the market will grow over decades or, at least, maintain its worth.
- A long-term commitment. Years with poor returns should be expected, so abandoning the strategy prematurely may mean forfeiting the opportunity for compensatory gains. If clients throw in the towel in the wrong year—typically, when asset prices are declining— this could significantly damage long-term average returns. Thus, the highest potential goes to the committed, as success hinges having faith and remaining confident during down years.
- Perennial patience. This is a strategy for long-distance runners, for tortoises rather than hares. The impatient shouldn't attempt it because being advised not to sell prematurely will likely make them uncomfortable. (Truly successful strategies tend to be those that investors not only profit from but can also live with along the way.)

The strategy's rationale reflects the time-honored investing maxim that plans designed to get rich slowly, through incremental gains, are superior to get-rich-quick plans that often involve much higher risk. Long-term options strategies can prove viable by exploiting the newly-recognized asset class that many investors confuse with risk itself: volatility.

Dave Sheaff Gilreath, CFP® a 36-year veteran of the financial service industry, established Sheaff Brock Investment Advisors LLC, a portfolio management company based in Indianapolis, with partner Ron Brock in 2001. The firm has more than $1 billion under management.