

## OPTIONS ENHANCEMENT STRATEGIES

### Summary

- Options are versatile investment vehicles. They have many uses for many different types of clients. All ways will not be appropriate for all clients. All ways will not be used in the same account at the same time. Options are often customized to meet client needs.
- We use options to enhance portfolios in three *different* ways. We will outline each way and describe the types of clients who may be eligible:
  - Hedging — protect portfolio against large market downturns
  - Enhancing Income — generate a modest amount of additional income without significant risk of loss of principal by using options as advanced buy/sell orders for individual stocks
  - 3) Risk-taking and Overlays — add risk to existing portfolio to seek higher returns or trade options on cash

### Who Are Options For?

Clients who:

- Desire protective or risk-management strategies (most common)
- Desire to improve a current portfolio or minimize capital gains
- Are interested in generating extra income
- Have concentrated positions (stocks, bonds, funds)
- Have a large tax-loss carry-forward
- Are interested in the diversification benefits of strategies that tend to benefit from volatility and have lower correlation to stocks

## 1— Hedging

The most common way we use options is to reduce/buffer risk is via hedging. Risk hedging is to some degree potentially appropriate for many types of clients who have various tolerances for risk. If you own insurance, you are already using hedging strategies in other areas of your life. For example, car insurance hedges the financial risk of driving. When you bought car insurance, you gave up a little of your income. In return, you get peace of mind that if you total your car, you limit your risk to the cost of your deductible. Hedging with car insurance did not remove all the risk, but it contained risk to a manageable level. This is what we attempt to do when we hedge stocks. You should expect to experience typical levels of stock market volatility. Fluctuations of 5% to 8% are very normal in the stock market, so hedged clients will keep that risk. It's the infrequent but devastating larger declines we seek to buffer.

We often employ hedging strategies on the “core” of a client’s portfolio, but it can also be used as a “satellite” strategy on a smaller portion of your money. Also, if you already own an existing portfolio of stocks, we may be able to enhance them with a hedging strategy.

### **May be appropriate for clients who:**

- Desire to reduce risk and have greater certainty on what they have at risk
- Want to protect their stock investments from the types of catastrophic losses like the markets endured from 2007 to 2009
- Have concentrated positions in stocks they want to protect
- Want more of their account dedicated to stocks, or less of it dedicated to bonds
- Desire the tax-efficiencies that come from staying invested, but need protection from bear markets
- Are of all levels of investing sophistication, from novice to pro

## 2 — Income Enhancement & Concentrated Position Enhancement

This is the second most common way we use options. This options enhancement is best for clients who already understand a bit about options and are comfortable accepting market risk, but would like an opportunity to generate more income.

The short story is this: we're generating current income by getting paid to use options as buy orders (e.g., selling cash-covered puts) and/or sell orders (e.g., covered calls) on stocks. This implies there will be more short-term capital gains, which may mean the strategy is best for either clients who need current income anyway, have tax-loss carry-forwards or can execute the strategy in a tax-qualified retirement account such as a traditional or a Roth IRA.

This type of strategy is meant for a smaller portion of a client's overall portfolio, not the core allocation. It is best used with individual stocks rather than funds. For more on this strategy, please see a video we did on the topic where we explain in a little greater depth.

### May be appropriate for clients who:

- Don't wish to increase the risk of owning stocks, but desire a modest increase in income over and above that already generated by the stocks
- Are comfortable buying and selling stocks from time to time and do not require a long-term hold
- Have concentrated stock positions they want to enhance, whether they desire to sell them or not
- Have a working understanding of basic options
- Desire a more customized strategy that does not follow a model

## 3 — Risk-taking & Overlays

Among all the different levels of risk that are available, this is the riskiest and most complicated way we can use options. Due to the complicated nature, it is not appropriate for novices, unless it is on a very small portion of their overall net worth. Few people really understand exactly how their insurance works, but they understand the cost and

how it reduces their risk. Risk-reducing strategies like hedging can therefore be appropriate for more people. However, if you are using options to *add* risk to your portfolio because you want to seek higher returns, the bar is higher. That being said, risk-taking options and overlays are appropriate for a smaller portion of clients, or at least a smaller portion of the money we manage for a client.

For most clients who want risk-taking options, we'll move a small portion of their overall portfolio to a separate account dedicated to options trading, one that's taxable or tax-qualified.

For clients willing to take on even more risk in a taxable account, we can “overlay” their current portfolio of investments with risk-taking options trades that attempt to add income to the account.

We do not generally accept relationships that are limited to only doing risk-taking options and overlays. These strategies are not appropriate for the core of your portfolio and are thus considered “satellite” strategies.

Trades use proprietary models to potentially capture option premiums and mitigate downside risk. Trades are actively managed and typically designed to last one to three months, with the vast majority closing in the three- to five-week range.

**May be appropriate for clients who:**

- Wish to dedicate a small portion of their assets to a riskier or more exotic strategy that typically has low correlation to the stock and bond markets
- Want to add risk to an existing portfolio in an attempt to generate more growth and income

## Information Relevant to All Enhancement Strategies

- There is no mandate to trade with any frequency. In other words, we don't trade just for the sake of trading and showing activity. If no trades can be found that meet our standards, no trades will be placed. Thus, clients can expect to see periods of low activity as well as high activity. Trading alone does not produce returns — good decisions and risk management do.



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- We close positions if they achieve a large percentage of max return in a short timeframe.
- We actively manage all accounts to ensure we have the ability to close trades early or let them run to expiration in an effort to maximize risk-adjusted returns.

## FAQs

### Are options “risky”?

All investments contain risk, including the stocks and bonds people often consider “safe.” Options are no different, so a better question is, “How risky are options?” It depends on *how* you are using options. When we *hedge*, we *reduce* risk. When we *overlay*, we *add* risk. It all depends on the specific trade we are considering and the expertise of the options trader; unfortunately, naive options traders who are trying to “learn as they go” often take on much more risk than they realized. To put that into context, the following is true: options can be traded with significantly less risk than the S&P 500, or with significantly more risk, and everywhere in between. Hedging seeks to reduce the overall risk of a portfolio and provide a greater breadth of diversification. Hedging is used to reduce risk, but it does not eliminate risk. On the other hand, all options designed to add more return to an account involve *adding* risk. In summary, options are very versatile and are as risky as you desire them to be.

### Where can I learn more about options and their risks?

We advise everyone considering options to familiarize themselves with their risks. The Options Clearing Corporation provides a free booklet available from your broker or by going to <https://www.theocc.com/components/docs/riskstoc.pdf>.

### Is this the same as doing “covered calls?”

There is a lot of misunderstanding about covered calls. A lot of people seem to think options are synonymous with covered calls. This is incorrect. All covered calls are options, but not all options are covered calls! “Covered call” is the name of one of the many strategies for trading options. We use the covered call strategy for some, but not all clients. There are pros and cons to a covered call strategy, and there are many other options strategies that are known by many different names that may be more or less appropriate either for your situation or for current market conditions.

## How much money should I expect to make with methods 2 and 3?

Before we discuss targets, we require a risk questionnaire to be filled out. If you haven't done that yet, please fill it out online at [bit.ly/WPQuestionnaire](http://bit.ly/WPQuestionnaire). There will be a range, because risk is not linear over time; in other words, risk varies. For example, one month we may find plenty of trades that meet risk and return specifications, and other months we won't find as many trades that meet our criteria. We have no mandate to trade just for the sake of trading. If our specifications aren't met, we will sit out. We will not raise risk just to ensure trades get placed. When you understand this phenomenon, you understand our trading may be just as successful year-to-year in risk-adjusted terms even though the bottom-line performance number may vary.

## Tell me a little about your risk-adding options trading, in general terms?

Our philosophy usually puts us into a category known as “premium sellers.” As premium sellers, time is on our side. Our trading doesn't have to pick one of the typical “postures”: bullish or bearish. Instead, we can trade neutrally. In other words, we do not depend on market direction to generate a return. We employ a variety of different options trading strategies, depending on market conditions. Generally, most of our trades will be various types of “spread” trades that combine multiple options into one trade. Spread trading uses one or more options to hedge the risk of one or more other options. In other words, it limits the potential risk to a predefined level, but it does *not* eliminate *all* risk. Spread trading is a bit complicated and thus may not be appropriate for beginners or for a large portion of your investment portfolio.

## What is the track record?

It's important to understand we offer a service — not a fund or product. A better question would be, “what should I expect?” A thorough understanding of this will answer most questions around this topic.

1. **Performance records are available for *uncustomized* strategies.** Performance is *not* available for *customized* strategies. We have track records on some models, but most of the things we do with options are for individual clients and are not models. How we add options to one account could be very different than how we add them to another account. For example, imagine you have a concentrated

stock position you don't want to sell that is held in a taxable account. We'd likely trade that differently than an IRA account that is all in cash. We'd likely trade it differently than an account with stocks you wouldn't mind selling. If you have any idea how many ways options can be used to enhance an account, then you understand there is no way to present a unified track record. There are too many accounts that are managed very differently. Such a track record would not be useful or relevant. It is better to talk about expectations for a given account after we've established why we'll be using options and how much and what type of risks you are willing to tolerate.

2. **Our options strategies aren't offered as funds.** The options are traded in your account individually. Performance on a fund is pretty easy to report, yet there are many disadvantages to a fund. A fund seeks to give everyone the same performance because you buy shares in the fund. A fund it does not specifically cater to you and it is not customizable. (Our ability to customize is in your favor.) That means a fund has no ability to work around current investments or customize. Lastly, funds can penalize you for the decisions other investors make, such as causing "phantom gains." Since we trade options in your account, we have more control over taxable events. However, all that customization means we don't have a relevant track record to show you. If you want a track record, we are restricted to using an uncustomized strategy. While our uncustomized strategies aren't set up like funds, we can report a useful track record on them since there are no customizations. If you want a customized approach, we'll set expectations based on what we can do for your situation.

**What if I have a large position I don't want to sell all at once, but I might like to sell some over time. Can you help me with that?**

Yes. This may require us to do some financial and tax planning with you before we come to any conclusions. We will seek to understand your unique situation and guide you on how to trim your position over time by balancing tax considerations, risk management, and opportunity costs.

**Should I expect risk-taking options to produce about the same return every month?**

No. Many factors influence how much opportunity there is to trade options. Volatility in the market is usually the biggest factor. Months with higher than normal volatility *tend* to give us more and better opportunities to trade and produce higher returns. The inverse tends to be true for periods of lower volatility. Again, there are many factors, so this is not always true, but it is true more often than not.

### **Can I use this on taxable accounts and tax-advantaged accounts such as a traditional or a Roth IRA?**

Yes, *most* everything we do can be done in these accounts.. The exception is risk-taking *overlays*, which aren't allowed in tax-qualified accounts.

### **How come more firms don't offer options trading?**

Options trading is a niche specialty. The obvious reasons are that it's very data- and technology-intensive, and extremely time-consuming. While most advisors tend to hold securities they purchase for clients for months or years, options trading is much more short term in nature. Trading options means *always* being ready to trade, but yet waiting patiently until the perfect setup becomes available — if it does at all. The constant state of readiness and need for analysis are very demanding and mean a *lot* more work for the advisor. Even more work is necessary if the options are customized to individual client needs rather than exposing clients to the many drawbacks of trying to put short-term securities into a fund.

The less obvious reason has to do with the history of options. Options weren't even publicly traded and standardized until the 1970s, and by the 1990s they were still only the tools of the ultra-high net worth. Even then, they were enormously expensive to trade. It wasn't until the mid-1990s that technology blew up and options trading through online brokers made it feasible to even consider doing them for more than the ultra wealthy. Of course, it still took time for them to catch on.

Someone who finished his or her MBA or master's in finance in 2000 was I very unlikely to have any significant exposure to options, much less expertise! When you think about it, it makes sense. Why would educators spend significant time on such a tiny area of the market? During that time period, what was being taught was largely theory from the '60s and '70s, and that is still overwhelmingly true today! Options are still taught at a *definition*

*level* rather than at the deeper levels of *application* and *integration*. As a result of all this, the vast majority of financial professionals actually have very little options understanding or experience in regard to options.

Traders in this niche overwhelmingly tend to be people who formerly worked on the floor of the exchange, or were fortunate enough to learn directly from them. It's a small circle that has not expanded quickly. Due to the complexity of options trading, it is very difficult for long-established professionals to attain the knowledge and experience later on in their careers while also maintaining their current practices. Most simply choose to ignore the options market entirely. Today, technology is advancing at lightning speed and investors can gain exposure to options in a very liquid and cost-effective manner through discount brokerages. The problem is that expertise is not gained as fast as technology can progress, so by far the biggest reason most firms don't trade options is they simply don't have the expertise to offer them.

### **Will I learn to trade options by hiring you?**

At a "definition level," you will learn some very basic options terms, if you desire. You will also learn how to understand a trade that has been placed and how to read it on your statement. You will not learn anything about trading or analyzing options trades. Options are appropriate for people who want to understand the big picture of what they are hiring us to do. It is not a good solution for people hoping to learn to trade options themselves, or who have a deep desire to learn about options trading intimately and want an expert with whom to discuss their education.



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## Important Notes & Legal Disclaimers

This brochure is for informational purposes only and should not be considered investment advice or a recommendation to trade options. Options trading is generally more complex than stock trading and may not be suitable for some investors. Before trading options, a person should review the document titled Characteristics and Risk of Standardized Options, which is referenced above. Return on Capital metrics differ between an IRA and a taxable account due to cash set aside differences between retirement accounts and Regulation-T margin accounts (taxable accounts.) Probability of profit is calculated using softwares provided by 3rd party brokers at the time of the trade. The calculation is based on an underlying historical average standard deviation within a similar time frame to contract expiration and, therefore, is not intended to imply that the account will be successful with a given trade on that specific basis. Risk management is necessary even when probabilities seem high. Accounts are traded by registered investment advisors (RIAs). Registration does not imply a certain level of skill or training. Information pertaining to RIA advisory operations, services, and fees is set forth in the most current Form ADV Part 2 brochure, which is available upon request or at [www.adviserinfo.sec.gov](http://www.adviserinfo.sec.gov).

Due to the customized aspect of some strategies, performance data is often unavailable. Targets provided assume management fees have already been taken out — they are approximately *net* of fees. However, differences in account size, age of clients, risk tolerance, timing of transaction and market conditions prevailing at the time of investment may lead to different results and clients may lose money. Fees and expenses also may vary based on custodial relationships, trading costs, management fees, and other factors such as account size. Thus commissions and other expenses may not be fully considered in the results, and if all potential fees and expenses had been taken into account, the results may be lower. Targets are not guarantees. No representation is being made that any account will or is likely to achieve results similar to those shown. Actual results may significantly differ from expectations.



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