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Diversifying Your Diversifiers: Part 2, The Differentials in Implied Volatility

This is one of a three-part series on how we think about and utilize options to create strategies designed to help an overall portfolio navigate today's markets.

A basket of options is worth more than an option on a basket. That's a crucial concept to our business. We wanted to explore two topics related to that concept (Part 1 and Part 2) and a third related to how we view risk management as a tool for higher return potential (Part 3).

Options/Derivatives seem to be a financial dirty word, but used correctly they can potentially change the landscape of a portfolio for the better. We've written about how options may provide the ability to hedge away risk and define uncertainty, but this series digs deeper into how we utilize options for specific objectives.

» Part 1: Asymmetry - More specifically, sporadic asymmetry. This applies to our Defined Risk Strategy

» Part 2: The Differentials in Implied Volatility - This applies to our Collared Investment Strategy

» Part 3: Managing Risk for Higher Return Potential - This applies to our Drawdown-Managed Equity Strategy

*Side note: we are writing about these concepts because we are in the minority when it comes to looking at things this way. More importantly, we actually carry out these concepts in our portfolios and day to day operations. Much of what's said in these posts represents high level ideas we've spent entirely too much time thinking and building on.

Repeat after me: a basket of options is worth more to us than an option on a basket.

Part 2: Differential of Implied Volatility

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This is a biggie, and to simplify the complex, let's start with the ultimate benefit: potentially more of the almighty greenbacks to a portfolio. We're talking about cash, in the form of income from a portfolio.

Higher income is attractive for anybody, especially with the 10-year Treasury yielding roughly 3% and banks slow to pay market rates for deposits.

If any of the below is confusing just remember, the outcome of tapping into this differential means the potential for an alternative source of income that's not (a) dividends from stocks or (b) interest from bonds.

Options 101

The price of an option has a few ingredients. An important ingredient is what's known as implied volatility, a fancy way of saying the expectation of price change in a security. If you don't mind, we're just going to use "IV" from here on out. Higher expected change, up or down, means higher IV, which means a higher price on options on that security.

For example, options on a biotech stock trade with higher IV's than options on an established utility stock. Or even better, options on the biotech stock trade with higher IVs than options on the market as a whole...a lot higher. The potential movement in a single stock has a far wider range of outcomes than the market as a whole, hence higher IVs = more expensive options.
OK, now we're getting somewhere.

> Putting this here if you need a quick reference:
>
> - Call option - the right to own a stock at a certain price
> - Put option - the right to sell a stock at a certain price

Investing 101

Buy low, sell high.

Investing 102

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Sell high, buy low…can you see where we're going yet?

Take this hypothetical example and apply the concepts to see if you can accomplish an income objective utilizing the differential in IV between a basket of options and an option on a basket.

Quick Option Lesson Before we go further: The Option Collar

The combination of owning a stock, selling a covered call, and buying a put is what's known as a collar.

If you own shares of ABC that's trading at $100, you can sell a call option at $105 and bring in some option premium. You sold the right to own ABC at $105 to somebody. Meaning, if ABC rises to $110, you'd only participate to $105 — beyond that, you capped your potential return. The sold call is known as a covered call and it is the top side of the collar. We need the bottom.

Let's say you took that premium from the call and bought a put on stock ABC at $95. That gives you the right to sell ABC at $95. So, if it drops to $50, you hedged away the risk below $95.

You are long 100 shares of ABC, sold at call at $105, and bought a put at $95. You have collared your stock position, giving it $5 on either side of the current price.

Back to utilizing the IV differential to generate income.

What if you sold options with higher IVs and bought options with lower IVs and the difference was extra cash? Yes! But… there's always a but.

Take a look back at our simple collar example. Selling a call up 5% on an individual stock and buying a hedge 5% down actually costs money. Why? Because put options are priced higher than call options, as the market

knows a sharp move down is much more likely than a sharp move up, and you have to pay a little extra for those hedges.

So, our simple collar example is actually selling IV and buying higher IV, no bueno. But...

Let's Put This Together

Let's say you start with a basket of 50 individual stocks. Those 50 stocks are going to be highly correlated with the S&P 500. Meaning, if the S&P is up or down 10%, your basket of 50 stocks is up or down roughly the same. The basket of 50 stocks will have a high correlation with the S&P 500.

The objective: Income. Growth comes secondary.

What if you sold options on each individual piece (higher IVs) in the form of covered calls, and bought put options on a highly correlated security, say something representing the S&P 500 (lower IVs)? You'd then truly be selling higher IV and buying lower IV. The difference, you guessed it, potentially more greenbacks, higher income.

Because of the differential in IV between individual stocks and a market index - you can sell call options on each individual name x% up and use those proceeds to hedge with an option on a basket of securities highly correlated with the 50 stocks at roughly the same x% down, and potentially have cash left over.

More importantly, you can increase the amount of cash left over by adjusting the % up of your calls relative to the % down of your puts. For example, if you sold calls 3% up on individual names and bought puts 5% below a correlated basket, you may significantly increase the amount of cash left over. As a result, you may generate meaningful income, keep potential for drawdown minimal, and still offer potential for some upside participation.

Return & Risk

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The return of a strategy like this can come from the underlying basket moving up, the yield that basket pays in dividends, and the additional yield generated by - you guessed it - leveraging IV differential.

Is the potential return as high as just owning stocks? Or course not, we've capped the upside, but we'd feel a lot better than relying on bonds, and income is the primary objective.

Is the potential risk as high as owning stocks? Of course not, we seek to generate additional income to offset moves down AND we've taken explicit actions against left tail risk.

Our preference is for as little drawdown as possible - a recurring theme of our strategies, as a whole.

Summary

This is the thought process behind our Collared Investment Opportunity Strategy. It was designed to help a portfolio inject additional income while aiming to minimizing credit risk and without exposing investors to substantial drawdown.

We aim to own quality equity securities seeking to generate income from the combination of dividends received from the equity securities held by the Fund and premiums received from the sale of options. Not to mention, we believe our strategy has the potential to capture upside in strong markets as well.

Again, repeat after me: a basket of options is worth more to us than an option on a basket.

Disclosures

An investor should carefully consider the investment objectives, risks, charges, and expenses of ACIO, as applicable, before investing. The prospectus for ACIO contains this and other important information and is available free of charge by calling toll-free at 1-800-617-0004 or writing ACA

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at 265 Young Street, Fairhope, AL 36532. The prospectus should be read carefully before investing.

Investing in ETFs are subject to additional risks that do not apply to conventional mutual funds, including the risks that the market price of the shares may trade at a discount to its net asset value("NAV"), an active secondary trading market may not develop or be maintained, or trading may be halted by the exchange in which they trade, which may impact a Fund's ability to sell its shares.

Shares of any ETF are bought and sold at Market Price (not NAV) and are not individually redeemed from the fund. Brokerage commissions will reduce returns. Market returns are based upon the midpoint of the bid/ask spread at 4:00pm Eastern Time (when NAV is normally determined for most ETFs), and do not represent the returns you would receive if you traded shares at other times.

Investing involves risk; Principal loss is possible. The Funds are non-diversified, meaning they may concentrate their assets in fewer individual holdings than diversified funds.
Therefore, the Funds are more exposed to individual stock volatility than diversified funds.

The Aptus Collared Investment Opportunity ETF is subject to the risk that the securities may be more volatile than the market as a whole. The Fund may invest in other investment companies and ETFs which may result in higher and duplicative expenses.

Stocks are generally perceived to have more financial risk than bonds in that bond holders have a claim on firm operations or assets that is senior to that of equity holders. In addition, stock prices are generally more volatile than bond prices.

A call option gives the owner the right to buy the underlying security at a specified price within a specific time period. A put option gives the owner the right to sell the underlying security at a specified price within a specific time period. A covered call refers to a transaction in which the investor selling the call option owns at least the equivalent amount of the underlying security. The S&P 500, or Standard and Poor's 500 Index, is a

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market-capitalization-weighted index of the 500 largest U.S. publicly traded companies. Drawdown is defined as the peak-to-trough decline for an investment during a specific period. Correlation is a statistic measuring the degree to which two securities move in relation to each other.

An option premium is the current market price of an option contract. It is thus the income received by the seller (writer) of an option contract to another party.

Tail risk is the probability that the asset performs far below or far above its average past performance. "Left" tail risk, is the likelihood that observations fall three standard deviations below the average expected return.

The Funds may invest in options, the Funds risk losing all or part of the cash paid (premium) for purchasing put and call options. The Funds' use of call and put options can lead to losses because of adverse movements in the price or value of the underlying security, which may be magnified by certain features of the options. The Funds' use of options may reduce the ability to profit from increases in the value of the underlying securities. Derivatives, such as the options in which the Funds invest, can be volatile and involve various types and degrees of risks. Derivatives may entail investment exposures that are greater than their cost would suggest, meaning that a small investment in a derivative could have a substantial impact on the performance of the Funds. The Funds could experience a loss if its derivatives do not perform as anticipated, the derivatives are not correlated with the performance of their underlying security, or if the Funds are unable to purchase or liquidate a position because of an illiquid secondary market.

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