
Protect Your Nest Egg with Options

By Louis Harvey Thu, Apr 2, 2020

Advisors can help protect their clients from market drawdowns by purchasing puts on the S&P500 Index, writes our guest columnist, the founder and CEO of DALBAR, which rates the quality of financial services.



Americans have now experienced the hazards of investing for a second time in 12 years, but unfortunately, they've rarely taken advantage of the protections that institutions enjoy. Investors saw as much as a third of their nest eggs disappear in 2008. This year, coronavirus has already taken a quarter of what many had accumulated.

Back in 2008, many individual investors and retirement plan participants dumped their investments only to find that, when the market came roaring back, they were not part of the rapid recovery. Instead, these investors did not reenter the market until prices had risen without them.

This habit of dumping investments in the face of a crisis and then missing the recovery is the main reason that individual investors do not earn as much as institutions. But holding on to investments in a crisis is not the only reason institutions do better. They also buy protection in the event that the market fails to recover!

The protection that institutions use is generally not offered to individuals or plan participants. No one—including most financial advisers—ever explains to them how this works or provides a simple way of obtaining it. But we're about to show you how to do so.

How institutions protect their investments

The fund managers at institutions know that investment markets rise and fall, sometimes farther than other times. They also realize that over time the rising is more than the falling. The institutions also know that there are a large number of investors who make bets on the market activity.

Just like the football pool at the office or workshop, some people win their bets and others lose. Knowing all this, institutions place their bets on both sides. In that way, "Heads I win, tails you lose." Not a bad way to do business, if you can do it. And yes, you can.

Protecting plan participants

The “bets” are known as options. Thousands of different options exist, some that bet on the markets to rise and others that bet on a decline. Some bet on specific stocks or commodities and others bet on the market as a whole.

For most individual investors, it is enough to buy protection against a decline, since their investments (as opposed to the options themselves) will reward them when the market rises. While individuals can buy protection against a decline in the value of their own investments, this is both difficult and unnecessary.

It is difficult because this would require a customized bet, and not all individuals have enough assets to justify the expense of a customized bet. It is unnecessary because they can buy less expensive generic bets, called index options, which pay off when the value of the market as a whole goes down.

The most widely used index options are options on movements of the S&P 500 Index. These come in two basic varieties, but individuals and plan participants need only consider the bet known as a “put,” which pays when the market declines.

You need to answer four key questions in order to protect yourself against market declines with an S&P 500 Index Put:

- Where does one buy an S&P 500 Index Put?
- How many of these Puts are needed?
- What is the cost?
- What are the risks?

Purchasing an S&P 500 Index Put

The S&P 500 Index Put is a security that can be purchased through most brokerage firms.

Index puts may be available to plan participants if their plan has a self-directed brokerage (SDBA) feature and they have a brokerage account that permits options. Outside of a plan, individuals can purchase puts through a discount brokerage account or, with their adviser’s help, through the adviser’s broker-dealer.

How much to buy?

Either way, an investor needs to buy sufficient puts to cover up to 100% of the potential losses on their investments. (As with any type of insurance, the potential loss depends on

the value of the asset, the degree of coverage, and the duration of the coverage.) This coverage will be needed for as long as the market is expected to decline. Market recoveries usually occur within three months after an initial decline. To be covered all the time, investors can buy puts that expire and renew annually.

Each put has a strike price that represents the level of the bet that's made. For cost-effective protection, use a strike price that is "at the money," or close to the current price of the index. If the strike price is "out of the money," or higher than the current price of the index, protection will cost more.

If the strike price is lower than the current price of the index (an "out of the money" put), the put will cost less but protection will also be less. Investors and their advisers can calculate the number of puts, expiration and strike price themselves or with any of several available online tools.

Cost of Index Puts

For the index put to be worthwhile, the cost must be far less than the potential loss. The cost of "at the money" puts ranges from 1% to 3% of the amount at risk, depending on the expiration date and the market volatility at the time. This means that the index put becomes profitable if the market declines 1% to 3% or more.

If the value of the investments falls farther than that, the profit from the put will pay for any additional market loss in the investments. If the market rises, the value of the investments increases and covers the cost of the puts.

This cost of 2% (average of 1% to 3%) lowers investment returns to a far lesser extent than using cash or bonds for protection. Historically (since 1928), a protective allocation to cash has lowered equity returns by 7.6% and to bonds has lowered equity returns by 6.1%.

Risks of Index Puts

Options are bets and therefore can be risky, depending on how they are used. The use described in this article is potentially the safest possible use of options. In fact, the risks here are less than the risks of the investments themselves.

Risks are neutralized by:

- Diversification; achieved by buying a put on a broad-based market index.
- Not using leverage; the options are not financed with borrowed money, but are backed

by the investor's own assets.

- Liquidity; achieved by using the S&P500 Index, the most popular index in the world.
- Trading convenience; the option can be purchased or sold on any trading day.

Conclusion

Use of index puts to protect individual investments is a drag on portfolio performance over the long term. But they help investors avoid the market shocks that occur periodically and cause them to act imprudently in trying to escape volatile markets. For this reason, it is highly prudent for plan sponsors and financial advisers to offer such protection to participants or clients who seek a less bumpy path to retirement income security.

Note: Over recent days, stock prices have benefited from quarter-end rebalancing strategies and a rebound from the fastest drawdown in stock prices ever. However, we believe investors should prepare for more volatility once we move through this short-term market dynamic.

As long as the U.S. remains in a health crisis, the market is unlikely to calm down in a more lasting fashion. Covid-19 cases are growing, and at an uneven pace across the country. It is also unlikely that America as a whole will return to regular activity over the next few weeks. This point alone increases the risk economic/market activity could be volatile, and unpredictable at times.

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