

Diversifying Your Diversifiers: Part 2, The Differentials in Implied Volatility

This is one of a three part series on how we think about and utilize options to create strategies designed to help an overall portfolio navigate today's markets.

A basket of options is worth more than an option on a basket. That's a crucial concept to our business. We wanted to explore two topics related to that concept (Part 1 and Part 2) and a third related to how we view risk management as a tool for higher return (Part 3).

Options/Derivatives seem to be a financial dirty word, but used correctly they can change the landscape of a portfolio for the better. We've written about how options provide the ability to hedge away risk and define uncertainty, but this series digs deeper into how we utilize options for specific objectives.

- » **Part 1: Asymmetry** - More specifically, sporadic asymmetry - This applies to our Defined Risk Strategy
- » **Part 2: The Differentials in Implied Volatility** - This applies to our Collared Income Strategy
- » **Part 3: Managing Risk for Higher Returns** - This applies to our Drawdown-Managed Equity Strategy

*Side note - we are writing about these concepts because we are in the minority when it comes to looking at things this way. More importantly, we actually carry out these concepts in our portfolios and day to day operations. Much of what's said in these posts represents high level ideas we've spent entirely too much time thinking and building on.

Repeat after me - a basket of options is worth more to us than an option on a basket.

Part 2: Differential of Implied Volatility

This is a biggie, and to simplify the complex, let's start with the ultimate benefit: more of the almighty greenbacks to a portfolio. We're talking about cash, in the form of income from a portfolio.

Higher income is attractive for anybody, especially with the 10 year Treasury yielding roughly 1% and banks paying you next to nothing.

If any of the below is confusing just remember, the outcome of tapping into this differential means the potential for an alternative source of income that's not (a) dividends from stocks or (b) interest from bonds.

Options 101

The price of an option has a few ingredients. An important ingredient is what's known as implied volatility, a fancy way of saying the expectation of price change in a security. If you don't mind, we're just going to use "IV" from here on out. Higher expected change, up or down, means higher IV, which means a higher price on options on that security.

For example, options on a biotech stock trade with higher IV's than options on an established utility stock. Or even better, options on the biotech stock trade with higher IVs than options on the market as a whole...a lot higher. The potential movement in a single stock has a far wider range of outcomes than the market as a whole, hence higher IVs = more expensive options.

OK, now we're getting somewhere.

Putting this here if you need a quick reference:

- » Call option - the right to own a stock at a certain price
- » Put option - the right to sell a stock at a certain price

Investing 101

Buy low, sell high.

Investing 102

Sell high, buy low...can you see where we're going yet?

Take this hypothetical example and apply the concepts to see if you can accomplish an income objective utilizing the differential in IV between a basket of options and an option on a basket.

Quick Option Lesson Before we go further - The Option Collar.

The combination of owning a stock, selling a covered call, and buying a put, is what's known as a collar.

If you own 100 shares of ABC that's trading at \$100, you can sell a call option at \$105 and bring in some option premium. You sold the right to own ABC at \$105 to somebody. Meaning if ABC rises to \$110, you'd only participate to \$105, beyond that, you capped your potential return. The sold call is known as a covered call and it is the top side of the collar. We need the bottom.

Let's say you took that premium from the call and bought a put on stock ABC at \$95. That gives you the right to sell ABC at \$95. So if it drops to \$50, you hedged away all the risk below \$95.

You are long 100 shares of ABC, sold at call at \$105, and bought a put at \$95. You have collared your stock position giving it \$5 on either side of the current price.

Back to utilizing the IV differential to generate income.

What if you sold options with higher IVs and bought options with lower IVs and the difference was extra cash? Yes! But...there's always a but.

Take a look back at our simple collar example. Selling a call up 5% on an individual stock and buying protection 5% down actually costs money. Why? Because put options are priced higher than call options, as the market knows a sharp move down is much more likely than a sharp move up, and you have to pay a little extra for those hedges.

So, our simple collar example is actually selling IV and buying higher IV, no bueno. But...

Let's put this together

Let's say you start with a basket of 50 individual stocks. Those 50 stocks are going to be highly correlated with the S&P 500. Meaning, if the S&P is up or down 10%, your basket of 50 stocks is up or down roughly the same. The basket of 50 stocks will have a high correlation with the S&P 500.

The objective - Income. Growth comes secondary.

What if you sold options on each individual piece (higher IVs) in the form of covered calls, and bought put options on a highly correlated security, say something representing the S&P 500 (lower IVs)? You'd then truly be selling higher IV and buying lower IV. The difference, you guessed it, more greenbacks, higher income.

Because of the differential in IV between individual stocks and a market index - you can sell call options on each individual name x% up, and use those proceeds to buy protection with an option on a basket of securities highly correlated with the 50 stocks at roughly the same x% down, and have cash left over.

More importantly, you can increase the amount of cash left over by adjusting the % up of your calls relative to the % down of your puts. For example, if you sold calls 3% up on individual names and bought puts 5% below a correlated basket, you'd significantly increase the amount of cash left over. As a result, you generate meaningful income, keep potential for drawdown minimal, and still offer potential for some upside participation.

Return & Risk

The return of a strategy like this can come from the underlying basket moving up, the yield that basket pays in dividends, and the additional yield generated by - you guessed it - leveraging IV differential.

Is the potential return as high as just owning stocks? Of course not, we've capped the upside, but we'd feel a lot better than relying on bonds, and income is the primary objective.

Is the potential risk as high as owning stocks? Of course not, we have additional income to offset moves down AND we've taken explicit actions against left tail risk.

Our preference is for as little drawdown as possible - a recurring theme of our strategies as a whole.

Summary

This is the thought process behind our Collared Income Opportunity strategy. It was designed to help a portfolio inject additional income without taking crazy amounts of credit risk and without exposing investors to substantial drawdown.

We aim to own 50 quality companies that track the S&P and pay us 2% or more in dividends. We then leverage the IV differential to attempt to generate an additional 2% to 5% of more yield. Not to mention, our strategy has the potential to capture upside in strong markets as well.

Again, repeat after me, a basket of options is greater than an option on a basket.

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A call option gives the owner the right to buy the underlying security at a specified price within a specific time period. A put option gives the owner the right to sell the underlying security at a specified price within a specific time period. A covered call refers to a transaction in which the investor selling the call option owns at least the equivalent amount of the underlying security. The S&P 500, or Standard and Poor's 500 Index, is a market-capitalization-weighted index of the 500 largest U.S. publicly-traded companies. Drawdown is defined as the peak-to-trough decline for an investment during a specific period.

Investing involves risk; Principal loss is possible. The Funds are non-diversified, meaning they may concentrate their assets in fewer individual holdings than diversified funds. Therefore, the Funds are more exposed to individual stock volatility than diversified funds. The Funds may invest in options, the Funds risk losing all or part of the cash paid (premium) for purchasing put and call options. The Funds' use of call and put options can lead to losses because of adverse movements in the price or value of the underlying security, which may be magnified by certain features of the options. The Funds' use of options may reduce the ability to profit from increases in the value of the underlying securities. Derivatives, such as the options in which the Funds invest, can be volatile and involve various types and degrees of risks. Derivatives may entail investment exposures that are greater than their cost would suggest, meaning that a small investment in a derivative could have a substantial impact on the performance of the Funds. The Funds could experience a loss if its derivatives do not perform as anticipated, the derivatives are not correlated with the performance of their underlying security, or if the Funds are unable to purchase or liquidate a position because of an illiquid secondary market.

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