Two Options Strategies for Cautious Optimists

BY STEPHEN SOLAKA

By most measures, 2013 was a great year for stock investors. The major benchmark indexes rose to stratospheric levels as the economy improved, and risk was rewarded handsomely.

But as 2014 looms, it's not unreasonable to worry about stocks after their 29% run-up in the past year. Yet fixed income looks no more attractive. The Federal Reserve is expected to continue to taper its bond-buying program, and perhaps even raise the historically low interest rates that have helped us recover from the financial crisis. This creates real challenges for investors.

The investment strategists are out in force, giving crystal-ball musings on what will come, but these predictions are like New Year's resolutions: Most will fall by the wayside and be forgotten by March. That may be particularly true in 2014, because the March Federal Reserve meeting may be a game changer if employment numbers improve and tapering increases.

So instead of making predictions, deal with what is known, rather than what isn't. Depending on whether you are sitting on cash, profits, or both, two options strategies can be used to guide your portfolio next year. The "half-and-half" strategy lets you cost-effectively buy stocks, while a cheaper portfolio hedge protects your profits.

THE HALF-AND-HALF: If an investor wants a more measured approach to buying equities, this strategy balances the potential reward of stocks with the risk of buying them while the market is uncertain. In this strategy, investors sell calls on half of an equity position, while also selling puts at prices below the stock's current quote.

Here's how it works: Investors who want to deploy $1 million in the U.S. stock market could put half that amount in the SPDR S&P 500 exchange-traded fund (ticker: SPY). This recently traded at $183.50 per share while March 191 covered calls—with a strike price about 4% above the market level—were at $1.06. Selling the calls limits some potential upside, but would generate income that would help offset any investment losses if the market heads south.

The other $500,000 stays in cash, but is the basis for the second half of the strategy: selling cash-secured puts on the March 172 strike for $1.38.

If the ETF falls below the put strike, which recently was 6% below the market, you'd have to buy the shares, albeit at a lower price than you paid for the first $500,000 you invested. If the SPDR S&P 500 never trades below the strike price, however, the money received for selling the put can be pocketed. Think of this part of the trade as getting paid while you wait to buy stocks at a lower price.

HEDGING GAINS: Of course, not everyone wants to add equities to their portfolio. Some investors are afraid that 2014 will be defined by an erratic stock market. These folks can shelter their portfolios with put spreads. These are cheaper than buying a straight put, though the protection they provide is only partial.

Again, let's use the SPDR S&P 500 as an example, though the strategy applies to all securities. With SPY at $183.50, investors can hedge a $1 million portfolio by buying March 178 puts and selling the March 162 puts for a total of $1.85. The trade would protect a portfolio in any market decline of 3% to 12%.

Now, as with most insurance, you can lose the entire amount paid—which is why many investors like to pair put spreads with short calls. By selling the March 191 call for $1.06, you can lower the cost for the put purchase, but you limit the portfolio's upside if the stock goes past $191.

Momentum and buy-the-dip trades worked like a charm in 2013 as the market defied all skeptics. But 2014 could be a year for level heads. Investors who favor planning over predictions should consider our two strategies, which could profit their portfolios in the new year.\(t_{1/2}\)

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