PORTFOLIO WATCH

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You Have Options

Sometimes it's good to have options, and sometimes not. In general, it's good to keep your options open. On the other hand, my son recently got married and intentionally closed off his options for the rest of his life, which is also a good thing. It all depends on the context, and since this is a financial newsletter, I want to talk about mutual funds that use options instead of stocks.

What You Need to Know About Options

You don't need to be an expert in stock options in order to invest in a fund that uses options, but you should know why they could make sense in a portfolio, so here goes. It's pretty widely accepted that a good portfolio needs diversification, and that means it needs investments that don't all act the same. Ideally, you want something that makes money when other parts of your portfolio are losing money. Since the bulk of most portfolios involves owning stock, it makes sense that you would want to own something that can make money when stocks go down. Good luck finding something like that, unless of course, you own a fund that uses options.

More Than One Option

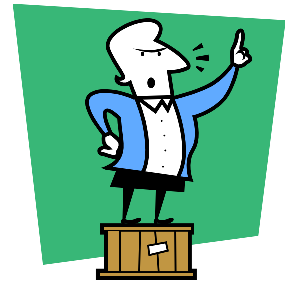
When it comes to funds that use options, you have more than one option (perhaps we should exercise our option not to use "option" more than once in a sentence). There are investments that are designed to simply do the opposite of what the stock market does (e.g. inverse funds), and yes, these funds use options. But if a fund simply does the opposite of the stock market, you could accomplish the same thing by just owning less stocks. Fortunately, there are other choices. The benefit of stock options is that they can be combined in ways to create almost any risk/reward characteristic you want…except one. There is no combination that allows for no risk and all reward. There is always risk. So for a diversified portfolio, we just don't want the risk to be the same as stocks.

Time Can Be Your Friend…Or Not

A pretty simple characteristic of stock options is that they eventually expire. As long as they exist they contain "time value," and they have a little less time value each day as they get closer to expiration. Why is this important? If a fund mostly buys options, then it will gradually lose value if the market doesn't move in the right direction. If a fund mostly sells options, it will gradually *gain* value if the market doesn't move in the *wrong* direction. That means that funds that sell more "time value" than they buy will gradually gain in value when the market simply stands still, which makes them even less correlated with the stock market.

Pretty Simple, Except When It's Not

One thing that stock option funds are not good for is the entertainment of watching their values every day. The reason is that there is more that goes into the price of an option than just its relationship to the underlying stock or index. If a fund owns options on the S&P 500 for example, the price of the S&P will definitely affect the value of the options, but so will volatility, the amount of time until expiration, and a few other factors that scientists in lab coats haven't quite figured out yet. In general, these 2^{nd}-order effects are temporary, but they do affect the daily price and this can make it frustrating trying to figure out why the value of the fund didn't behave as expected on a given day. Despite this element of mystery, though, option funds are one of very few truly non-correlated investments you can own.



Market Comments

The last time the S&P 500 had more than a 1% drop in a single day was Sept 9, 2016. This is the longest streak without a 1% drop in over 22 years. Volatility remains extremely low, which means that investors are not very interested in protecting their portfolios. That could mean that either the stock market is great again and we no longer need to worry about it falling, or it could be that investors have gotten over-confident, or that the Fear Of Missing Out is causing people to continue to push money into stocks that are already over-priced. Six months is a long time to go without a single hiccup, but so was 3 months, and 4 and 5. The longer it goes, however, the more pressure builds for a round of profit-taking. Just sayin'.

This month's article on option funds pointed out that no fund is without risk, and this became painfully obvious over the last few months with one of the major funds I use for downside protection, the Catalyst Hedged Futures Fund. This fund is one that sells more time value than it buys, so it will tend to gain in value if the market holds still. The fund also gained 50% in 2008, so clearly it has the ability to be a good counter-balance to stocks in bad times. A unique characteristic about this fund is that it also tends to achieve very good returns when the market is in a simple uptrend. But there HAS to be risk, and that risk is an explosive move higher in the S&P 500, which we got with the presidential election. That's OK…explosive moves have happened before. In fact, from a price standpoint, the movement due to the election wasn't enough to get the fund in trouble…it simply jumped too fast. As the time value in the February options burned off, the price began to recover as expected. However, shortly before the February options were due to expire, the market made another jump and this is what caused problems. The perfect line-up of price movement and timing hadn't happened in the fund's 10-year history. That doesn't make it impossible. Just rare. Could it happen again? Sure, although the fund has put in some safeguards to make sure a single month's position can never get too big again. Does this mean the fund's strategy is broken? Absolutely not.

We often mistake "low probability" with "can't happen." Obviously that's not the case. But a rare event followed immediately by another rare event is even rarer, and you can keep that string going. The mistake that's often made is immediately assuming that a rare event has suddenly become the norm. Every investment we own has an element of probability in it, and one of the most common mistakes in investing is optimizing for the last thing that happened. Because of the nature of volatility and time decay, most option funds have a tendency to return to the mean. In other words, extreme events tend to correct themselves within a reasonable amount of time. It's generally a mistake to get rid of insurance simply because you haven't needed it in a while.