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In Pursuit of Value

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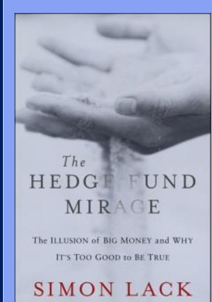


Short Put Options Covered Up As Calls

Writing covered calls sounds like such an innocuous strategy. You own shares in a company that you like for the long term. Its performance has been modestly positive but fairly unexciting. You don't want to sell but want to make a little more money out of the investment. So you sell call options to generate some income. Covered call writing is widely used. As benign as it sounds, it's generally not a great way to approach investing. Most obviously, this is because your underappreciated investment can unexpectedly rise, when the sold calls will deny you the full return you had sought just as it reaches the valuation you expected. It also impedes your flexibility should you decide to sell the stock, since the sold call option will also need to be bought back.

It's really not as conservative as it sounds. Put-call parity is a Mathematical identity that determines the price of a put option if you know the price of the identical call option and the underlying security. In the jargon of option Math, a long put option can be created by a short position in the stock combined with a long call option. P = C - S. It's as rigid as 2+2=4. Options market makers routinely make prices based on "conversions" as they're called. If call options are well bid, traders offset the calls they've sold by going long the underlying stock and buying put options. In this case, C = S + P. You can rearrange the symbols following the rules of algebra.

Options 101				
Long Stock	**AND**	Short Call	**=**	Short Put

What this means is that if you are long a stock and you sell a call option against it, you have created for yourself a short put option (last bit of algebra: S - C = - P). The returns on a short put option and the equivalent covered call position are identical. They are economically equivalent. You retain the risk of a complete loss of your investment, but the short call means you now have only limited upside. Most obviously, if your risk appetite runs to shorting put options on individual stocks, why not just do that instead of going to all the trouble of owning the stock and selling a call? The transaction costs are lower and it's simpler to execute. More important though, shorting put options can be bad for your financial health. For some, there is a certain appeal to getting paid an option premium in return to agreeing to buy a stock you like if it becomes cheaper. Put option sellers are happy to commit to buy at that lower price and to be paid in return. Others like to retain flexibility around their price targets – after all, maybe the stock has fallen 10% for good reason and no longer looks so attractive. You might be happy to be able to change your mind based on new information. The difference is a philosophical one. However, not all writers of covered calls recognize that they are in fact writers of puts.

I once met a hedge fund manager whose strategy was substantially one of selling covered call options. I asked him why he didn't simply write put options and save himself some trouble and commissions. His honesty exceeded his marketing ability, for he quickly pointed out that few clients would consider investing in a hedge fund that sold put options. That is economically what he was doing, but he was sensibly customizing his message for the audience. I can't say I followed his subsequent progress, but I imagine that the 2008-09 market collapse and subsequent recovery was a memorable experience for his investors. We were not one of them.

For the client whose financial adviser sells covered calls, there exists an additional problem. As skilled as the adviser may be in selectively selling call options that will expire worthless, it's hard to evaluate the results. Selling out of the money call options may earn you a small premium most of the time, but markets are full of surprises and occasionally the covered call position will deny the investor a substantial return on a long stock position that suddenly appreciates. To say that most of the time selling call options generates a small profit isn't the same as saying that selling call options is a profitable strategy.

Importantly, you can no longer simply compare the performance of your account with a benchmark such as the S&P500, because in a strong market your account will underperform as your longs get called away. The premium income may compensate at other times, but you'll never really be able to evaluate your results with numbers. Performance may be reported to you as "quite good", or "acceptable under the circumstances" as opposed to "2% better (or worse) than the market".

Investing results that defy quantitative assessment but instead rely on adjectives are to the advantage of the advisor and the detriment of the client. As much as one wants to retain a positive view of the financial advisory business, as new clients open accounts and transfer over the investments that their former adviser had made on their behalf, one's faith in the judgment of other investment professionals can be challenged. Recently, a new client's portfolio was transferred and included therein were short call options doing what they're not supposed to, which is moving into the money and causing the underlying long positions to be called away, thereby limiting the return on the stocks that would otherwise have been retained.

So next time you or your financial adviser contemplate selling calls on a stock you own, consider whether you would just as readily be simply short the put options. Because that's the position you'll have.

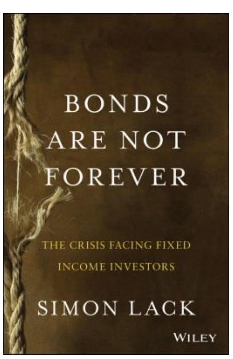
SL Advisors, LLC focuses on identifying securities that are trading at a discount to intrinsic value.

SL Advisors Business Update

Just over three years ago, in January 2010, Henry Hoffman joined SL Advisors to lead our investment research. Since that time I can honestly say that not a day has passed when I've doubted the wisdom of bringing Henry on board. We spend a lot of time together, and my respect for his analytical abilities and judgment is matched by the enjoyment I derive from working with him. Three years is enough time to consider whether a long term commitment makes sense. Consequently, Henry is now a partner in SL Advisors, a formal recognition of the way I've thought about him pretty much from the beginning. Every strategy we run and every investment we make is the result of our joint efforts and collaboration. Our business has maintained its steady growth trajectory. As I said to somebody the other day, if you happen to catch me saying something intelligent, there's a good chance Henry said it first.

Bonds Are Not Forever

It's been said that everybody has one book inside them waiting to get out. When I completed *The Hedge Fund Mirage* in 2011 I thought I had checked that particular box and my literary career would be complete.



However, it turns out that I have rather more to say about investing than I thought (some may conclude too much more). The success of my first book, most especially including the indignant protestations from the London-based lobbyists AIMA (Alternative Investment Managers Association) made it altogether much more fun than I expected. That, combined with some gentle prodding from my publisher (and I must shamelessly confess that it didn't require much) have led to my latest effort.

Bonds Are Not Forever: The Crisis Facing Fixed Income Investors may not upset an entire industry as did my first book, but then hedge funds are a soft target and bonds by contrast really have been a good investment for a very long time. However, it's virtually certain that bond returns will disappoint in the future, and I hope to offer a perspective on why that is as well as how investors should respond. The book will be out later this year but is already available on Amazon for pre-order. As with my first book, I'm happy to autograph any legitimately acquired copies.