
WHY OPTION-SELLING STRATEGIES MAKE SENSE IN 2018

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2017 was a unique year in two respects. One, it was the ninth consecutive positive year for the [S&P 500](#) (a [bull](#) run, which has happened only twice since the 1950s); and two, this bull run was accompanied by extraordinarily [low volatility](#) for equities. For most of 2017, the [Chicago Board of Options Exchange \(Cboe\) Volatility Index \(VIX\)](#), a measure of the market's expectation for [forward volatility](#), traded below 10. That is less than half its long-term average of 20. In the baseball world, this would have been like the Yankees winning all games in 2017 with no nail-biters going down to the last innings. As much as I love the Yankees, it has rarely happened, in my memory at least!¹

In quite a contrast, the first quarter of 2018 has been a true testament to many nail-biting performances. There were multiple such days, most interestingly February 5, when the [VIX spiked](#) by 20 [basis points \(bps\)](#) in a single day (an event with a historical likelihood of 0.002%. Just as a stressful inning can separate an average player from one who can handle pressure, days of market stress can separate ordinary strategies from ones that could be match winners for your portfolio.²

The [WisdomTree CBOE S&P 500 PutWrite Strategy Fund \(PUTW\)](#) and the [WisdomTree CBOE Russell 2000 PutWrite Strategy Fund \(RPUT\)](#) track [Cboe's PUT](#) and [PUTR](#), respectively, after fees and expenses. The underlying Indexes of the two strategies have an established track record of handling stress and being a potential match winner for investors seeking portfolio risk reduction. Let's see how the two players performed in the last volatile season of Q1 2018.

Q1 2018: A Batting Average of 100% in Down Markets

In Q1 2018, out of a total of 62 trading days, the S&P 500 had 28 negative trading days, while the Russell 2000 had 26. A true test of any VOLATILITY-reducing strategy lies in its relative performance on these negative days. Thus, we created a table comparing PUT and PUTR performance to their benchmarks on those down days.

| | Days When S&P 500 Index Closed | |
|---|-------------------------------------|----------|
| | Negative | Positive |
| Total # Days | 28 | 34 |
| Days Where PUT Index lagged S&P 500 Index | 0 | 28 |
| Average S&P Return | -0.994% | 0.80% |
| Average PUT Index Return | -0.658% | 0.47% |
| Average Daily Downside Protection by PUT Index | 0.337% | |
| | Days When Russell 2000 Index Closed | |
| | Negative | Positive |
| Total # Days | 26 | 36 |
| Days Where PUTR Index lagged Russell 2000 Index | 0 | 32 |
| Average Russell 2000 Index Return | -1.057% | 0.75% |
| Average PUTR Index Return | -0.648% | 0.41% |
| Average Daily Downside Protection by PUT Index | 0.409% | |

Sources: Bloomberg, CBOE. Period covered is 12/29/17 to 3/31/18. Past performance is not indicative of future results. You cannot invest directly in an index.

Quick takeaways

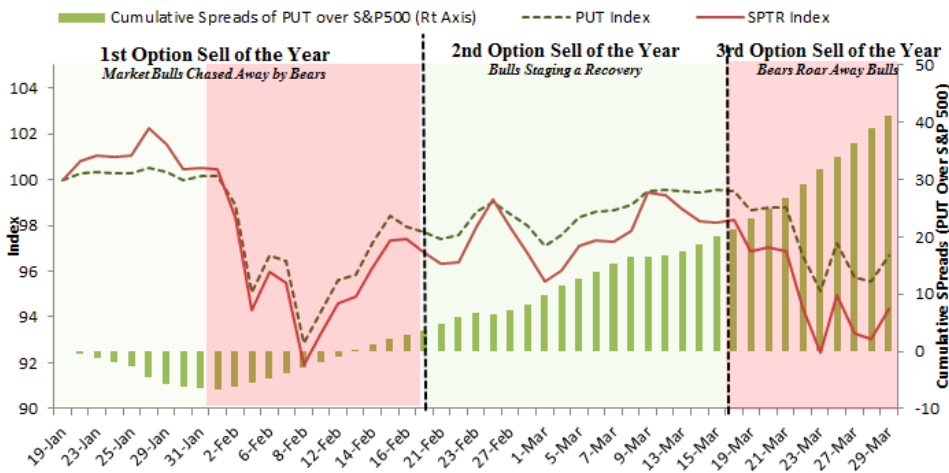
- PUT outperformed the S&P 500 on every single negative day.
- Additionally, PUT on average delivered downside protection of ~33 bps on each one of those down days.³
- Similarly, PUTR outperformed the [Russell 2000](#) on every single down day, and it did so with average downside protection of ~41 bps on each of those down days.⁴

Taking a Deeper Look

Let's take our comparison a step further and delve into how the two strategies performed since they sold their first [options](#) for the year. As a refresher, both strategies collect premiums by selling an at-the-money European-style put options with monthly maturity, with PUT involving selling on the S&P 500 Index and PUTR involving selling on the Russell 2000 Index. Monthly options typically expire on the third Friday of every month, and therefore the first time both strategies rolled into a new position was January 19 (i.e., the third Friday of January 2018). Now, in mid-January markets were trending to new highs and volatility was still low. To be fair, both strategies, which typically benefit when volatility is high (by collecting higher option premiums), were still not at their full glory when they rolled into their first option sell for 2018. Exhibits below (top for PUT and bottom for PUTR) show the three phases of the market's boom and bust for Q1 2018.

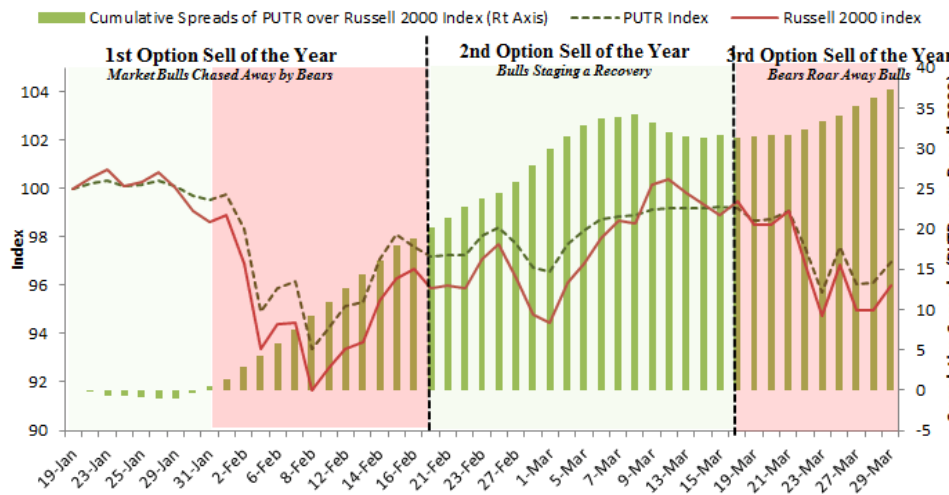
- Phase 1 (mid-January through mid-February): On January 19, both strategies roll their first options of the year.
- Phase 2 (mid-February through mid-March): On February 16, both strategies roll their second options for the year.
- Phase 3 (mid-March through the end of Q1 2018): On March 16, both strategies roll their third options for the year.⁵

Performance of PUT Index vs S&P 500 Index During Market Correction Early This Year



Sources: Bloomberg, CBOE. Period covered is 1/19/18 to 3/31/18. Past performance is not indicative of future results. You cannot invest directly in an index.

Performance of PUTR Index vs Russell 2000 Index During Market Correction Early This Year



Sources: Bloomberg, CBOE. Period covered is 1/19/18 to 3/31/18. Past performance is not indicative of future results. You cannot invest directly in an index.

In both instances, it is evident that:

- During Phase 1, initially both strategies lagged their respective benchmarks as markets reached new highs. However, their real benefit kicked in right when markets started correcting toward the end of January.
- During Phase 2, by rolling onto the second option of the year when VIX spiked (owing to a February 5 spike in volatility), both strategies collected richer premiums, which then helped their total return build up over respective benchmarks. Therefore, while markets were sideways, the two strategies delivered decent outperformance.
- Finally, in Phase 3, as both strategies sold their third options for the year, continued higher volatility ensured continued collection of higher premiums—in other words, a continued basis for outperformance.⁶

Conclusion

Warren Buffett once famously said, “You only find out who is swimming naked when the tide goes out.” I think similarly, the true colors of any risk-reduction strategy are not revealed on days when the market is up; rather, they are revealed on days when the market is down.

We believe incorporating PUTW and RPUT in large-cap and small-cap allocations is akin to incorporating a batter with a batting average of 100% from last season, which was an extremely volatile one!

¹Sources: Bloomberg, CBOE.

²Sources: Bloomberg, CBOE.

³Sources: Bloomberg, CBOE. Period covered is 1/19/18 to 3/31/18.

⁴Sources: Bloomberg, CBOE. Period covered is 1/19/18 to 3/31/18.

⁵Sources: Bloomberg, CBOE. Period covered is 1/19/18 to 3/31/18.

⁶Sources: Bloomberg, CBOE. Period covered is 1/19/18 to 3/31/18.

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DEFINITIONS

S&P 500 Index: Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Bullish: a position that benefits when asset prices rise.

Low volatility: Characterized by lower standard deviation of price over time. This term is also associated with the Low Volatility Factor, which associates lower volatility stocks with better risk-adjusted returns vs the market over time.

Forward volatility: Forward volatility is a measure of the implied volatility of a financial instrument over a period in the future, extracted from the term structure of volatility (which refers to how implied volatility differs for related financial instruments with different maturities).

Basis point: 1/100th of 1 percent.

CBOE S&P 500 Putwrite Index (PUT): Measures the performance of a hypothetical portfolio that sells S&P 500 Index (SPX) put options against collateralized cash reserves held in a money market account. The PUT strategy is designed to sell a sequence of one-month, at-the-money, S&P 500 Index puts and invest cash at one- and three-month Treasury Bill Rates. The number of puts sold varies from month to month but is limited so that the amount held in Treasury Bills can finance the maximum possible loss from final settlement of the SPX puts.

Russell 2000 Index: Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

Put options: an option to sell assets at an agreed price on or before a particular date.