TACKLE Buy and Hold STRATEGIES HEAD ON

By: Chad Butler

In today's market environment, the buy-and-hold investor may be inclined to go beyond re-evaluating his investment strategy and change strategies altogether. What the buy-and-hold crowd should do instead of throwing the proverbial "baby out with the bath water" is to take a strong look at "sub-strategies" that may complement and assist the overall strategy of buy-and-hold. To do this, it makes sense to lay a foundation using Exchange Traded Funds (ETFs) that buy-and-hold investors can examine, build on and, hopefully, use to enhance their returns.

First, the investor must determine the overall goal and time horizon for his investment objectives. Is this a long-term investment? If so, short-term market fluctuations should not rattle the investor from the strategy.

During the current bear market, a number of traders and investors have been pointing to the declines in certain stocks and shouting,

"See. Buy-and-hold doesn't work!" This may be true in certain situations, but it brings up another important key to the trading plan. It is crucial that a long-term investor choose the correct vehicle for his investment.

Finally, it is also important to cover some investment "enhancement" opportunities. By incorporating option selling (writing) strategies into the overall plan, the investor will be able to enhance overall returns over traditional buy-and-hold strategies.

ETFs May Hold Promise, Depending on Your Time Horizon

Determine Goals and Time Horizons

According to ***Investor's Business Daily***, there is no 30-40 year period in the last 75 years in which an investor would have lost money in the market if he had sustained an index position. It is widely accepted that stocks have outperformed all other investment vehicles over time.

If the goal is capital appreciation over time, then a trading plan that is in and out of the market on a regular basis may not be wise. This subjects the investor to more risk via research costs, transaction costs and adverse tax implications, as well as risk of being whipsawed. Rather, a plan that seeks to remain in the market for a long period of time may be more prudent.

The problem with the buy-and-hold strategy for most investors is not the strategy itself, but rather their choice of investment vehicles. It may be more prudent for an individual investor to steer clear of individual stocks because a single news event can dampen or drown the investment. Additionally, while looking at a long-term time horizon to weather the fluctuations in the market, the trader needs to remember that the leaders of one bull market rarely are the leaders of the next bull run.

One of the most popular and oft-quoted examples is that of RCA. In the early 1920s, David Sarnoff publicly speculated on the possibility of "every farmhouse equipped not only with a sound-receiving device but with a screen that would mirror the sights of life." During those years, RCA was akin to the Internet stock of a few years ago, and investors couldn't get enough of it. Even though it did not pay a dividend, they bought as much RCA as they could afford, and the price surpassed $400 a share in 1929. When the Dow bottomed out in 1932, RCA stock dropped to the low single digits, much like some of today's former sweetheart stocks. RCA traded below $10 into the 1940s and never again rose to its former exalted status.

Following the recent bear market, the market is riddled with low-priced stocks that once traded as market darlings. Some of these will go out of business, be absorbed by other companies, or just stay at their low prices indefinitely. Others might yield stellar returns. The real problem, then, lies in what stocks to choose. So, why not just avoid the whole lot?

ETFs Are an Option and Also Are Optionable

Everyone says that over time, the stock market has always gone up. That is true of the Dow and other indexes, but not necessarily of individual stocks. Why not just invest in the index? Investors can do this effectively and efficiently with Exchange Traded Funds, or ETFs. These are basically closed-end mutual funds, but unlike mutual funds, ETFs trade all day on the exchange like a stock.

Some of the ETFs are also optionable. That is to say that an investor can buy or sell an option on the ETF itself. This point makes the ETF ideal for a strategy that can employ some different option strategies in an investment plan.

While ETFs represent various market sectors, let's focus on those that represent only major market indexes. Since there is a need to use options in the investment plan as well, the trader would only want major market index ETFs that actually *have options available.*

Open interest (the number of options that are open and not offset by an opposite position) in the options also is an important number to consider when looking at ETF options. A too-low open interest in a particular strike price indicates an illiquid market. There are no hard-and-fast rules as to how much open interest is sufficient to give traders the best opportunity to easily offset their positions, but it bears exploration before charging into a transaction.

Considering that the trader only wants index ETFs with options that have a high open interest, the choices are narrowed from more than 100 to about six. These include the following:

ETF	Symbol	Represented Index	% of Index
Diamonds	DIA	Dow Jones Industrial Average	1/100th
S&P MidCap 400 SPDRs	MDY	S&P MidCap 400	1/5th
NASDAQ 100 Trust	QQQ	NASDAQ 100	1/40th
iShares Russell 2000	IWM	Russell 2000	1/5th
iShares S&P MidCap 400	IJH	S&P MidCap 400	1/5th
iShares S&P SmallCap 600	IJR	S&P SmallCap 600	1/2

Market Entry Using Puts

The typical investor usually enters the stock market by purchasing the stock outright. By using a put selling strategy, the investor is able to enter the market at a "discount" from the current market price. Even if the put expires worthless without the ETF being "put" to him, the investor *still* obtains a return for that month.

A put gives the purchaser the right, but not the obligation, to sell a stock at a particular price at some point in the future. By selling a put, the purchaser is given the right to sell the ETF at this predetermined price, called the strike price, between now and the option expiration. As the option seller, the investor does not retain any rights. Instead, the investor has the obligation to take a long position from the option buyer at the option strike price if the option is exercised. For this obligation, the option premium is received from the buyer.

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The put writing (selling) strategy offers a return while trying to buy the ETF at a "discount" from the current market value. The investor does this by writing an uncovered or "naked" put at a strike price below the current market value. Uncovered or "naked" means that

there is not an existing offsetting position in the stock. By doing this, the investor will receive the option premium. If the market goes up, the ETF will not be "put" to the investor, and he/she will simply let the option expire and keep the premium. If the market comes down, the investor should let the ETF be "put" to him and still keep the option premium.

The advantage of this method of market entry is simply this: when the ETF is put, it will be for a price below where the market was when the investor initially wanted to enter the market. The added benefit is that the option premium actually lowers the cost basis even further.
For example, if the NASDAQ 100 Trust (QQQ) was trading at $23 per share and the $22 puts for the next month were trading for $2, the investor would sell the $22 put and bring in $200 in option premium for every 100 shares he wanted to buy. Because the total cost of buying 100 shares of the ETF if the option were exercised would be $2,000 ($22/share - $2 option premium x 100 = $2,000), the margin required for the position would never be more than this total. This is an important point to understand when determining returns.

If the option expired worthless, the investor would retain the option premium of $200 for a minimum return of 10 percent on $2,000. In this case, the investor would not have a position in the ETF. But because his eventual goal is to actually "own" the ETF, he would need to repeat this process for the next month.

When the underlying instrument is trading at a price beyond an option's strike price, the option is said to be "in-the-money". If the option goes in-the-money, it would be exercised. In this case, the investor would take the ETF with a cost basis of $20 per share. The cost basis is determined by subtracting the premium received ($2 per share) from the strike price ($22 per share). This is a 13-percent discount from the $23 at which it was trading when the investor decided to enter the market.

We Are in the Market. Now What?

The primary premise, again, is to stay in the market for an extended period of time, say 20 years. During a true bull market, one could just sit idly by and watch the value of the ETF go up with the index. But what about *bear markets*, or worse, a long-term secular bear market like the period covering 1962 to 1982 where the DJIA was in a 250-point range?

In this case, an investor wants to sell covered calls against his position. A call option gives the option buyer the right, but not the obligation to purchase a stock at a given price (the strike price) before the option expires. Selling a covered call gives the option buyer the right to purchase the ETF at the agreed upon strike price if the option goes in the money. For this obligation, the investor will gain the option premium. The fact that the underlying instrument is owned means this is a "covered" position.

The covered calls can be sold to establish gains when the market is moving lower, sideways or, for the slightly more aggressive investor, higher. By doing this, one captures option premium that will enhance returns.

So, if the investor owns the QQQ and the market is at $23, with the 25 call at a $2 premium, he would look to sell the call. Since he plans to be in the market for the long term, regardless of whether it goes up or down, it is best to figure short-term returns at the time of writing the option. In this case, $2 in option premium is received when the ETF is $23. This is a return of eight percent.

ETFs can be thought of as an asset that can produce cash returns while in the portfolio.

There is no question that some type of risk tolerance accompanies a long-term outlook. If the market goes down (and, as we have seen recently, it does sometimes), the investor needs to remember that he is in it for the long term and stay with the plan. If investors can gain five to fifteen percent monthly returns by using covered calls on the ETF position, then short- and intermediate-term downtrends in the market should not shake them out of the market. In this respect, ETFs can be thought of as an asset that can produce cash returns while in the portfolio.

This also reinforces the primary reason that the ETF is chosen over individual stocks. An ETF on a major stock index protects the investor from a company going bankrupt. As of this writing, two bankrupt companies have been removed from the NASDAQ 100 Index— WorldCom and Adelphia Communications. Investors in those companies who had a long-term buy-and-hold approach may be wondering what will happen to their investment when or if the company emerges from bankruptcy protection. For investors in the QQQ, the ETF itself did not declare bankruptcy or go out of business. Those issues were merely replaced in the index with new companies.

In addition to the QQQs, a representation of mid-cap stocks in a long-term portfolio might be desirable as well, depending on the particular index with which the investor is most familiar or comfortable. The S&P MidCap 400 SPDR (or MidCap Spiders) is an ETF that represents the S&P MidCap 400 Index. For example, consider an investor who is using the MidCap SPDRS at a price around $80 per share.

Clearly, the investor would like to own them for less than $80, so he writes the $78 put for a $2 premium. This position would offer a return for the month of $200 per option. If the MidCap Spiders are put to the investor at expiration, the cost basis will be $78 per share less the $2 per share that was received for the option, for a total cost of $76. This translates to a five-percent discount from the prevailing market price at the time the option was written.

With the MidCap Spiders now in the portfolio, the investor looks for opportunities to write covered calls against the position. If the market is at $80, and the $84 calls are at a $1.50 premium, writing the call would yield $150 that month. If the MidCap Spiders are at or above $84 at option expiration, the option would be exercised, forcing the investor to sell shares at $84. This is known as being "called out." The return on being called out would be the difference between the strike price of the call, or $84 less the current market price of $80, plus the premium received, or $1.50. For a 100-share position, this would be a total of $550.

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This example illustrates an important point. If a fair premium can be received for a strike price that is further away from the current price, it may be a good idea to avoid being too greedy for option premium. Remember, the goal here is not to be called out of the position but, rather, to obtain some additional returns on the long-term position. Although this is less important in a tax-free or tax-deferred account, being called out causes unnecessary turnover in the portfolio and creates some additional tax implications. If the market analysis is clear and the market is trending up, one would be less likely to write calls during bull markets. Why? For the premium received, it may not be worth the risk of being called out.

The problem with the buy-and-hold strategy for most investors is not the strategy itself, but rather their choice of investment vehicles.

Don't Put All Your Eggs in One Basket…

Since we have just come through a speculative bubble in the NASDAQ 100, now actually may be a good time to invest long term in this particular index. But rest assured, due to the speculative history of this index, any investment could be a volatile one. For the very same reasons that the investor does not want to be in an individual stock, he also does not want to be in just one ETF. Consideration should be given to diversifying the portfolio in a well-balanced group of funds.

Just what is well-balanced depends on a number of conditions, including an investor's financial condition, risk tolerance, age and investment objectives. There are many ETFs from which to choose, and that gives investors a wide array of investment options.

The model portfolio may include the QQQ for the risk portion, Dow Jones DIAMONDS Trust (DIA) to represent large-cap stocks, S&P MidCap 400 SPDR (MDY) to represent mid-cap stocks, and the iShares Russell 2000 Index Fund (IWM) for the small caps. By spreading the risk among four different indexes, investors are more easily able to weather the storms that the market may bring.

To fully understand the benefits of including small and mid-cap stock indexes in a portfolio, compare the recent performance of the above four indices. After a market low on September 21, 2001, the S&P MidCap 400 went on to make new highs while the Dow and NASDAQ did not. Diversification helps take advantage of broader stock market moves.

While there is no "holy grail" of investing, there are still prudent decisions that can be made. To stay the course is one of those decisions for the long-term oriented individual investor. In times of market turmoil, a broader look at the markets is necessary. At this point in time, many of today's younger investors have never before witnessed a bear market. Unfortunately, the current bear has been of historic proportions, making this a good time for not only portfolio analysis, but also total strategy analysis.

Many investors, of course, were caught in the speculative greed of the technology bubble and have paid dearly. Blindly following the herd is not a good long-term strategy. Speculation in individual stocks can be a dangerous game. Since the market indices tend to move higher over time, many will consider a strategy that takes advantage of this long-term trend and uses strategic option selling to capture returns during shorter-term downtrends. SFO

(Of course, trading commodities or securities involves risk. There are no guarantees that any strategy will be profitable as there is a risk of loss in trading. The above strategy merely provides a foundation to be considered. It is not intended to be utilized as investment advice. An individual should consult with a professional to determine what may or may not be appropriate for that individual's investment objectives and risk tolerance.)

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