



## Commentary

### A Premium in Hand is Worth More than the Market's Return

When marketing, I often give a quiz. I first ask what was the compound-rate-of-return (CAGR) of the S&P 500 Total-Return-Index (SPTR) from mid-1986 to mid-2009? Given this time period includes the crash of 1987 and the bear markets of 2001, 2002, & 2008, the average guess is 5% CAGR. Amazingly it was 11.1% which makes it one of the greatest bull markets in history.

I then ask what the returns would have been if we did a monthly call and put overwrite vs. owning the SPTR outright. In a call overwrite (BXM) you are long the SPTR and short a one-month at-the-money call option. In a put overwrite (PUT) you are short a one-month at-the-money put option and have cash in 30-day T-bills.

In both of these strategies you are giving up 100% of the monthly appreciation of the SPTR in return for the option premium, while still having 100% exposure to the downside. You would expect these overwriting strategies to underperform the SPTR in a bull market.

Amazingly, 90% of people answer correctly that the returns of the overwrite strategies would have produced higher returns than owning the Index outright. They are correct, as the returns were 11.6% CAGR for the BXM and 13.5% CAGR for the PUT. The PUT returns were higher due to the addition of the 30-day T-bill returns.

To explore why option overwriting outperformed the bull market, I broke the 280 months into bullish months, sideways months, and bearish months.

#### **Bull months, option writing underperforms:**

For 111 of the 280 months the SPTR rose greater than 2%. For those months, the average monthly return was 4.8% for the SPTR, 2.9% for the BXM, and 2.6% for the PUT.

#### **Flat months, option writing outperforms:**

For 109 months the SPTR's returns were between -2% and +2%. For those months, the average monthly return was 0.2% for the SPTR, 0.9% for the BXM, and 1.1% for the PUT.

#### **Bear months, option writing massively outperforms:**

For 60 months the SPTR's returns were less than -2%. For those months, the average monthly return was -5.6% for the SPTR, -3.4% for the BXM and -2.7% for the PUT.

Option overwriting gives you the best of all worlds. Overwriting outperformed the SPTR in one of the greatest bull markets in history. It accomplished this by trading certainty (the monthly premium) for uncertainty (the returns of the market). In addition, overwriting returns were approximately 33% less volatile than the market. Most importantly, the strategy lost less money in down markets.

Effectively, option overwriting smoothes the returns. The highs are not as high and the lows are not as low. Monthly returns are much more consistent. You are trading uncertainty for certainty.

Looking forward, most investors do not expect the market to continue to appreciate 11% long term. This is a reasonable assumption given that much of the past appreciation was due to the significant decline in interest rates. The consensus is that markets will most like trend sideways overtime and volatility will remain high. If this is the case, option overwriting will massively outperform the markets in the future.

- Derek Webb

**Disclaimer** Analysis was compiled using various sources of data. Fund distributions, reinvestment price and MERs were from globefund.com dated December 31, 2010. Net asset values, dividend income, interest income and other income for the funds used for comparison came from their respective interim and annual financial statements. Data used to analyze Webb Enhanced Income Fund came from interim financial statement and trial balance of the underlying portfolio dated December 31, 2010. Income Yield is the total income received over the average net asset value. Where income data was collected from interim financial statement the income yield was annualized. Distribution Yield is the average distributions over reinvestment price for 12 months prior to December 31, 2010. Income Deficit or Accretion is the Income Yield minus MER minus Distribution Yield.

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