What have you done with your "Investment Options" lately?

Several years ago, I wrote an article titled "Exploring your Investment Options in the 21st Century." The article discussed a defined-risk strategy[1] ("the Strategy") that my investment advisory firm has implemented since 1997. The article was timely since the market had experienced a decline of approximately 50% after a multi decade bull market. I wish I could say that my timing was prophetic given that the market bottomed within months of my article. Regardless, I thought it was important that the analysis contained both a bull and a bear market to properly evaluate the performance of the Strategy.

I have updated the performance of the Strategy and discussed several implementation issues since the market has rebounded by approximately 50% since the last update and an additional 2½ years has elapsed. Maybe my timing of this article will once again prove prophetic in that the markets maybe entering the second phase of the bear market.

For the record, I believe that it is unreasonable to assume that the bull market that lasted from 1975 until 2000 would be entirely corrected in 2½ years given the current demographics, debts levels and valuations levels of the market.

Performance

The following is the performance of the Strategy since inception on 7/1/97.[2]

Growth of $ 10,000

	S&P 500				Strategy (SPDRs + Puts/Calls)				
Year	Return	Value	Annualized Return	Standard Deviation	Return	Value	Annualized Return	Standard Deviation	Relative Performance % - Cum.
1997	9.98%	10,998	20.96%	0.00%	17.68%	11,768	38.50%	0.00%	7.70%
1998	27.43%	14,015	25.23%	8.72%	19.92%	14,113	25.82%	1.12%	0.98%
1999	20.99%	16,957	23.52%	7.20%	21.92%	17,206	24.24%	1.73%	2.49%
2000	-9.58%	15,332	12.99%	14.04%	3.72%	17,845	17.99%	7.14%	25.13%
2001	-11.32%	13,596	7.07%	15.69%	5.71%	18,863	15.15%	7.56%	52.67%
2002	-22.01%	10,603	1.07%	18.06%	9.80%	20,712	14.16%	7.06%	101.09%
2003	27.89%	13,561	4.80%	18.92%	7.10%	22,183	13.04%	6.87%	86.22%
2004	10.84%	15,031	4.56%	17.77%	12.82%	25,026	13.01%	6.42%	99.96%

The inception-to-date return is 150% versus 50% for the S&P 500 ("the benchmark") since adopting the Strategy. The annualized return and standard deviation (variation

[1] Please refer to the original article that discussed the defined-risk strategy, the various key considerations and benefits.

[2] Please note that all expenses (management fees, margin interest (if any), etc.) have been removed from the performance figures. In addition, these figures are an average for all accounts under management that have primarily implemented the Strategy or a variation thereof and have more than ½ a year of performance figures. The performance figures would be increased if non-strategy performance figures were excluded. Please note that 7½ year period ended December 31, 2004 encompasses the entire period that the Strategy has been implemented.

around expected return, e.g. the higher the standard deviation the greater the risk) for the Strategy over the same 7½ period is 13.01% and 6.42%, respectively, compared to 4.56% and 17.77% for the benchmark.

For purposes of this article, I have separated the entire 7½ year period into 3 distinct periods: (1) 7/1/97 – 12/31/00, (2) 1/1/03 – 6/30/02, and 7/1/02 – 12/31/04. The 3 periods are labeled Bull 1, Bear 1, and Bull 2.

Performance Analysis

The Strategy's inception-to-date performance is impressive for the following reasons.

First, the Strategy has outperformed the S&P 500 by 100% over the past 7½ years.

Secondly, the Strategy has substantially less risk as defined by the standard deviation and the guaranteed sales price component of the Strategy. The Strategy is currently guaranteed a selling price of 1250 on the S&P 500 until December 2006. This protects the portfolio in the event of a decline in the S&P 500. In other words, the Strategy has outperformed the benchmark in; arguably, the biggest bull market and potentially the biggest bear market in history, without the risk normally associated with investing in stocks.

Thirdly, the Strategy has increased the number of shares in many of the portfolios by using the proceeds from the sales of the guaranteed sale price component to purchase additional shares, thus increasing the probability of out-performance of the markets in the future.

Strategy's Relative Performance versus Investor with Perfect Timing

One of the primary goals of the Strategy is to protect previously earned gains and to profit from a market rebound after a substantial market decline. Basically, the goal is to profit from bull markets and protect the capital in bear markets. The following example should illustrate whether or not the Strategy's goal has been realized.

Example

> Investor WPT (with perfect timing) buys the S&P 500 on July 1, 1997 at 900. Investor WPT sells the S&P 500 @ 1500 in March 2000 for a 70% profit (including 3% dividends). Investor WPT invests cash for the next 2.25 years and earns 3% interest. Investor WPT buys the S&P 500 in July 2002 @ 800. Investor WPT sells the S&P 500 @ 1,200 in December of 2004 for a 50% profit plus 3% dividends. Investor WPT would have gains totaling 168% over the past 7½ years.[3]

[3] Please note that the S&P 500 figures are rounded and are not intended to imply the absolute high and lows of the S&P 500 over the past 7 ½ years or that an investor WPT could not have traded more accurately or

The Strategy's gain over the past 7½ years has been 150%. In other words, the Strategy has underperformed an investor with perfect timing by only 18% over the past 7½ years. In my book, that is close enough even in the real world (as opposed to government work).

Therefore, the objective of having unlimited potential with limited risk has been met since adopting the Strategy as evidenced by the performance of the Strategy, the current guaranteed sale price component and the additional S&P 500 shares obtained.

Implementation Issues - Hedging

There are several implementation issues that should be discussed. This would primarily deal with hedging components of the Strategy. As a result, a brief discussion of hedging is warranted.

The basic Strategy involves purchasing the S&P 500 via SPDRs in addition to purchasing and selling options (hedging transactions).[4] The hedging transactions are intended to protect the stock from market declines. The cumulative gain/ (loss) from your hedging transactions determines the relative performance versus the benchmark since the SPDRs are held indefinitely and were created to match the performance of the S&P 500.

The premise of the Strategy is that the options, which are used to hedge your SPDRs, reduces your return on the upside in the short-term but that your performance is enhanced over the long-term due to bear markets and flat markets as evidenced by the inception-to-date performance. The Strategy captured the profits from Bull 1, protected and even profited from Bear 1 and profited from Bull 2.

However, it is important to point out that in order for the Strategy to make money, it cannot protect against every type of outcome. As a result, the Strategy makes allowances for most market outcomes while leaving gaps in the coverage (i.e. similar to deductibles and caps on insurance coverage). The Strategy is making calculated risks while assuming that no one can accurately predict the market. The Strategy adopts a philosophy that an investor should only insure the risks that are unacceptable; manage the risk that is acceptable and sell the opportunity that is unrealistic to others.

An analogy is how a good poker player handicaps each hand by weighing each outcome and only betting on those hands which the odds to win are at least good. A good poker player increases the bet when the probability of profit is good. There are of course no guarantees in any endeavor (whether investing or gambling) but obviously the good poker players are able win over the long-haul.

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effectively given the myriad of trading possibilities. The return was calculated as follows: Bull 1 return = $10,000 X (1500-900)/900 = 66.7 % + 3%dividends = $17,000; Bear 1 return = $17,000 X 3% = $17,500; Bull 2 Return = $17,500 X (1200 – 800) / 800 + 3 % dividends = $26,800. Total Return = ($26,800 - $10,000) / $10,000 = 168%.

[4] It is important to note that there are several variations on the basic Strategy that changes the risk and profit / (loss) profile.

The same holds true with the Strategy. To succeed, the Strategy must be fundamentally sound and implemented correctly to be successful. The fundamental premise of the Strategy is that there are techniques to combine different stock and option positions that not only maximize your profit potential but maximize your probability of profit. Option writing, calendar spreads and bear spreads are examples of such strategies. It is important to note that the options market, like poker, is a zero sum game whereby there is a loser for every winner.

The following are three implementation issues that have arisen during Bull 2 that need to be considered.

The first issue that needs to be discussed is the extreme fluctuation in hedging costs. During the implementation period, the cost to hedge the S&P 500 via long-term put options has fluctuated dramatically. This cost to hedge is primarily related to the risk perceived by the markets. The risk is measured by the implied volatility of an option that is part of its price. During the past 7½ years, the market has oscillated back and forth between cheap and expensive several times.

This is not a problem over the long time periods because the cost is normalized. However, it can cost the Strategy in terms of performance if the initial implementation occurs in a period of high market volatility (i.e. during the end of Bear 1 or beginning of Bull 2) versus beginning to implement the strategy in a period of low volatility (beginning of Bull 1 or end of Bull 2).[5] Alternatively, implementing the Strategy during a period of low volatility, as is the case now, gives the performance an extra boost. The volatility index for the S&P (VIX) hit a 9 year low at the beginning of 2005. The cost to hedge is probably on a rising trend that should last for several years. In other, portfolio insurance is relatively cheap.

Another issue regarding the implementation of the Strategy has to do with the timing and the price level of the annual hedge adjustment.[6] In other words, the subjective nature of when to re-hedge and what price level to guarantee lends itself to a myriad of outcomes; each possibility changes the dynamics of the risk and profit/ (loss) profile. As a result, discussing each one would not be practical. The main point is that optimal timing and price adjustments are not required for the Strategy to be successful.[7]

Finally, the issue of call income needs to be addressed. The Bull 2 phase of the implementation period has been extremely difficult from a option writing perspective.

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[5] It is important to note that there are numerous ways to offset the high cost of hedging during a period of high market volatility that are beyond the scope of this article.

[6] In other words, the rolling out and either up or down of the put option position that is hedging the downside risk of the SPDRs.

[7] The experience of this advisor is that adjustments are rarely made at the optimum time and price. The criteria changes based upon the individual client's risk/reward characteristics. However, the adjustments should be made annually due to the characteristics of option prices.

The reasons are twofold. First, there have been an unusually large number of market surges on the upside that has limited the profit over Bull 2. Secondly, the risk level via implied volatility has decreased premium on call options over Bull 2. The combination of both of these has made it difficult to make money writing calls over the past 2 ½ years. This has been frustrating since the call option income is used to pay for the put options during a bull market. This is part of the reason that the relative performance over Bull 2 has been less than spectacular.

Conclusion

As previously discussed, I am skeptical that the excesses of prior bull market have been corrected. In addition, I believe the demographics, debts levels of individuals, businesses and governments (including unfunded liabilities) and valuations make stocks unattractive at this time (to say the least). The bottom line is that I believe that there will be a better buying opportunity in the future. I realize that statement is subjective and that is why I will allow the perma-bulls and perma-bears to make their perspective cases about whether or not the bear market is over or just beginning another phase.

Regardless of who is correct investors need a strategy that can succeed in all types of investment climates. The following are 5 keys reasons why the Strategy is suitable for all types of investors (conservative and aggressive) and why now is good time to implement the Strategy. They are (1) upside participation in the market, (2) defined risk upon initiation of investment, (3) no predicative ability required to be successful, (4) ability to profit from a decline, and (5) protect future unrealized gains. Of course these are the same reasons that I mentioned 7 ½ year ago.

The Strategy, as evidenced by the performance, reduces market and opportunity risk substantially by protecting the capital in the event of a major decline and allowing an investor a second bite at the apple. In other words, implementing the Strategy as current levels allows you to buy at a lower level if the bear has unfinished business. Alternatively, implementing the Strategy at current levels allows you to get the best prices available if the bear market is over. Regardless, there are going to be additional bear markets in the future which is why the implementing the Strategy makes sense. In other words, there is market risk and what are you doing about it?

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"Prophesy as much as you like, but always hedge."

Oliver Wendell Homes, 1861