

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, Cboe Global Markets 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 5 February, when the VIX spiked by 20 points 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) tracks Cboe's PUT Index after fees and expenses. This underlying Index has an established track record of handling stress and being a potential match winner for investors seeking portfolio risk reduction. Let's see how it 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. A true test of any volatility-reducing strategy lies in its relative performance on these negative days. Thus, we created a table comparing PUT performance to the S&P 500 Index on those down days.

Sources: Bloomberg, Cboe. Period covered is 31 Dec. 2017 to 31 Mar. 2018.

You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.

Main takeaways are:

- PUT outperformed the S&P 500 on every single negative day.
- Additionally, on average PUT delivered downside protection of approximately 33 bps on each one of those down days.³

Taking a Deeper Look

Let's take our comparison a step further and delve into how the strategy performed since it sold the first options for the year. As a refresher, the Cboe S&P 500 PutWrite Index collects premiums by selling at-the-money European-style put options with monthly maturity on the S&P 500. Monthly options typically expire on the third Friday of every month, and therefore the roll for the index into a new position was 19 January (the third Friday of January 2018). During mid-January markets were trending to new highs and volatility was still low. The strategy, which typically benefits when volatility is high (by collecting higher option premiums), was still not at its full glory when it rolled into its first option sell for 2018. The exhibit below shows the three phases of the market's boom and bust for Q1 2018.

- Phase 1 (mid-January through mid-February): On 19 January, the Cboe S&P 500 PutWrite Index rolled its first option of the year.
- Phase 2 (mid-February through mid-March): On 16 February, the Cboe S&P 500 PutWrite Index rolled its second option for the year.
- Phase 3 (mid-March through the end of Q1 2018): On 16 March, the Cboe S&P 500 PutWrite Index rolled its third option for the year.⁴

Figure 2 - Performance of PUT Index vs S&P 500 Index During Market Correction Early This Year

Sources: Bloomberg, Cboe. Period covered is 19 January 2018 to 31 March 2018.

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In both instances, it is evident that:

- During Phase 1, initially the Cboe S&P 500 PutWrite Index lagged the S&P 500 as markets reached new highs. However, the 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 spike in volatility on February 5), the Cboe S&P 500 PutWrite Index collected a richer premium, which then helped its total return build up over the S&P 500. Therefore, while the S&P 500 was sideways, the two strategies delivered decent outperformance.
- Finally, in Phase 3, as the Cboe S&P 500 PutWrite Index sold its third option for the year, continued higher volatility ensured continued collection of higher premiums—in other words, a continued basis for outperformance.⁵

Conclusion

Warren Buffett once famously said, "You only find out who is swimming naked when the tide goes out." Similarly, the true colours 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.

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