Value Investing with Options

VALUEx Vail 2013

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Three Questions

- What are options and why do value investors hate them?
- What can the option market tell an investor about stock valuations?
- How can understanding options tilt the risk / reward equation in one's favor?

Morale of the Story

An intelligent investor using rational valuation methodology

always has an edge over

mechanically-determined,

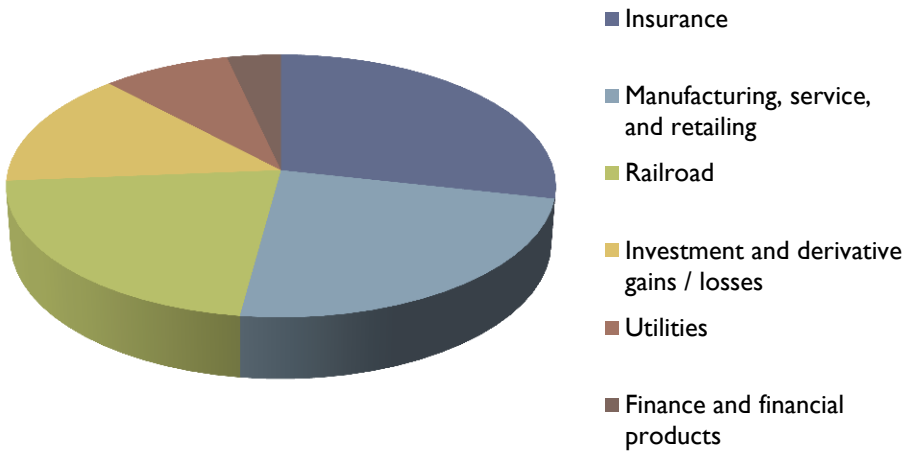
EMH-based market valuations

Buffett hates options

"I view derivatives as time bombs, both for the parties that deal in them and the economic system. Basically these instruments call for money to change hands at some future date, with the amount to be determined by one or more reference items, such as interest rates, stock prices, or currency values"

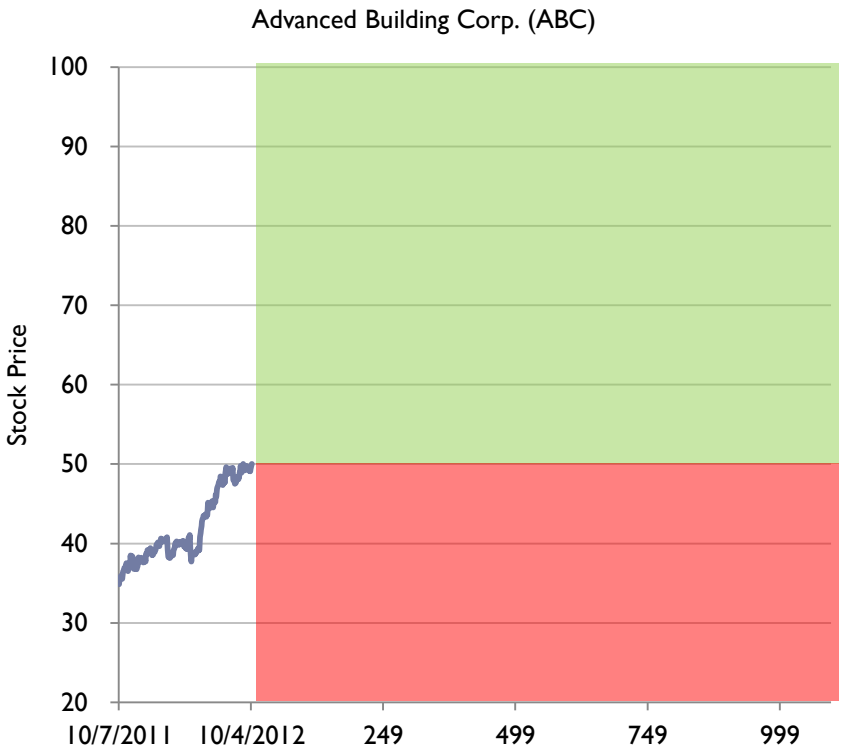
--Warren Buffett (2002)

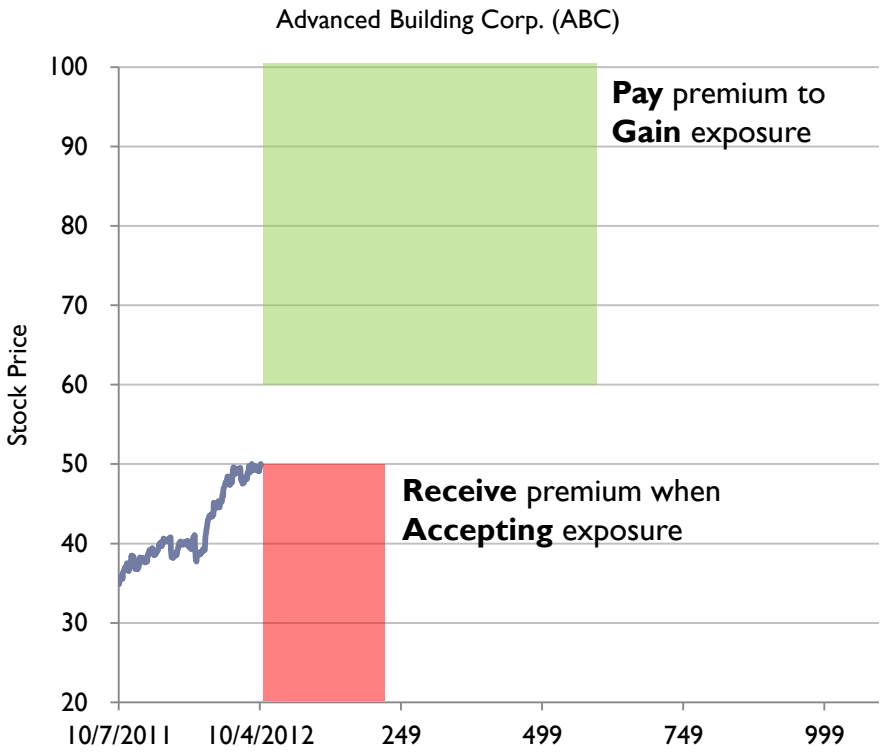
…Or does he?



Insurance—selling put options—is Berkshire Hathaway's biggest business, accounting for 30% of corporate profit in 2012

Options are directional instruments that offer greater flexibility than stocks





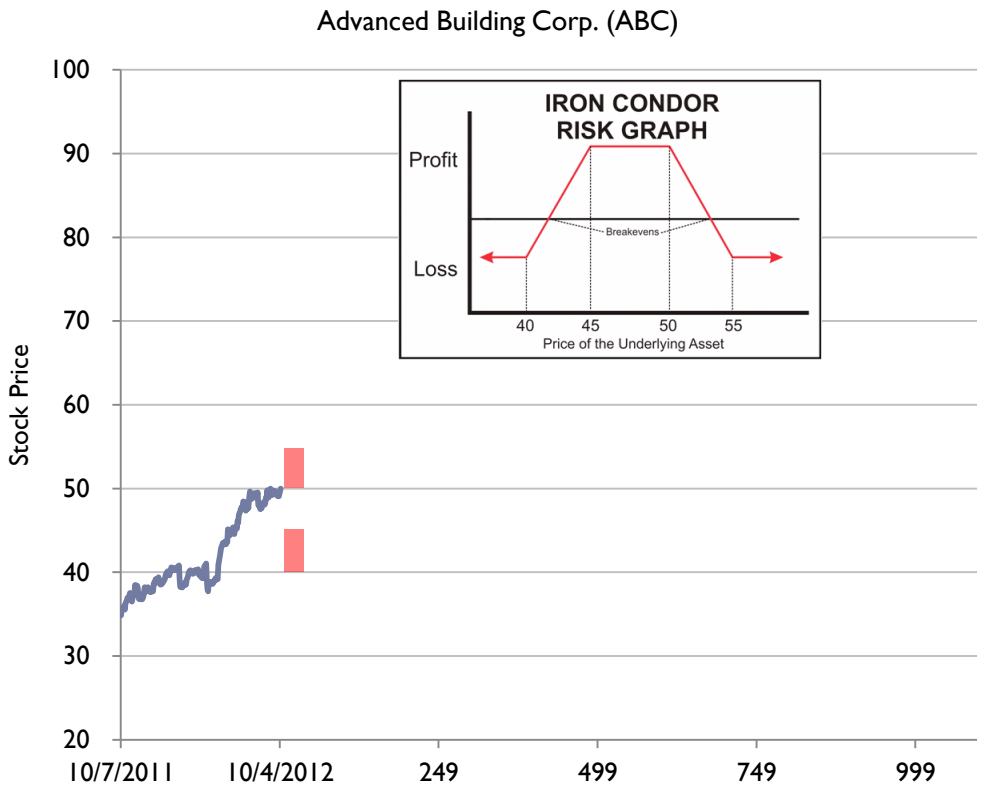
Stocks

- Directional instruments
- Investors must accept the opposite exposure to that which they are trying to gain
- Perpetual legal claim

Options

- Directional instruments
- Investors may flexibly gain and / or accept exposure
- Legal contract granting time-limited exposure

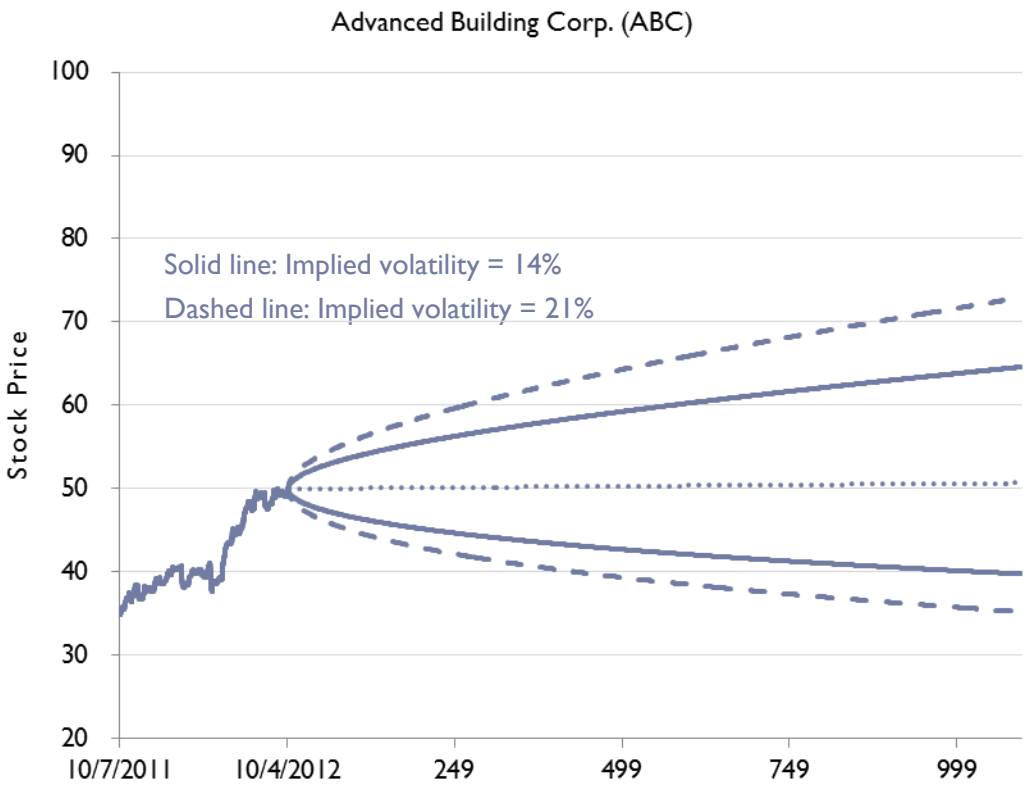
Hating options because fools use them is as rational as hating cars after driving in New Jersey



("Iron Condor" diagrams courtesy of Optionetics.com)

- Most option 'gurus' are ex floor traders or spreadsheet jockeys who couldn't tell the value of a stock if it hit them with a club
- 'Gurus' advocate option strategies that 1) benefit market makers and 2) attempt to minimize rather than exploit the inherent directionality of options
- "When you combine ignorance and leverage, you get some pretty interesting results."

What can the option market tell you about stock valuations?

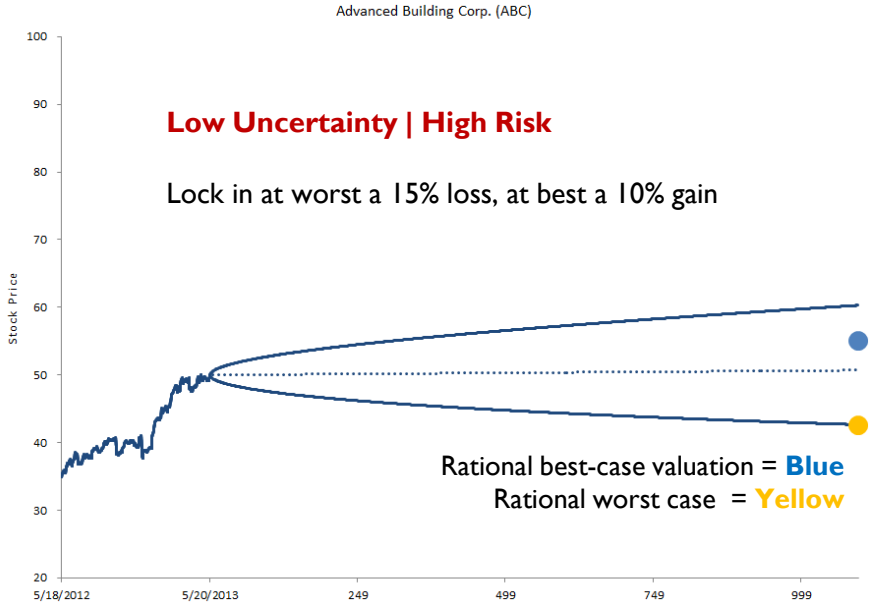


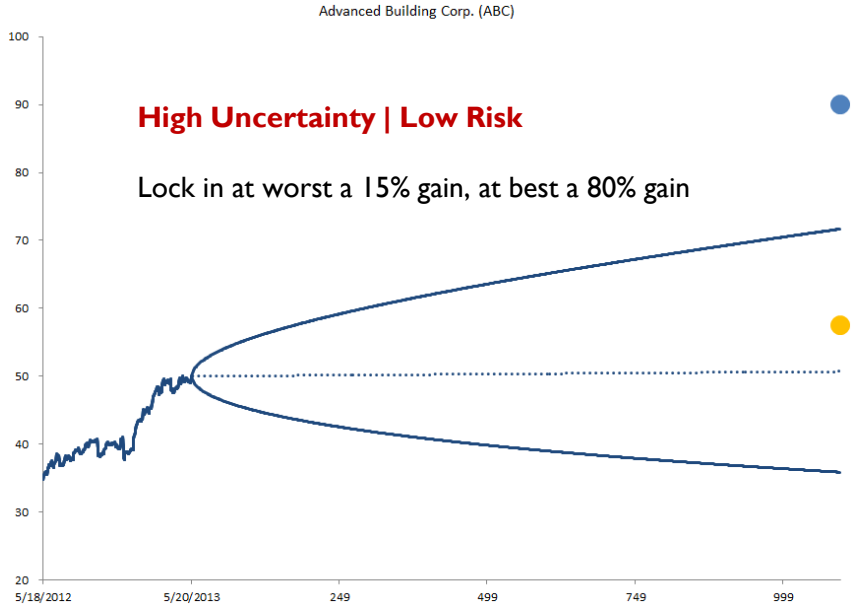
- Option pricing is a mathematical representation of how the EMH (read "Mr. Market") determines an intrinsic value range for a stock
- Option pricing formulas use purely historical price and volatility measures without regard for fundamentals
- The option market is a sausage grinder—it takes inputs and spits out a valuation in a purely mechanical way
- Scared investors pay enormous premia for downside insurance in times of stress—intelligent, rational investors are happy to accept the downside exposure

Stock investing in a market that has actively traded options is like playing poker with an opponent who always lays his cards face up on the table

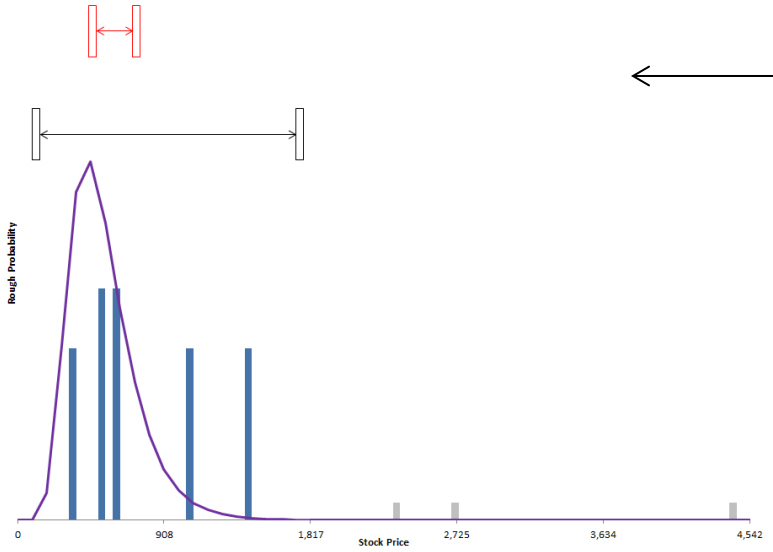
Tilting the risk / reward balance in one's favor

"Efficient" Market		Intelligent Investor
Extrapolate value from current stock price		Look for opportunities where valuation differs from current stock price
Valuation range determined by - Risk-free rate - Dividend yield - Market fear ('implied volatility')		Valuation range determined by - Best / worst likely revenue growth - Best / worst likely profitability - Best / worst likely medium-term FCF growth
Risk = (Symmetrical) Uncertainty		Risk = Not having an edge over the market





Intelligent Option Investing



Step 1:
Create scenarios based on best / worst cases of:

- *Revenue growth*
- *Profitability*
- *Medium-term growth*

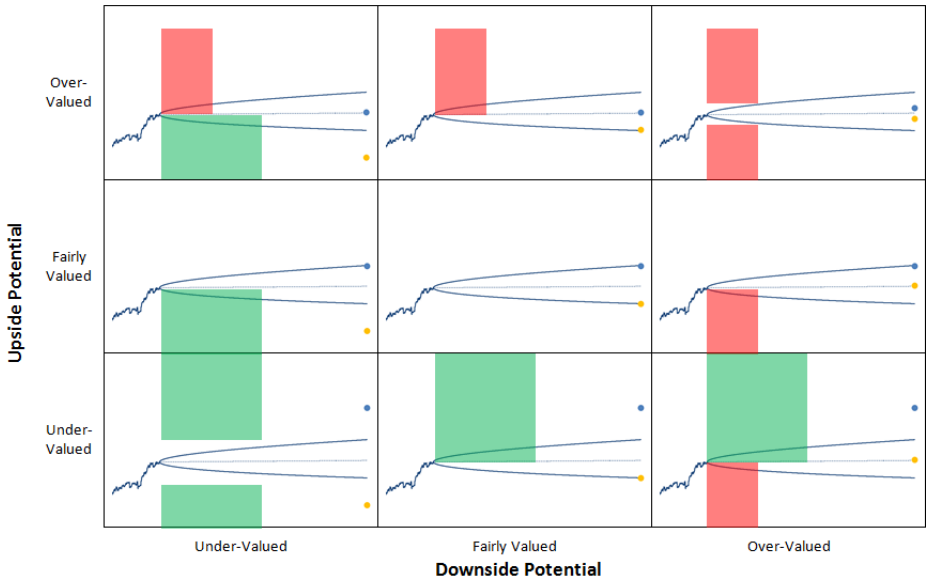
Total of $2^3 = 8$ scenarios

Select most likely valuation range & improbable scenarios

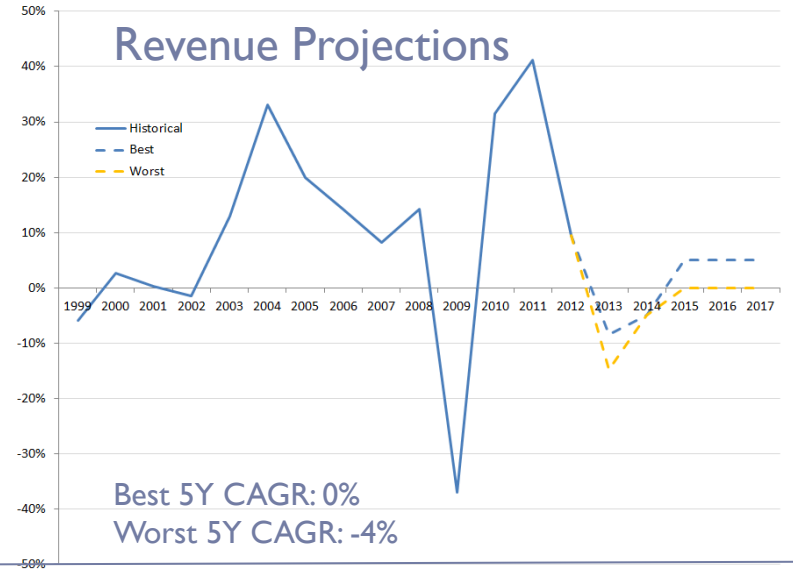
Step 2:
Option strategy becomes a trivial exercise

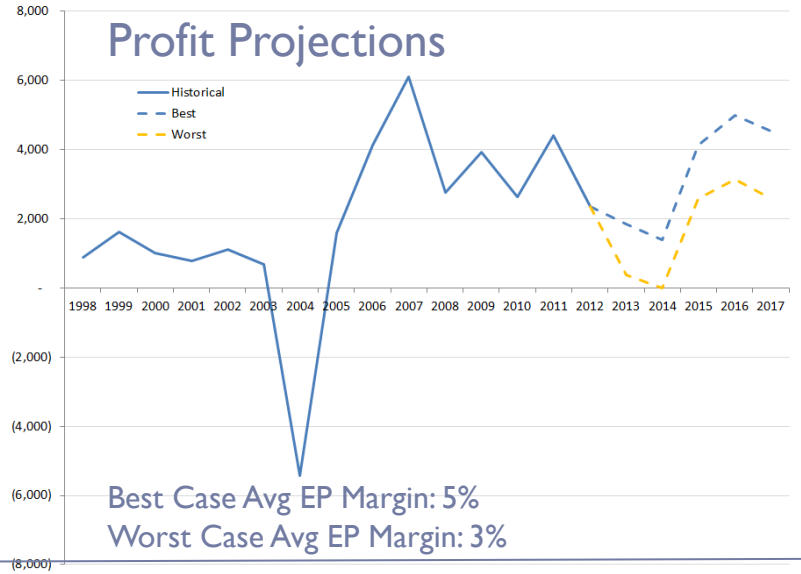
Look for mispriced upside and / or downside

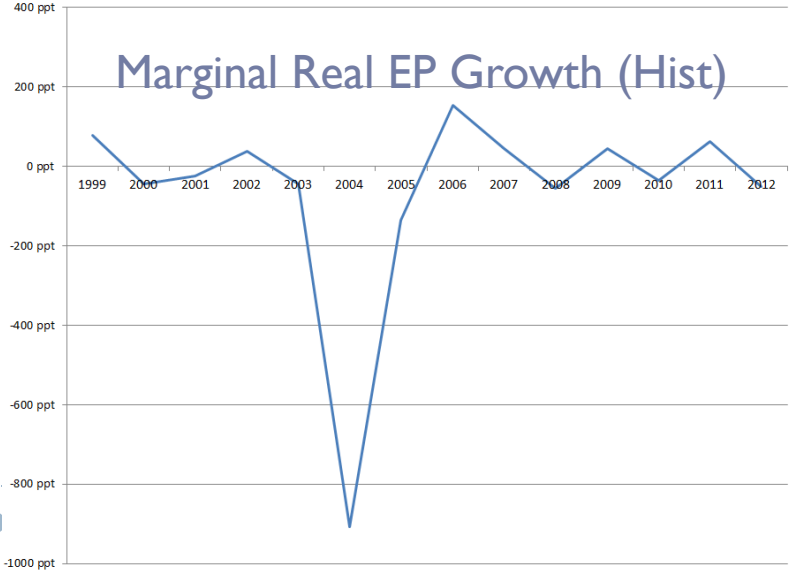
Effect investment using listed or listed look-alike options

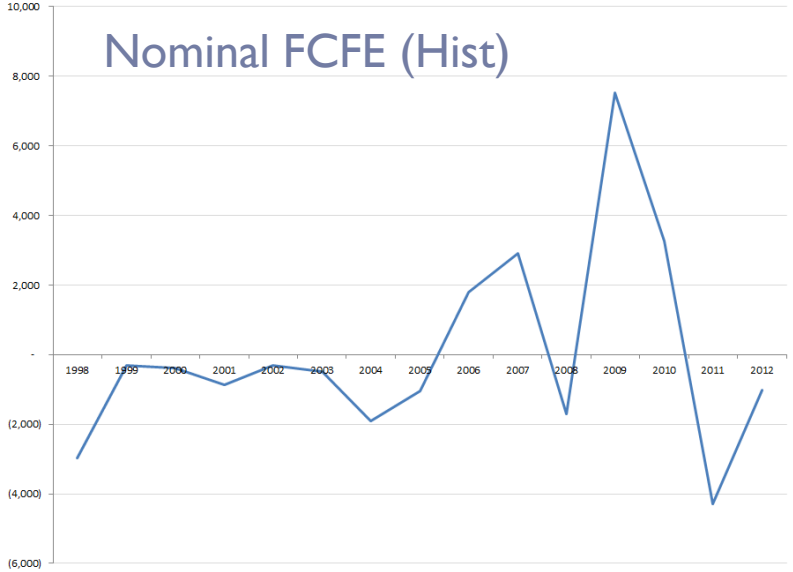


In Practice – Caterpillar (CAT)



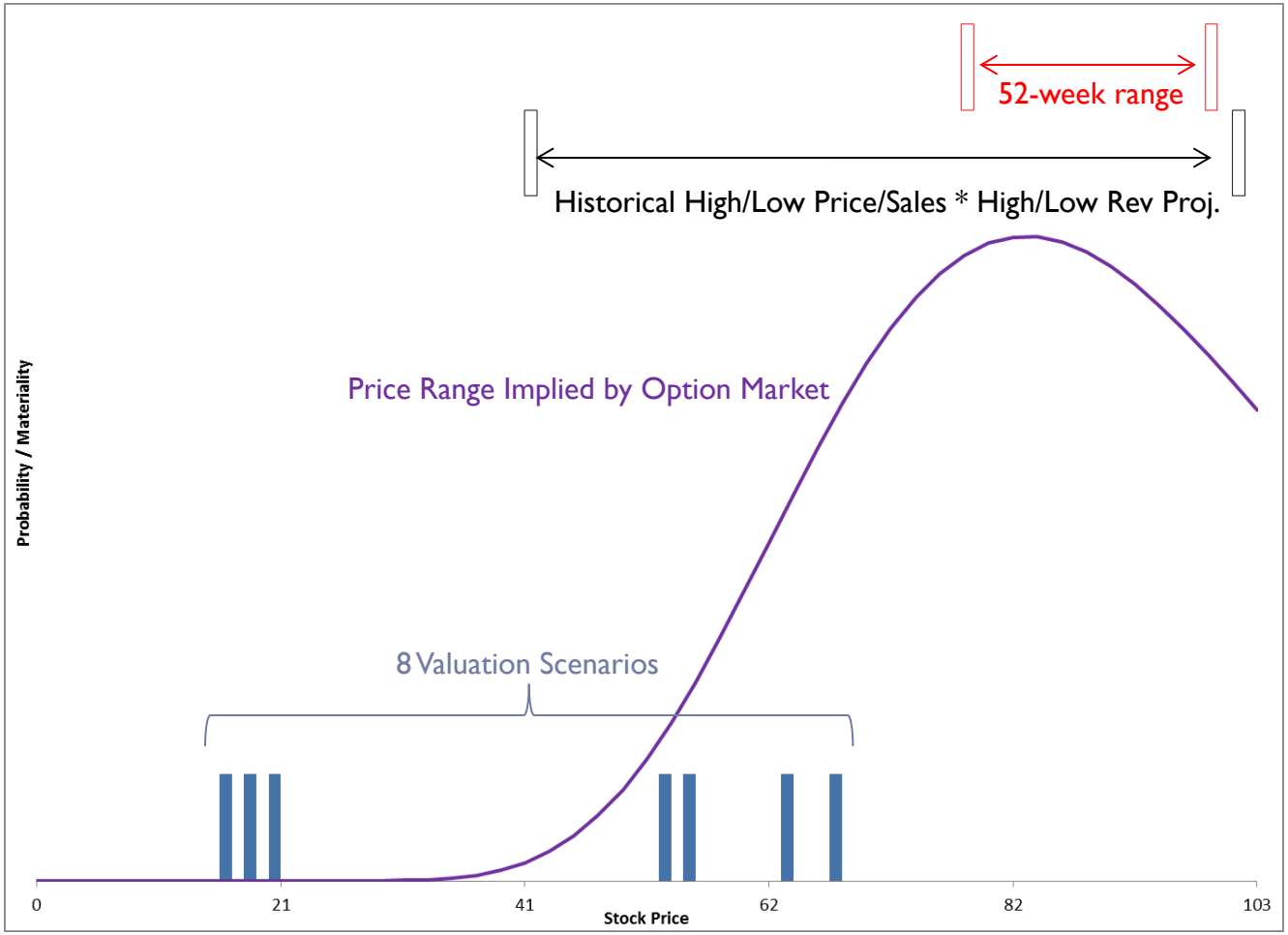




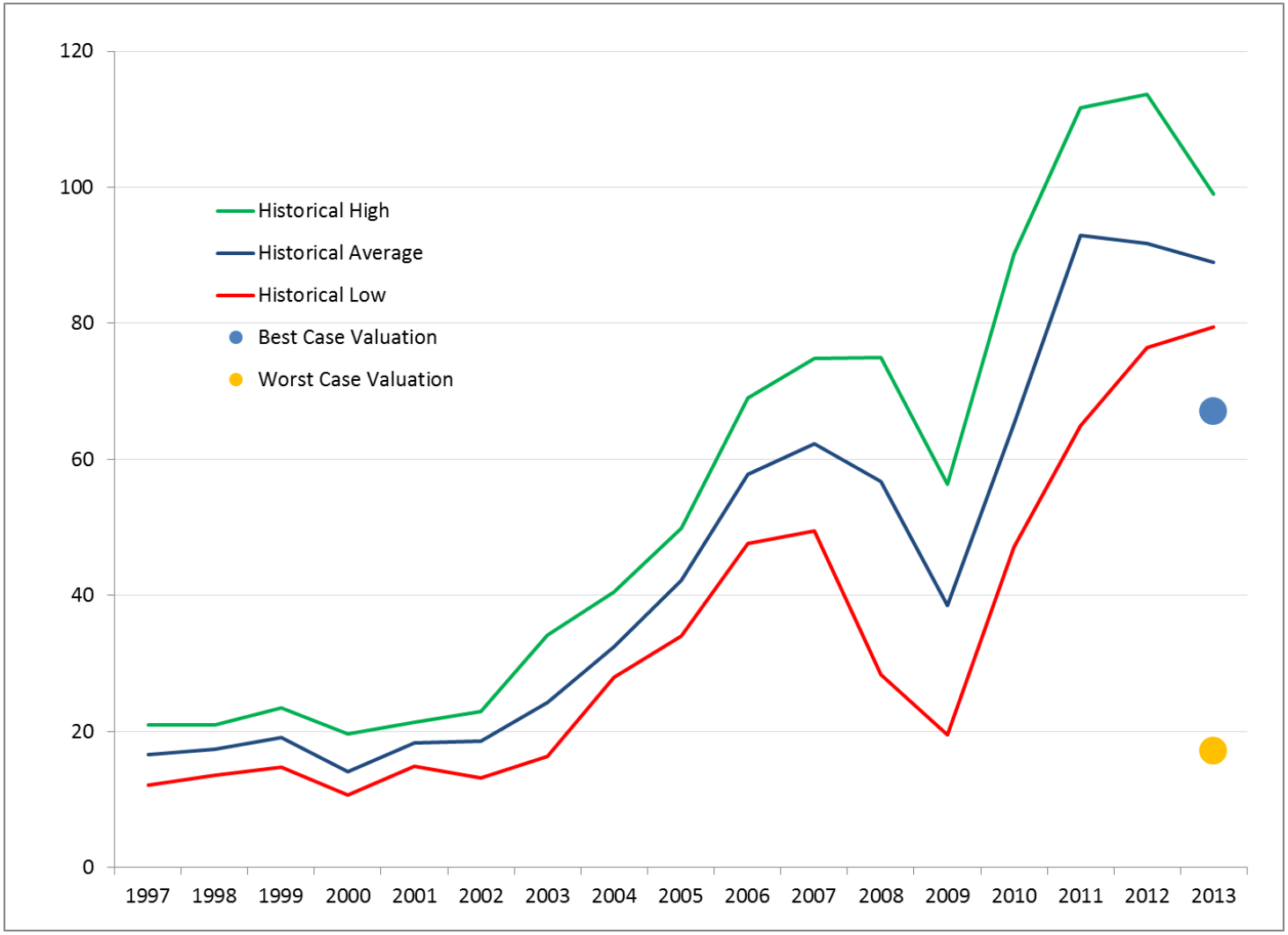


CAT Scenarios

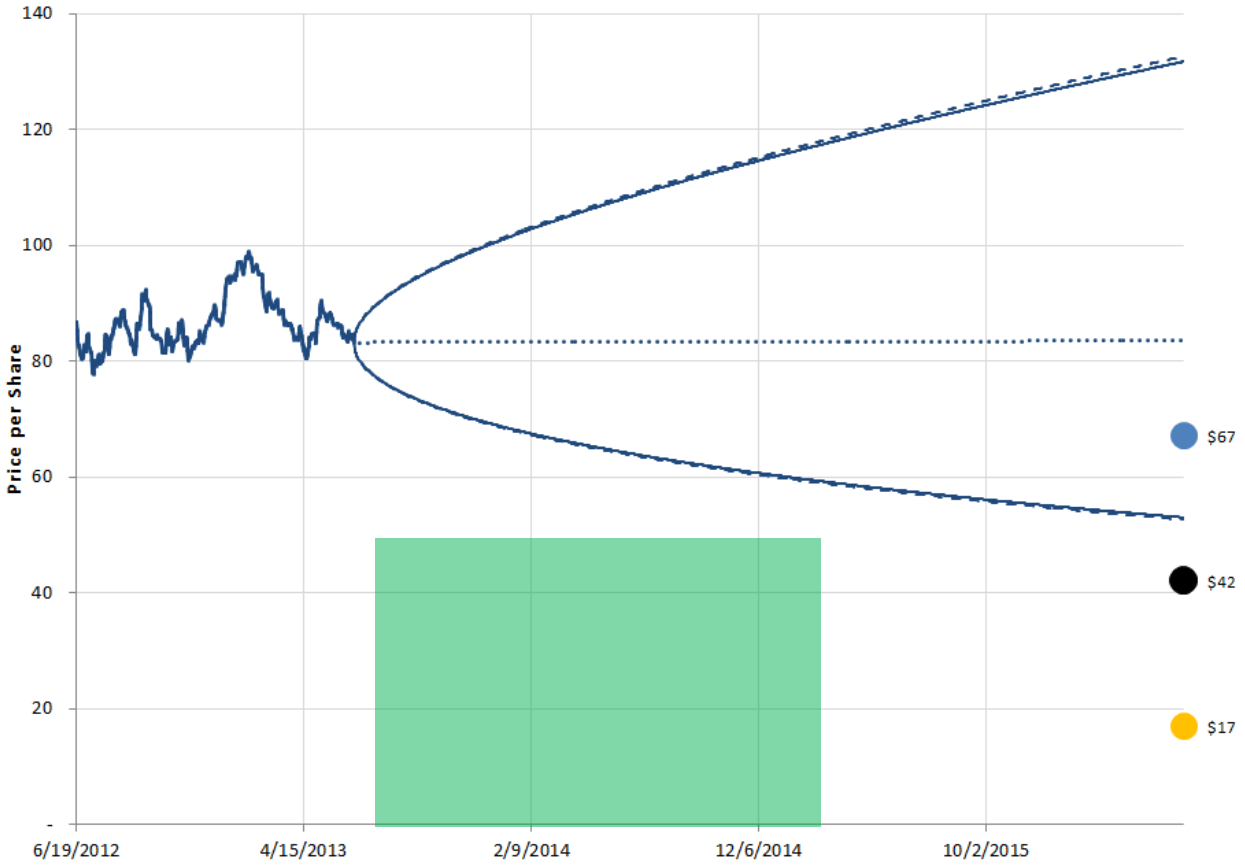
Case / Scenario	Value
-4% | 3% | 5%	17
-4% | 3% | 6%	18
0% | 3% | 5%	19
0% | 3% | 6%	20
PSR Implied Low	41
-4% | 5% | 5%	54
-4% | 5% | 6%	56
0% | 5% | 5%	64
0% | 5% | 6%	67
252-day Low	78
252-day High	99
PSR Implied High	103



Stock Price History vs. Valuation Range



CAT Option Strategy



Gain Exposure to Downside Potential by Purchasing 50-strike Put.
Expires JAN '15 (574 Days)
Price: $1.80

Return to Best Case: -100% (-$1.80)
Return to Worst Case: 1,733% (+$33.00)
Return to Blended: 344% ($6.20)