Combining Value Investing Strategies with Long Term Options

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What is Value Investing? Options?

- Value investing is an investment strategy that involves buying undervalued stocks based on fundamental analysis, with the expectation that their true value will be recognized over time, leading to capital appreciation.
  - The Warren Buffet Method
- Options are financial derivatives that give investors the right, but not the obligation, to buy or sell an underlying asset at a predetermined price within a specified time frame.
- A LEAP (Long-Term Equity Anticipation Security) is a type of options contract with an expiration date that is longer than one year, allowing investors to speculate on or hedge against the future price movement of an underlying asset over an extended period.

Why Combine?

- Utilizing options allows investors to make more money with smaller up front capital then they would be able to make if using equity only.
- If your price target is significantly above the current stock price and your analysis indicates that the stock is likely to appreciate over time, purchasing LEAPS at a low premium can yield substantial profits as the stock rises, particularly if it surpasses the strike price.

Article in Question

- Equity LEAPS Calls vs. Stocks: An Empirical Study for Long-Term Speculation
- **Authors:** S. Leila Beheshti Shirazi, Izlin Ismail
- **Institution:** University of Malaya

Objectives in Study

- The objective in the study was to examine the performance of "Buying In-The-Money LEAPS Calls vs. Purchasing Stocks.”
- **Focus:** Risk-return trade-off and risk-adjusted performance.
- **Sample:** 54 stocks on NYSE/NASDAQ and corresponding LEAPS calls (2008-2010).

Key Findings

- **Performance Comparison:** LEAPS calls underperform compared to common stocks for risk-averse traders.
  - Higher negative returns and volatility during market downturns for LEAPS calls.
- **Risk-Seeking Traders:** Prefer LEAPS calls with high Book-To-Market (BTM) ratios in favorable conditions.
  - This is value investing ideology mixed with speculation
  - Buying long-term options on undervalued securities that are projected to go up with time opens the opportunity to magnify gains at a lower up front cost.

Speculation vs. Investment

- **Speculation:** Profit from price fluctuations; involves higher risk.
- **Investment:** Focused on long-term income and safety.
- **LEAPS:** Longer maturity reduces market timing risk.
  - In a way using LEAPS combines attributes of both speculation and investment. The study focused on in-the-money LEAP options, however out-the-money calls could also be used if an investor has a smaller pool of capital and a high confidence of the stock appreciating in value.

Methodology

- **Data Collection:** Selected stocks and LEAPS based on industry diversification and BTM ratios.
- **Analysis Tools:** Mean-variance framework and risk-adjusted performance measures (Sharpe, Treynor, Jensen Alpha).

Results from Study

- **Mean-Variance Analysis:** LEAPS portfolios show significantly greater negative returns than stock portfolios.
- Higher volatility in LEAPS portfolios.
- **Risk-Adjusted Performance:** Negative Sharpe ratios indicate underperformance relative to risk-free rates.

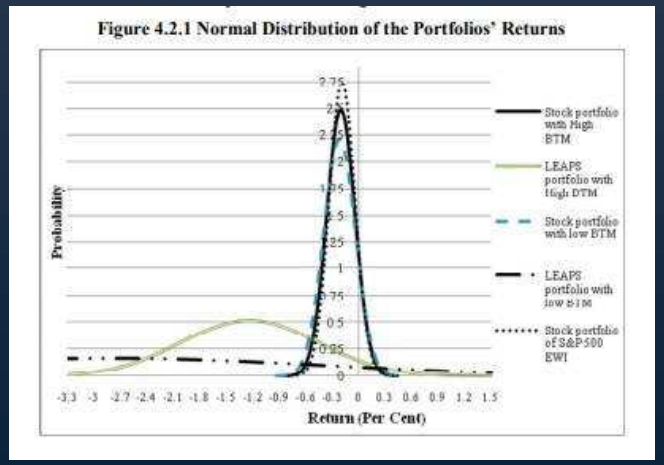


Table 1: Summary Statistics of Risk and Return Tradeoff, Jan 2008 –Dec 2010

	Stock portfolio with High BTM	LEAPS portfolio with High BTM	Stock portfolio with Low BTM	LEAPS portfolio with Low BTM	S&P 500 EWI
Mean of monthly rates of return	-20.18%	-123.54%	-21.59%	-281.14%	-18.31%
Standard Deviation of returns	16.06%	77.57%	18.01%	244.03%	14.52%
Highest Return	6.19%	-16.25%	6.31%	31.42%	3.07%
Lowest Return	-49.54%	-308.37%	-58.38%	-804.35%	-51.12%
Number of months returns are positive	3	0	1	1	1
Number of months returns are negative	33	36	35	35	35





13. United Airlines Holdings Inc. (NYSE:UAL)

Number of Hedge Fund Holders: 40

United Airlines Holdings Inc. (NYSE:UAL) shares have gained about 27% year to date through September 8, thanks to the rising travel demand. United Airlines Holdings Inc. (NYSE:UAL) is still considered as an undervalued play by many mainstream media outlets. United Airlines Holdings Inc. (NYSE:UAL)'s PE ratio as of September 8 stands at 5.95.

As of the end of the second quarter of 2023, 40 hedge funds tracked by Insider Monkey have stakes in United Airlines Holdings Inc. (NYSE:UAL). The biggest stakeholder of United Airlines Holdings Inc. (NYSE:UAL) is Ken Griffin's Citadel Investment Group which owns a $272 million stake in the company.

Alternative Viewpoint Successful Scenario

- Case Study: United Airlines UAL
  - If an investor understood that UAL was intrinsically undervalued in September 2023 and bought $500 worth of LEAP calls rather than equity they would have over $10,000 within 14 months.

Conclusion

- **Summary:** LEAPS calls may not be a suitable replacement for stocks, especially for risk-averse investors.
  - However, for investors with high risk tolerance and a goal to magnify returns leaps can be a viable strategy.
- **Future Research:** Explore long-term performance of LEAPS calls across varying market conditions and strategies.