

Enhancing Portfolio Yields Using Options on Stock Index Futures

Presented as an educational illustration and not as a trade recommendation

This strategy originally appeared on the CBOT educational website, though in an abbreviated version and without the illustrations we have provided

Stock price fluctuations often seem to alternate between directional bursts of volatility and directionless oscillations. These market phases are often called “trading range markets” or consolidation phases. When you expect the market to continue in a trading range, you can enhance the stagnant return on your securities portfolio by **selling calls on appropriate stock index futures**. This trading strategy is referred to as a cross-covered write. (*)

Portfolio: You hold a mutual fund or ETF whose value is tied to the Dow Jones Industrial Average (DJIA).

Scenario: In late May, the spot value of the DJIA is 12600. Based on your market observations, you don’t believe that the DJIA will emerge from its current trading range of 12700-12500, with a slight chance of increasing above 12700 within the next thirty days.

Strategy: Sell June calls at a strike price of 12700. The premium of the June 12700 call is 14.70. Selling the 12700 call generates an immediate credit of \$1,470.00.

Results: You keep the entire premium if the June futures price stays below 12700 by the June expiration. In return for this immediate gain, however, you give up all price appreciation above 12700. The break-even point is 12,847, where the DJIA is equal to the sum of the strike price (12700) and the call premium (147.0). It is only above this point that the cross-covered call portfolio becomes less profitable than the original portfolio. (**)

Comments: Since the short call is a cross-hedge against a long position in the spot index, the strategy has limited risk. The primary price risk is in the correlation of the spot portfolio (mutual fund, ETF or basket of individual securities) against the DJIA futures contract. There is upside risk in that you may limit the spot portfolio price appreciation should the spot index rally above the perceived upper boundary of the trading range. However, the call premium paid to you at the onset may compensate for this risk. Note too, that this is not a true hedge and the strategy is not intended to protect the portfolio against a drop in the index below 12553 (12700-147). This is a yield enhancement strategy, not a hedge against falling stock prices. The optimal strike price of the call depends on the probabilities you have assigned to future increases of the DJIA.

Page two reviews various outcomes

Transactions in futures, options, & forex carry a high degree of risk. Traders can and do lose money.

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Possible outcomes (based on prices on the option expiration day) *
[illustrations ignore commissions and fees]

	The spot Index is Unchanged	The spot Index Falls	The spot Index Rallied
Spot Index	12600	12400	12900
Option value	0	0	\$2,000
outcome	Value of the portfolio is unchanged. Trader retains the entire \$1,470 premium	The value of the portfolio loses 200 DJIA points. Trader retains the entire \$1,470 premium	The value of the portfolio increases by 300 DJIA points. Trader was short the Option from \$1,470. Loss on the futures option position is \$530.00.

* In a cross-hedge, the spot position is not deliverable against the futures contract specifications. In futures options, the only true covered write is when an option is sold against a futures position. Our illustration assumes a cash market position. Therefore if the option were to be exercised, the call option seller would retain the cash market position but would assume a short futures position. Therefore we refer to this strategy as a cross-covered write.

** In DJIA futures options, the premium is quoted in basis points. We used 14.70 in our illustration. But the underlying DJIA futures contract price quote does not use any decimals. So an option premium of 14.70 has the same dollar value as a futures price quote of 147.

NOTE: The same approach can be used for portfolios tied to the S&P 500, S&P 400 Midcap, the NASDAQ 100, the Russell 2000 and any other liquid options on stock index futures contracts.

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