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Stock Market Volatility Is Back. These Funds Can Help Manage It.

By Lewis Braham May 13, 2021 2:42 pm ET

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Options sellers feed off fear, while buyers feed off overconfidence. These financial contracts are priced off volatility, and the more afraid investors are, the more expensive they become. On May 12, investors panicking over bad inflation data drove the stock market down and volatility up 26% in one day—bad news for them, but good for options sellers.

Before the pandemic, few investors were afraid. The Cboe Volatility Index, or VIX, which measures the S&P 500's volatility and is known as the "fear index," hit an all-time low of 9.1 in November 2017. It bounced around some but without any major events until February 2020 when it went from 13.7 on the 12th to 40.1 at month end as news of the pandemic spread. Then on March 16, it hit an all-time high of 82.7. It's fallen since then, but has stubbornly resisted falling meaningfully below its long-term median of 17.5. On May 12, the VIX hit 27.6.

All of which makes options funds interesting. Options provide insurance, enabling investors to lock in an expected price of a stock, index fund, or exchange-traded fund in advance. A call option gives investors the right to buy a security at a certain price and time; a put option, to sell it at a certain price and time. Embedded in the option's price is the security's "implied volatility." The higher the implied vol, the more investors must pay to lock in the security's price in advance—what options investors call a premium. Funds that sell—or "write"—options make greater premiums when the VIX is high.

When done right, an options portfolio can act as a hybrid substitute for bonds, which continue to offer little in the way of yield for income-starved investors. (The 10-year Treasury yield sits near 1.7%, while high-quality corporate bonds yield about 2.2%.)

The JPMorgan Equity Premium Income ETF (ticker: JEPI), for instance, is designed to distribute income of 7% to 9%, says Hamilton Reiner, the fund's co-manager. When volatility is high, like it was in 2020, the fund can pay out much more than that. "Last year, with volatility through the roof, [premium income] was actually north of 12%," he explains.

To generate that income, Reiner writes S&P 500 call options that cap the upside of the value of his portfolio at the predetermined "strike" price of the option. Depending on the level of the volatility, he might cap the upside at 2% if vol is low, or—if more premium income is to be made because markets are volatile—cap the upside higher, as he did at 9% last March. "Our strategy is not just about income, but balancing [the stock portfolio] upside with [options] income," he says. "We want to have a little bit of our cake and eat it too."

Historically, Morningstar grouped all funds using options-based strategies in one category, even if the strategies targeted very different outcomes. Returns in the Options-based funds category over the past three years ranged between 18% annualized for AlphaCentric Premium Opportunity (HMXIX) to minus 42% annualized for Navigator Sentry Managed Volatility (NVXCX). Even among the nine Options-based ETFs with three-year records, there was a wide dispersion between Amplify CWP Enhanced Dividend Income's (DIVO) 15% annualized return and First Trust Hedged BuyWrite Income's (FTLB) 2%.

The good news is as of April 30, Morningstar split the category into two—Derivative Income and Options Trading—to more accurately reflect strategy diversity. "The previous Options-based category has historically been one of the most heterogeneous of all the alternative categories that we have at Morningstar," says Erol Alitovski, a Morningstar research analyst who covers alternative funds. "Some of these strategies are highly correlated to equity markets, while others are very uncorrelated because they're trying to be a hedge against equity markets, so they go up when markets come down. What we are trying to do with splitting these [categories] is to have one group that is equity-sensitive and one that is less equity-sensitive."

JPMorgan Equity Premium Income now falls into the more equity-sensitive Derivative Income category as it doesn't buy downside hedges such as put options. Reiner also co-manages the $18 billion JPMorgan Hedged Equity fund (JHQAX), which is now in the Options Trading category as it employs puts designed to protect capital when markets sell off from 5% to 20% in a given quarter. That fund is closed to new investors, though JPMorgan recently launched similar funds that are open—Hedged Equity 2 (JHDAX) and Hedged Equity 3 (JHTAX).

The $7.4 billion Gateway Fund (GATEX), whose 1977 founding makes it the oldest options fund, is also in the Options Trading category. It employs a similar strategy to JPMorgan Hedged Equity, although more conservatively by limiting losses with puts to 10%. Yet Alitovski rates Gateway, which has a 4.9% 10-year annualized return, "Neutral" and JPMorgan "Bronze" because of the latter's more consistent performance.

Other funds in the Options Trading category include AlphaCentric Premium Opportunity, which has different options strategies for what its manager Russ Kellites has identified as four different market environments. Similarly, Calamos Hedged Equity (CAHEX) adapts tactically to market conditions. "Rather than force our way into the same hedge each quarter, we'd rather take a step back and say, 'What's unique about today's market?'" says Calamos' co-manager David O'Donohue. Lately, O'Donohue has been writing calls and employing "put spreads," selling one put to buy a different priced one to hedge a portion of the fund's downside.

Ultimately, investors need to decide whether they are nervous about the market and want downside protection—the hedged Options Trading category—or are just looking for alternative income sources—the unhedged Derivative Income category.

In the current environment, one could easily make the case for either option.

Write to editors@barrons.com