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An Options Strategy That Helps Returns Fly High

BY STEPHEN J. SOLAKA

Income-oriented investors face serious challenges.

Interest rates on bank deposits are near zero, and effectively below zero after factoring in inflation. Buying bonds to generate cash flow is not much better, especially for investors in the growing number of nations with negative bond yields, such as Japan and Switzerland.

Many investors have responded by purchasing stocks and hoping (the most dangerous word in markets) that prices will keep rising, even though valuations seem stretched—or at least that stocks won't fall, or get stuck in a trading range.

But investors can enhance their portfolios, diversify returns, and generate income with a few well-placed puts and calls.

We are seeing sophisticated investors increasingly focus on selling, or "writing," short-term out-of-the-money call-and-put spreads on equity indexes. The strategy, known as the "iron condor," has an impressive history. The Chicago Board Options Exchange S&P 500 Iron Condor index returned 10.40% in 2015, compared with the Standard & Poor's 500 index's 1.38%. In the volatile 2008 market, the condor index fell 3.99%, as the S&P 500 sank by 37%.

THE IRON CONDOR'S seeming complexity often frightens investors. But the strategy simply entails selling a put spread and call spread, two very common trading strategies. To implement a condor, investors sell out-of-the-money calls and puts, and hedge their risk by buying calls and puts that are even further out of the money.

By combining a put and call spread, the strategy can generate significant income. After all, you get paid for selling calls or puts that are, say, 5% above and below the market. More distant puts and calls can often be bought for less money, which means investors can pocket the difference, effectively getting the options market to help pay them to implement their condors.

The strategy's key risk is that the underlying security turns out to be more volatile than anticipated, and shoots through the short strikes. While this sounds bad, the risk is defined. How? All short options are paired with long options. Ideally, the underlying security remains between the two short strikes and investors collect the entire premium.

In my experience, the condor's return depends less on the associated stock's direction than it does on how quickly the security moves.

THE FOLLOWING TRADE illustrates how the strategy works:

With the SPDR S&P 500 exchange-traded fund (ticker: SPY) trading at 216, investors could sell the SPY 222 call that expires Sept. 2 and buy the SPY 227 call with the same expiration date.

At the same time, they could sell the SPY 206 put that expires Sept. 2 and purchase the SPY 195 put with the same expiration date.

The trade would generate a $1.10 credit, which means the options market is paying investors to assume the risk that SPY remains between 206 and 222. Should that prove accurate, a $1 million position would generate a $5,000, or 0.50%, return in just over a month. If SPY moves sharply higher or lower, the maximum loss on either spread is the difference between the short and long strike, minus the total premium collected for the trade.

Investors uncomfortable with so many moving parts can generate income or enhance returns by simply selling puts on the broad market indexes or on stocks they want to own. A Chicago Board Options Exchange study found that selling puts on the S&P 500 from June 1986 to December 2015 returned 10.13% per annum, outpacing the market's 9.85% return with one-third less volatility.

The bottom line: Less risk and better returns are something all investors should take a look at. And prudent options strategies can provide them.

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