The income option

The process of buying and selling equities for most investors is a simple one – you either buy at the market price immediately or set a price that you're happy with and wait until that price is reached - assuming it even gets there.

This is all well and good, but, as we have discussed elsewhere, there is more than the usual risk in equity markets.

The US, for example, stands out. A few expensive stocks, particularly in mega-capitalization tech, have skewed the broad S&P 500 index so that characteristics such as growth and momentum, for example, have strongly outperformed factors such as value and small capitalization.

One way to manage risk is by using a different, more complex process to enter stock positions - via put options.

A put option is a contract between buyer and seller that gives the buyer the right to exit an underlying security at a pre-determined price (the strike price) within a specified timeframe. (It sounds oxymoronic, but just think of it as you **sell a put** to **buy an equity**)

The advantage for the put buyer is that she knows her downside: if the share falls below the strike price, she can offload her position.

For the put seller, the advantage is that he is paid a fee or premium to sell the put and if he ends up owning the equity as well, he does so at a better price than he might otherwise have received. If he doesn't get the equity, he still keeps the premium. The example below illustrates how it works for the seller of the put:

For illustrative purposes only and not a recommendation to buy or sell a particular stock. Annualised return will vary based on the option premium received and the time to maturity.

At Talaria we have been selling puts for over 15 years because it creates:

- more consistent income,
- creates a downside buffer to first loss
- reduces portfolio volatility, and
- diversifies the sources of return.

Plus we never speculate – they are always fully cash backed.

Just as it is possible to buy an equity through selling a put, it is possible to sell an equity through call option selling.

A call option is the opposite of a put option, giving the call buyer the right to acquire an underlying security at the strike price within a specified time frame.

Investor A: SELLS CALL > TO SELL EQUITY

Investor B: BUYS CALL > TO BUY EQUITY

In this case the call seller receives a premium as an incentive to deliver the equity should she be asked to do so.

At Talaria we've been selling calls for as long as we have been selling puts as it can improve the price at which we exit an equity.

As we like to say, certainty empowers you.