

A Diverse Equity Portfolio A Case Study

Enhancing income for a family office with diverse holdings

A family office holds a \$25 million equity portfolio comprised of a diverse basket of stocks, including 10% allocations in several listed companies that as a group, behave very much like the market as a whole.

Concerned that the upside market ascent will not continue into perpetuity, the family seeks a source of returns beyond just stock market advances.

To generate additional income, the family office sells upside calls as well as downside puts on cash-settled index options that expire within one month.

Index Options

The listing of options on various market indexes has allowed many investors to trade a broad segment of the financial market with one transaction. Investors looking to trade options on market indexes have two choices: physically settled options on exchange-traded funds (“ETFs”) such as the SPDR S&P 500 ETF Trust (SPY) and cash settled index options, such as the S&P 500 Index (SPX) options. In this example, we will focus on cash-settled SPX options.

The first thing to note about SPX options is that, unlike SPY options, they are based on the calculated value of the S&P 500 Index which cannot be bought or sold like an individual stock or ETF. As a result, SPX options settle in cash based on the level of the index when the options expire.

The second thing to note is that SPX options, unlike ETF options, are “European” style contracts that can only be exercised on their expiration date. Moreover, cash-settled index options offer different, and sometimes favorable, tax treatment on any capital gains that might be generated (Please consult with your tax advisor for more information).

Options Solutions Research
5425 Wisconsin Ave
Suite 600
Chevy Chase, MD 20815
www.OptionsSolutions.com

Michael J. Oyster, CFA, CAIA
Chief Investment Officer
moyster@optionsolutions.com

William (Bill) Speth
Chief Research Officer
bspeth@optionsolutions.com

Amalia Rosen
Investor Relations
301-968-2450
arosen@optionsolutions.com

The example below describes a portfolio of five stocks, which as a group, exhibit a high correlation to the stock market. Rather than sell options on each stock individually, the family office sells SPX call options to generate additional income. The number of index options sold would be based on value of the five stocks rather than the number of shares held.

Why Index Options?

The combination of cash settlement and European exercise is attractive to certain investors looking for efficient ways to participate in the price movement of the market, or to hedge all or some part of a portfolio that might correlate closely to the S&P 500 Index.

The cash settlement feature of SPX options means that an investor can participate in the movement of the S&P 500 Index but avoid the complications of selling or buying shares of stock when the options expire – which may or may not be viewed as a benefit by some.

The "European" style exercise for SPX options means they can only be exercised on their expiration date. Options on individual stocks and ETFs on the other hand are "American" style options, which means they can be exercised at any time up to and including their expiration date. Some investors believe that the certainty of knowing when index options expire make them an attractive tool for option selling strategies.

Results:

The index option overlay strategy provides incremental monthly income of \$29,260 on a \$25 million portfolio of diverse equity.

Family Office										
Total Assets										
\$50,000,000										
Individual Stocks	Price	Shares	% of Total Assets	Stock Value	Option Overlay			Strike	Price	Total Income
ABC	105	47,619	10.0%	\$4,999,995	19	SPX	Calls	3370	\$7.70	\$14,630
DEF	21	238,095	10.0%	\$4,999,995	19	SPX	Puts	3000	\$7.70	\$14,630
EFG	32	156,250	10.0%	\$5,000,000						
HIJ	84	59,523	10.0%	\$4,999,932						
KLM	303	16,501	10.0%	\$4,999,803						
Total Individual Stocks				\$24,999,725						\$29,260

Graph is for illustrative purposes only.

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