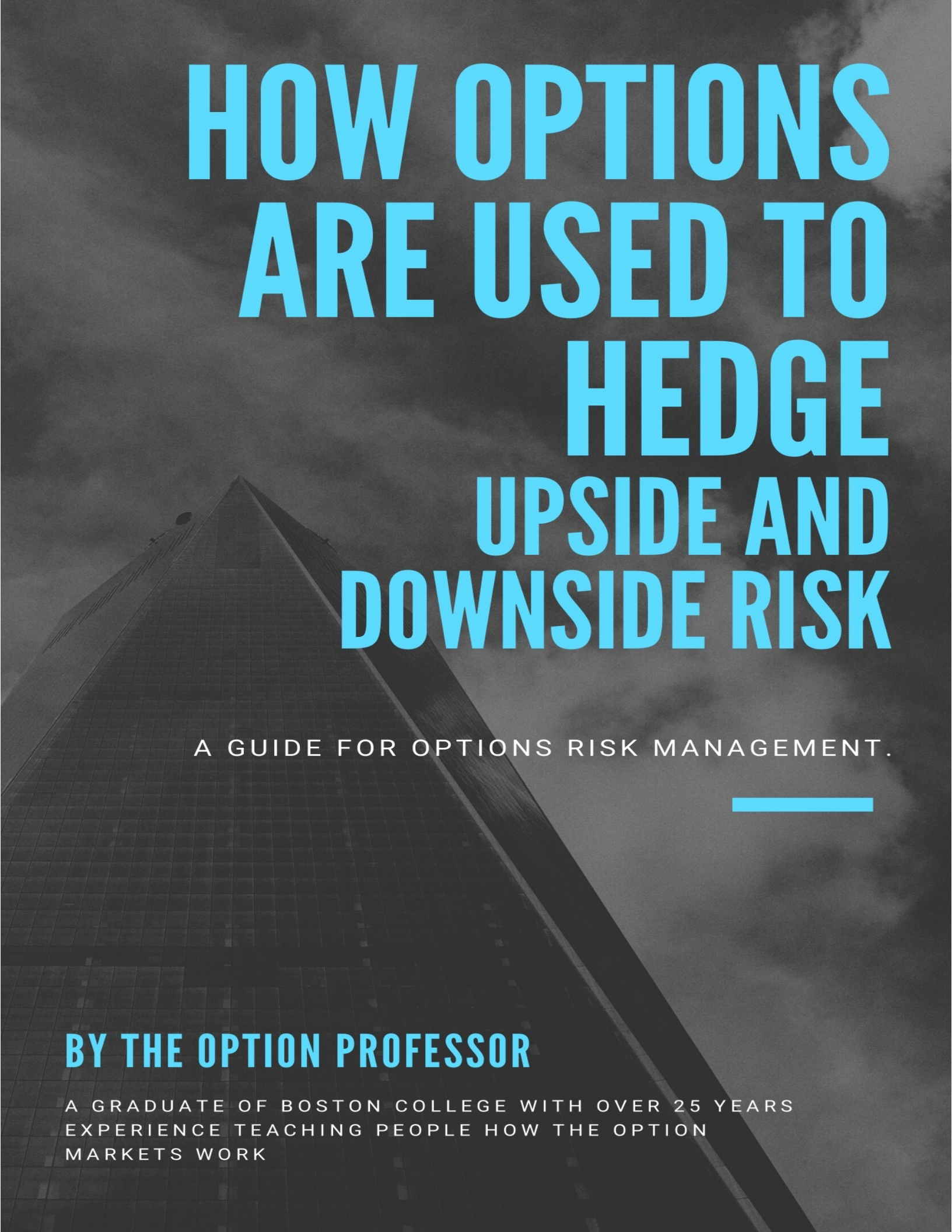

HOW OPTIONS ARE USED TO HEDGE UPSIDE AND DOWNSIDE RISK

A GUIDE FOR OPTIONS RISK MANAGEMENT.

BY THE OPTION PROFESSOR

A GRADUATE OF BOSTON COLLEGE WITH OVER 25 YEARS EXPERIENCE TEACHING PEOPLE HOW THE OPTION MARKETS WORK

Options trading has been considered a high risk investment for the many decades since their inception.

Did you know many investors actually use options to REDUCE risk in their portfolios?

Before we begin; I would like to introduce myself as the person sharing his views and opinions. My name is Jim Kenney and I have been the content provider for OptionProfessor.com for decades. As a graduate of Boston College and having conducted hundreds of option seminars for thousands of investors nationwide; I have seen many investors struggle with the concept of options as a hedge.

Let's start out by understanding the concept of a hedge. If an investor owns a position (long) in their account; the risk is that asset will fall in value and value of the account will decline as a result. In this hypothetical example the investor could benefit from an option strategy that would increase in value during a market decline to offset in part or in total the decline in the underlying position. Conversely; should an investor not own a position in the market, a rise in price would be his opportunity risk in that he may be compelled to buy at higher prices. In this case an option strategy that would benefit from a rising market could be of value offsetting in part or in whole the risk of higher prices. Many of you have had trading experiences where a hedge could have added real value.

Before we go further; you may have some "let's cut to the chase" type questions right now. They may include "How much do these hedges cost?" and "How much hedge do I get?" and "When do you it? All great questions and some have factual answers while others do not. It's a combo of Art & Science. My opinions are my own and other opinions will vary. Ask your firm & advisor. Here's some scenarios.

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SCENARIO #1 - The investor initiates a position in a volatile tech stock. They are concerned about the downside risk as the stock has had huge moves up and down. They believe the stock will have a major advance but want some floor under their equity. They could use a stop loss but the risk of getting stopped out or the stock gaping thru their stop leads them to look for an alternative. There are a number of option tactics that I would consider including married puts and collars. Here's where the art and science comes in. There are questions that I would have to answer before reaching a decision. What is the implied volatility of the options? If the stock has been hugely volatile then the option premiums

are going to be big if not the premiums may be fair sometimes even cheap. How much of a hedge do I want? This is where you determine what strike price to choose. How much time to I want to be hedged? This is where you select your expiration dates. Some investors want to hedge specific events (e.g. Fed meetings/earnings announcements/dividend dates/splits/takeovers ect.) while others want to sleep at night with parameters around their positions. Always price out the puts in the far out expiration and compare to the nearby puts; you may find a little bit more money gets you a lot more time. Remember; like many other types of hedges, when your contract expires so does your hedge.

Hypothetical example on Apple. Let's say you take a position of 100 shares (each option contract is based on 100 shares) @ a price of 175. All of these hypothetical example are exclusive of any fees or commissions the total is $17,500. You decide that for the next 6 weeks you would like to get a hedge for an objective of hedging your position to a 3% draw down for that period. The monthly option expiring in 6 weeks with a strike price of 172.50 can be bought for $2.50 in this hypothetical example. The strike price of 172.50 minus the premium paid puts your hedge at 170 per share or about 2.8% below your entry level of 175 well with your parameters. There are many things that could happen between now and the expiration date but let's look at 3 outcomes at expiration settlement. Apple has risen to 195. The stock has risen $20 from your entry but you need to reduce that by the put cost of $2.50 or $17.50 gain. Should the stock decline to $155 or a decline of $20 in value. The put gives you the right but not the obligation to sell at $172.50 minus the cost of $2.50 or $170. The difference between $170 and $155 is a credit of $15 per share. In this example you hedged $15 of the $ 20 risk. Should the stock trade sideways but stay above $172.50; you lose the premium but still own the stock.

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Sometimes option premiums are very high due to many factors including implied volatility. My feeling on implied volatility is that the options are priced as to what has happened not what is going to happen and therein lies the rub. Options on slow moving stocks tend to be a lot lower than a fast moving stocks as the implication is the same volatility will continue. The problem is slow moving stocks can get news and volume that increases their moves and fast moving stocks can subside or correct.

When option premiums are high and you still want downside hedge you may need to consider and strategy that combines the use of covered call writing with put buying also known an options collar.

Since this strategy combines 2 strategies simultaneously; there are 2 risks that need to be considered among other things. First off; when you are selling calls against your stock, you are agreeing to sell your stock at a certain price for a certain amount of time and for that you receive the call option premium. Secondly;, when you are buying a put, you have the right but not the obligation to sell at a certain price for a certain amount of time and you pay the put premium. Among other things; you limit your upside but you also limit your downside simultaneously.

This hypothetical example with involve buying 100 shares of Boeing after major advance @ $440 or $44,000 again all examples are exclusive of fees and commissions. Again; your objective is to have the ability to participate in some while hedging against a down move for the next 6 months of time.

The options expiring in 6 months are priced at $25 for the 470 call and $25 on the 430 put. The collar strategy would be the selling of the 470 call @ $25 or $2500 dollars received. This obligates the investor to sell/deliver stock at 470. Simultaneously; the investor buys the 430 put @ $25 or pays a premium of $2500 for the right but not the obligation to sell at 430. Essentially; the investor has limited his upside to an additional 30 per share (470) while limiting his downside to $10 per share (430). Should the stock remain between the strike prices thru expiration; both options may expire worthless and the investor retains the stock. The investor has taken the premium received on the call and used that premium to buy the put. There are other considerable factors and adjustments.

This is known as collaring the position so that while additional upside after a substantial up move still exists; the put option strike price puts a floor under the position until the options expire. Other factors such as liquidity (bid/ask spreads) and volume (amount of contracts traded) should also be considered. Again no strategy is right for everyone so consult your brokerage firm and adviser.

I will be providing more details on my views and considerations when considering an option strategy. Should you want to receive updates or have question; I invite you to contact me at optionprofessor@gmail.com.

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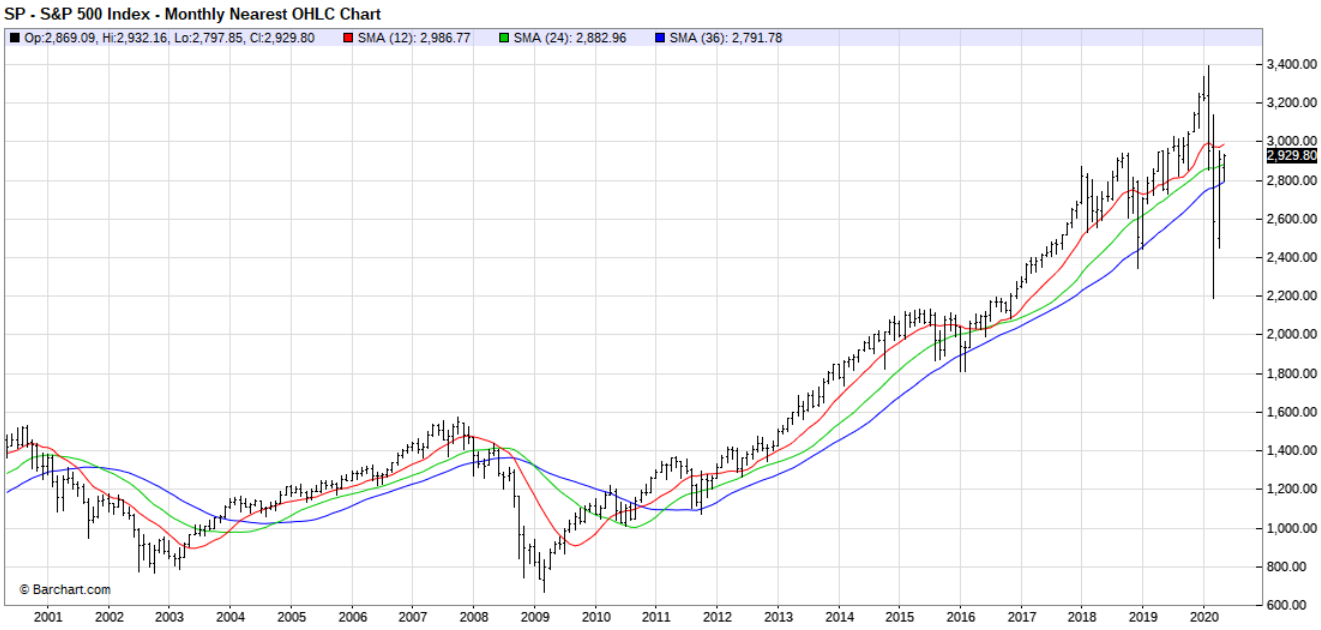
BONUS SECTION:
The Most Important Chart On The Stock Market Today (May 2020)



source: barchart.com, 05/10/20

Ok Everybody...that's a big statement so; as always, I'm going to share my Opinions & Observations on why this particular chart may be so important. First off... let's talk about the underlying index the S&P 500 Stock Index. The index is a market capitalization weighted index of the largest 500 U.S. publicly traded companies. This gives a higher percentage allocation to companies with the highest market capitalizations. It is widely regarded as one of the best gauges of US large cap equities. Top Stocks by Index weight include Microsoft, Apple, Amazon, BRK.B, Alphabet, Facebook, and JNJ.

Now, let's talk about the moving averages illustrated on the chart. There are three (3) different time frames to give you 3 different perspectives. They are the one (1) year, two (2) year and three (3) year moving averages. By adding the closing prices for the period described and dividing it by the number of days you get a number...by dropping the price off from the furthest date and adding the most current price the number is updated and in fact moving with the price. We always liked this as part of our research as it is based on TIME & PRICE and not on predictions & opinions.

YES: the information is HISTORICAL and may have limited if any predictive value; however, we believe it can be helpful in determining trends and points of acceleration. If you want the Holy Grail... look elsewhere...if you want something to add to your toolbox...keep reading...It's time to get to the punchline...

We believe that the STOCK MARKET has had four (4) big drops in the last twenty (20) years....2000=03...2007-09....2015-16 and 2017-18 and of course 2020. What can we see from the 1yr 2yr 3 yr moving averages as it relates to the TREND & TIME it took to recover back into an UPTREND??

Our conclusion is that during the severe CRASHES of 2000 & 2008; we can see all moving averages crossed over to the DOWNSIDE and it took YEARS for the S&P 500 Index to resume its UPTREND. We also see that in the more MODERATE & BRIEF down moves in 2016 & 2018; we can see that the all the moving averages DID NOT CROSS & in fact the 2 yr & 3 yr moving averages essentially remained up trending throughout the BRIEF decline.

RIGHT NOW; the 1-2-3yr moving averages come in at ballpark @ 2980...2880...2790....2 days before the Payrolls Report....we stand at about 2848. So far; the REVERSION RALLY has failed at the 1 yr moving average of 2980 area. Tech & some asset allocation models (e.g.80-20) have surpassed all their moving averages and are actually UP on the year...most are NOT.

OUR CONCLUSION is that if the S&P 500 can MAINTAIN ABOVE 2790 & build on its GAINS...the FED & Treasury & Corporations may have engineered (by issuing a Mt. Everest amount of DEBT) a RESUMPTION of the UPTREND against all odds....HOWEVER....if the S&P 500 FAILS @ the 2790 level and trades LOWER over the summer instigating a CROSSING of the moving averages to the DOWNSIDE.....then ODDS could FAVOR a situation of LOWER prices and a more EXTENDED ECONOMIC RECOVERY TIMELINE....we would suggest BE PREPARED for either SCENARIO.

Past performance is not necessarily indicative of future results. Option trading involves substantial risk and is not right for everyone.

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