INCOME GENERATION IN A LOW-RATE WORLD

Jonathan Molchan, lead portfolio manager of the Nationwide Risk-Managed Income ETF (NUSI), discusses how option-based strategies can provide a foundation from which to generate income while also seeking to protect investors from losses in down markets.

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With yield increasingly scarce, what are some of the market areas that investors might target to attain the income they need?

Amid a persistent low-rate environment, investors and advisors alike have increasingly sought out alternatives to traditional bond investing. These alternatives include high-dividend stocks, real estate, emerging market debt, preferred stocks and high-yield bonds.

However, it is important to fully understand the potential benefits and risks that come with these alternative income strategies. Yes, there is the potential benefit of high income; but one must really look below the hood to understand what they are exchanging for that measure of high income. For instance, do these strategies exhibit low volatility, provide portfolio protection or have enough liquidity?

How does your strategy differ?

Our approach uses an options-trading strategy for income generation. An option is the right, but not the obligation, to buy or sell a security at a specified price and date in the future. They can be used to speculate on the future direction of a security.

Specifically, our strategy targets high monthly income with fewer risks relative to traditional income-focused investments. It seeks to provide investors with a measure of downside protection along with the potential of upside participation.

The strategy is fundamentally designed with income generation in mind. It seeks to give investors and advisors the ability to generate high monthly income without adding excess interest rate sensitivity, duration-associated risk, inflation, leverage or commodity exposure.

Let’s review in more detail. How can options be used as a source of income?

Given that options can be both bought and sold, the primary objective of using the instrument to generate income is by selling an option and in return the seller receives an options premium.

Investors can turn to professional, risk-managed options’ strategies to potentially exploit current market dynamics whereby the strategies can adapt to current trading environments to grant a higher probability of success.

Success would be defined as the best risk-adjusted return while maximizing income generation combined with a reasonable measure of downside protection.

Simply put as the markets change and the rules-based dynamic nature of the positioning of the options in these strategies will change as they seek the highest probability of a positive outcome.

First, we seek to replicate the Index by purchasing all its underlying stocks. Then we deploy our rules-based strategy and couple the underlying stocks with index options.

We sell a near-at-the-money to out-of-the-money call option to generate options premium and use a portion of the premium to purchase a protective put below the current market level. Then we distribute a monthly dividend using a portion of the options premium and seek to reinvest remaining net premium.

How does your strategy build in protection for the investor?

As described, we use a protective net-credit collar options strategy. This strategy combines two common options strategies but regarding protection we can focus on the protective put. Although this strategy combines two common options strategies – selling calls and buying puts – the primary goal of purchasing a put option is to limit potential losses in a price decline. It’s important to note that this put cannot be exercised and is always present.

The profitability of a protective put is determined by the gains in the underlying stock minus the cost of purchasing the put option. However, in exchange for foregoing some of the upside, an investor can potentially benefit from limiting the maximum potential loss. This is because the put option will profit if the stock price declines below the strike price. This strategy is ideal for investors with a bullish outlook who are looking to hedge a long position in an underlying stock in the event of a downturn.

How would you expect this strategy to perform in different market environments?

Our strategy follows a systematic, rules-based system which allows us to close the short-call option prior to expiration. This, in effect, ‘uncaps’ the portfolio by allowing the underlying equity portfolio to potentially participate in a rising market. So, in a rising stock market, total return will likely come from capital appreciation of the underlying stock portfolio.

The covered call component used as a part of the net-credit collar strategy may limit some of the upside growth potential but will still support the monthly dividend. In a sideways market, the strategy will pay its monthly dividend from the net-credit due to the covered call component and benefit from a potential move higher in the equity market while still providing a measure of downside protection from the protective put.

In a down-trending stock market, the strategy is designed to seek higher total return than standard covered call strategies as well as the broader equity market. The net-credit from the covered call component will support the monthly dividend while the protective put seeks to preserve portfolio capital if the equity market drops below the put strike price.

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