



# Defending An ETF Portfolio (Part 2)

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**Y**ou will recall from my previous article (January 2005) that I focused on the use of alternative asset classes to defend an ETF portfolio, with a primary focus on low or negative correlations with stocks and bond holdings. Furthermore, I discussed the separation of beta (market risk and associated returns) with alpha (manager risk and their associated returns) and the concept of “portable alpha”. This month I discuss various other strategies for defending an ETF portfolio. Each strategy, including the one discussed last time, has its own advantages and disadvantages. It is up to each investor to determine which is best suited for his/her risk profile and investment objectives.

## Tactical Asset Allocation Program Trading ETFs

In this case, an advisor uses selection and timing strategies to get into, and out of, various asset classes. These strategies provide opportunities to “tilt” the portfolio based on geographic region, industry sector, market capitalization or style (value versus growth). By “tactical” asset allocation, this does not presume that trading occurs daily or even weekly, although this is not uncommon. In some cases, there may only be a few trades per month. However, if we presume that the portfolio is built with 25 ETFs or more, it just makes sense that there is a greater potential for higher turnover versus a 10-ETF portfolio. Imagine if you had a 2-ETF portfolio: one for stocks and one for bonds. Rebalancing would only require two trades: one to bring the stock position back to its policy allocation, another trade to bring the bond position back to par. Now imagine the effect of trading costs if you had a portfolio consisting of 25 ETFs! At the end, the decision to use this tactical strategy comes down to the same one for choosing any active manager: How comfortable are you with the manager’s ability to “buy low, sell high”?

## Covered Call Strategy

There are various derivative strategies available to inves-

tors, many of which are geared to provide some form of hedge to an underlying stock or other security. For investors who wish to hold on to an underlying security (in our case, the ETF), I will focus on the covered call. Here’s a short description of how it works:

Covered call writing is a strategy where an investor establishes a long position on an ETF (or any security that is “option eligible”) and sells or “writes” a call option on this underlying security. A call option gives the buyer the right to buy the underlying security at a set price within a given period of time. By selling any option, the writer earns the option premium which is considered income. Note, however, that there’s no free lunch. The writer of the call option must be willing to sell the underlying security at a set price to the buyer, within the period of time determined by the contract. The writer accepts the premium income knowing that they have given up any potential appreciation of the ETF above the strike price. Bottom line: you’ve just given up some unknown future benefit (possible ETF appreciation above a set price) for a known present benefit (the option premium). Therefore, a key decision is which option to sell based on its strike price. There are three types of options to sell based on price.

- **In the money (ITM)**-This is when the stock price is above the strike price. If you’ve bought the call option and its ITM, you can buy the underlying stock at the strike price and then sell it at the current market value for a profit. But in a covered call strategy, you’ve sold the call option. If the option remains ITM until expiration (i.e., stock is going up or has stayed up), then you will most likely be assigned and have to sell your underlying stock position. For an investor who wants to remain invested, it’s an annoyance of having to sell your position and re-establish a new one. The upside potential was gone while you held that option, but if the position was closed or you were assigned, then you can simply buy the underlying stock to gain full exposure again.
- **At the money (ATM)**-This is when the stock price equals the strike price. Because of volatility in stocks, it’s un-

likely an option will remain exactly ATM.

- **Out of the money (OTM)**-In this case, the stock price is less than the strike price. If you have sold the call option, this is a good place to be. You've sold the option and earned the premium. If the option is OTM at expiry, the option purchaser lets it expire worthless as they can buy the stock at the market price, which is cheaper than the strike price. If the option was sold OTM, then the premium would not have been as big as if it were ITM or even ATM.

Note that in addition to providing income, covered call strategies can also be applied for the purposes of hedging a long position on an ETF. The difference is subtle. Hedgers want to "lock in" a selling price to their existing ETF position, thereby protecting themselves from falling prices. This differs from "income oriented" investors who are accepting the possibility to sell at a set price, but are more concerned with being assigned (forced to sell). Income seekers are more likely to write OTM options since there is less chance of being assigned and as these option positions expire, they simply roll over to similar OTM options with later maturities. This can all be a complicated strategy for novice hedgers since there is a strong need for monitoring. If prices go up strongly, you have to be prepared to be assigned at which time you will be forced to sell the ETF and re-establish a new position in that ETF. Another consideration is time and, hence, the term of the option. What if the stock goes up or down as expected, but not within the life of the option traded? Perhaps, this all seems like a fairly complicated process. For pure hedging purposes, an option strategy like a protective put (buying a put) may be also worth considering, but in this case you are buying insurance and, hence, paying the premium as opposed to earning it.

Another related solution may be found through the Montreal exchange. An option overlay on the Canadian equity asset class exists in one security listed as MCWX. More information can be found at: [http://www.me.org/produits\\_en/produits\\_indices\\_mcwx\\_en.php](http://www.me.org/produits_en/produits_indices_mcwx_en.php). More specifically, MCWX is an index that mimics a covered call strategy over an underlying position on the S&P/TSX 60 iUnits (XIU). There is also a covered straddle strategy (MPCX) at [http://www.me.org/produits\\_en/produits\\_indices\\_mpcx\\_en.php](http://www.me.org/produits_en/produits_indices_mpcx_en.php). Similarly in the U.S. there is an index called the CBOE Buy-Write Index (BXM) that mimics a covered call strategy over an underlying position on the S&P 500. The performance of these strategies over the buy-hold strategy of the index alone justifies further investigation by prudent risk-conscious investors. However, I would strongly suggest that you discuss the implementation of any option strategy with a properly experienced advisor. If you can not dedicate the time to monitor your positions in the first two strategies, the next strategy may apply.

## Principal Protected Note

This strategy is similar to many of the index-linked GICs sold at a branch of your local bank. In recent years, many hedge fund products have also been sold through some sort of a principal protected vehicle. The principal protection is provided through various methods from the most simple to the highly complex. Often times, the complexity results in increased fees embedded in these structured products. Frankly, if you believe that markets as a whole will not be positive over the term of a note (often they have maturities of 5 years, 8 years or 10 years), then this is a good choice for you. However, some things to consider: How often in the past (or likely in the future) is it that you will have a negative total return over a 5, 8 or 10-year period? Will you be satisfied with a 0% return, assuming that markets were down over the term of the note? Of course, 0% is better than a negative return, but one must still be aware that at best, you will earn 0%.

I am unaware of principal protected note products with underlying ETFs. However, there exists various structured products, some with principal protection that have underlying index positions, which is basically the same as what has been explained here. Here is a list of notes (some with principal protection) from the Business Development Bank of Canada, many with an underlying long position on a specific index: [s:www.bdc.ca/en/about/investor\\_relations/index\\_notes\\_listed.htm](http://www.bdc.ca/en/about/investor_relations/index_notes_listed.htm). Also very interesting are the Index Optimizer Notes from Open Sky Capital: [www.openskycapital.com](http://www.openskycapital.com). There may be more examples of these types of products, so consult with your financial advisor and do some research online.

## Conclusion

It will be interesting to see if a major downturn will cause investors to panic and attempt to time the market or otherwise trade aggressively. Panic is never good, but some investment managers may have a proven track record demonstrating their success with a defensive tactical allocation program capable of reacting to a downturn in the market. Covered call strategies have been used for years and may be a reasonable choice for an investor who can afford to be "hands on" with their portfolio. Principal protected notes have been increasingly popular over the past few years, but cost-conscious ETF users may not agree with the costs embedded in such products. Overall, there is more than one way to defend an ETF portfolio.

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