



Rampart Investment Management

THE CASE FOR HEDGED EQUITIES

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Introduction

There is no question that the recent unprecedented volatility in the world capital markets has had a dramatic impact on all investors, individual and institutional alike. Debating the reasons that precipitated the worldwide crisis, or the means we might employ to extricate ourselves from the situation, are and will be subjects for discussion for years to come. In the meantime, it is highly likely that we are in, or are about to enter, a lengthy global recession that will in all likelihood cast a pall on equity market returns for the foreseeable future.

The media has had a field day devoting seemingly endless coverage to the discussion of the extreme volatility in world stock markets, equity indexes, individual stocks and various volatility or “fear” indexes. One of the consequences of the current credit-crisis-induced equity market collapse is the elevation of the volatility regime to historic levels. Even if there is a partial retracement or reversion of actual or “realized” volatilities to more normalized levels, the “new normal” is likely to be considerably higher than what we have experienced in many years.

Opportunities to Capitalize on Today's Volatility

In the options world, “implied” volatility represents the expected future volatility of an underlying asset, e.g., a stock or an index. Implied volatilities can expand or contract significantly faster and greater than realized volatilities and are the primary driver of option pricing. With higher implied volatility levels come greater equity and index option premiums for the option seller or writer. We believe that the current market environment offers option writers very compelling

premiums. We would caution, however, that the reason one is getting paid such high premiums is due to the greater theoretical risk one is assuming by investing in today's uncertain equity market.

Many investors and traders consider the CBOE (Chicago Board Options Exchange) Volatility Index® (VIX®) a barometer of investor sentiment and a proxy for the U.S. markets' benchmark volatility. Some even refer to the VIX as the market's “fear gauge.” It is calculated using near term S&P 500 Index option prices. Recently, the VIX established the highest closing readings in its 18-year history, reflecting the extreme uncertainty and anxiety that investors have when viewing the near term prospects for U.S. equity markets (Chart 1).

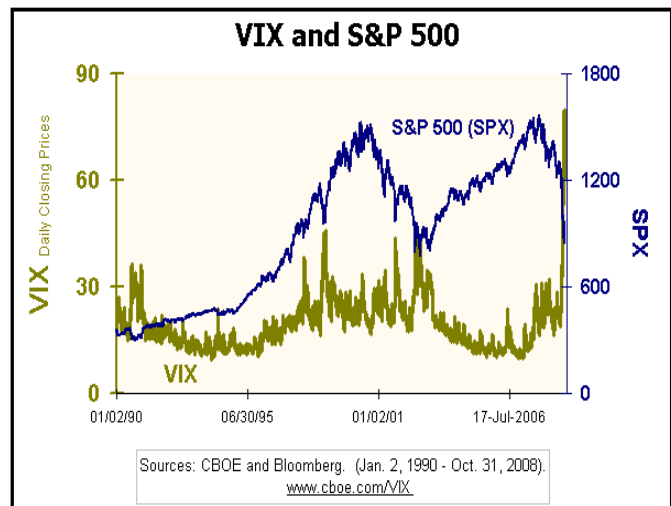


Chart 1.

The CBOE S&P 500 BuyWrite Index (BXMSM)

One methodology an investor can use to exploit the higher level of index option premiums is to establish a systematic stock index buy-write portfolio strategy. The CBOE S&P 500 BuyWrite Index or BXM was developed over several years and launched in early 2002¹. It is a straightforward strategy in which the underlying portfolio is the S&P 500

Index against which a one-month, near-the-money S&P 500 Index call is written. At the end of the option's one-month maturity, the option is settled in cash and a new, one-month near-the-money S&P 500 Index call is written.

Using the CBOE's BXM buy-write performance history², the strategy produced annualized total returns approximately equal to those of the S&P 500, but with only two thirds the risk, as measured by standard deviation of returns. (Chart 2).

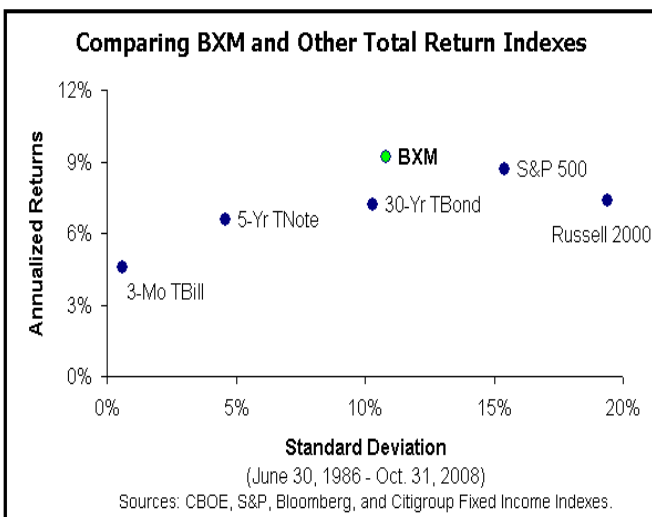


Chart 2.

Equal returns at less risk – a compelling argument. From its inception through the September 2008 BXM monthly transaction, the average monthly gross premium the

writer received was 1.6%³. On October 17, 2008, the monthly gross premium received by the writer was 7.1%. That dwarfs the previous monthly premium “high water mark” of 4.4% on September 21, 2001 (Chart 3).

An investor looking to deploy cash to make new equity investments or an investor already owning a portfolio highly correlated to the S&P 500 may wish to consider this “buy-write” strategy as an attractive alternative to additional long equity exposure. The income produced will certainly be welcome in a market environment that will likely see additional dividend cuts. Additionally, if history is a guide, the long-term returns should approximate those of the long equity benchmark after implementing a buy-write strategy.

Options for Institutional Investors

Investment officers at tax-exempt plan sponsors (pension funds, endowments, foundations, municipal retirement systems, etc.) that have any exposure to equities are likely facing the toughest financial markets of their careers. The losses that these investment programs have incurred may be substantial enough to affect prospective benefit payments or grants. These institutions can benefit from

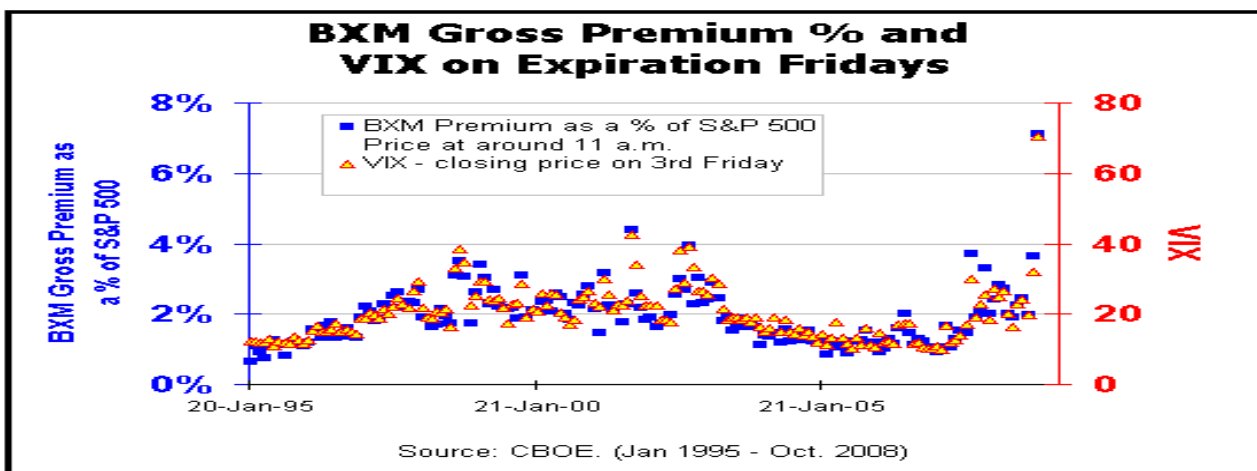


Chart 3.

increased market volatility by writing options on their underlying portfolio assets. One alternative is the use of a concentrated portfolio overlay program that utilizes options on individual securities owned by underlying equity managers. In this example, a simple analysis of a plan sponsor's custodial statements helps identify a number of securities that are held in a sizeable quantity by looking across individually-managed portfolios. If these securities are relatively static and optionable, an overlay strategy consisting of covered call writing on these stocks could enhance the plan's aggregate yield by a few percentage points per annum.

Another alternative is to look at Exchange Traded Fund (ETF) holdings – such as the SPDR® (corresponds to the total return of the S&P 500) or QQQQ (PowerShares QQQ™ seeks to replicate the NASDAQ 100 Index®) – at the plan level and employ a covered call writing overlay strategy to those securities. The incremental cash yield provided by such a program, for example, can then be ported to potentially higher alpha generating investment managers or be used to fund distributions to beneficiaries.

A further alternative is a BXM or BXM-like approach. Since most institutions' public equity investment programs are typically highly correlated to a broad market index like the S&P 500, it is relatively easy to implement a BXM or BXM-like hedged equity program for a portion of their equity allocation. This can be done in a transparent manner, whereby the underlying managers are unaffected by the options program. Rather, an options manager is engaged to provide an options overlay against these assets.

If the BXM offers such attraction, why isn't everyone employing this strategy? This question has been asked over the course of many years. One reason is that plan sponsors typically do not have a "bucket" or category within their asset allocation policy for "hedged equity." Another reason is the common adverse reaction to buy-write or covered call writing strategies; that investors are reluctant to give up the appreciation potential once a new recovery phase in the market is in place. By definition, writing calls at 100% of portfolio value limits the upside potential to the strike price of the call written. Importantly, however, strike prices are reset at least several times per year (12 times in the BXM) and markets do not generally go up in a single movement. Therefore, the potential opportunity cost may be acceptable for most investors.

The *Market Line of Return* graphic (Chart 2) depicts the long-term risk and return for the BXM as it compares to a variety of other widely followed performance benchmarks. Over the long term, we have seen that the risk/return tradeoff for the BXM is compelling. However, what about those periods of market recovery where a hedging strategy by definition has to constrain returns?

Below we examine two periods characterized by strong equity markets. In each of these bull market phases, the hedged equity strategy certainly lagged, but absolute returns were still rather compelling.

	<u>S&P 500</u>	<u>BXM</u>
11/30/94 – 3/31/00	27.4%	20.2%
9/30/02 – 10/31/07	15.5%	12.8%

Source: Bloomberg, annualized

If we examine two recent bear market environments below, the hedged equity strategy delivers strong relative performance versus the S&P 500.

	<u>S&P 500</u>	<u>BXM</u>
8/31/00 – 2/28/03	-19.9%	-9.4%
10/31/07 – 10/31/08	-36.0%	-23.2%

Source: Bloomberg, annualized

Options for Individual Investors

What about investors who already own a non-correlated portfolio of stocks or a large concentration in one stock? Despite the diversity of market projections for the future, one recurring comment from individual investors is common: "I wish I had liquidated or reduced my position in XYZ before the evaporation of so much of my equity value. Now that my stock has declined so precipitously, is there anything I can do while I wait for the value to recover?"

Owners of individual stocks can become beneficiaries rather than victims of the increased volatility in the capital markets by

employing equity call writing strategies. In the U.S., there are more than 2,700 stocks against which equity calls are exchange-traded on a national securities exchange. And like the index call writing opportunities, equity calls have also experienced record highs in option premiums available to writers.

Rampart's *Time Premium Index* (Chart 4), published each week in *Barron's*, calculates the arithmetic average of "normalized" at-the-money, six-month maturity, equity call options, based on the more than 2,700 optionable stocks. The index reading of 25.87 on October 16, 2008 represents a new record high, exceeding the previous highs of 24.50 on April 20, 2000 and 20.36 on September 20, 2001.

Typically, equity calls offer far greater levels of premium than comparable (maturity, strike price) index calls. The reason is simple: the volatility of an index with hundreds of stocks is always less than individual volatilities of the index constituents.

In its most basic form, a covered call writing strategy – writing an at-the-money equity call

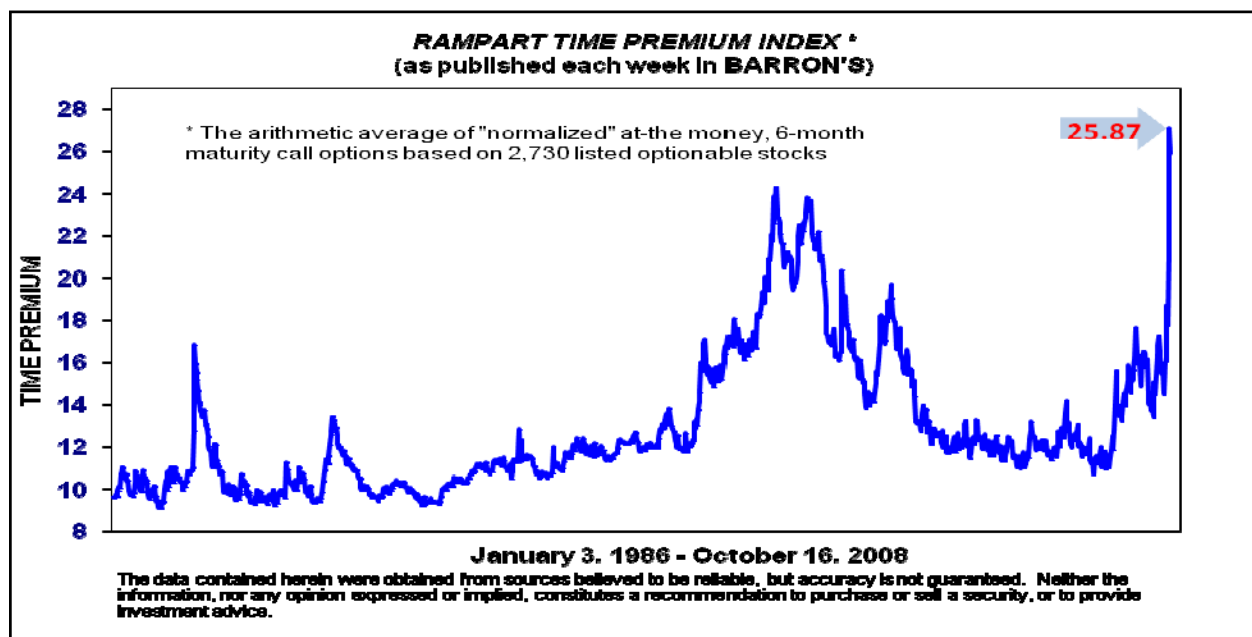


Chart 4. Copyright©2008 Rampart Investment Management

option against all available shares of a stock – is likely to produce potential standstill (stock remains unchanged) rates of return significantly greater than the comparable returns available using the same underlying security a year ago. The recent *Rampart Time Premium Index* reading of 25.87 suggests that a fully written 6-month equity call would produce a premium of 25.87% of the value of the underlying stock. One year ago, that premium would have been 14.5%. What a difference a year makes.

Single Stock Options – Opportunities and Risks

While these returns are potentially quite attractive, there is an underlying assumption that the investor is willing and able to deliver the hedged stock should the option be exercised. Many investors, however, are interested in retaining their shares, generating some incremental income while looking to benefit from at least some upside movement in the markets after the decline that we have recently experienced. For investors not wanting to give up their stock at current or only slightly higher price levels, one can write far “out-of-the-money” calls. Unfortunately, these types of options are not always available, and if they are, they typically offer very small premiums to the call writer.

Rampart can employ its proprietary technology platform “ROMS” (*Rampart Options Management System*®) to create the functional equivalent of an out-of-the-money equity option. This is accomplished by using near-the-money strike price options written against a portion of the number of shares available. This provides for the opportunity to sequentially “roll-up” to larger quantities of new, higher strike price options at higher

stock prices, until all of the shares are covered at a strike price known as the *Target Price*. For every *Target Price* there is a commensurate amount of potential cash flow yield (Chart 5).

In this example of Home Depot at \$21.06, one can see depicted a range of cash flow yield potentials (return), both forecast annual (light blue bar) and the initial trade (dark blue bar) for a variety of *Target Prices*. The *Target Price* is that price where all of the shares become fully hedged or written, and therefore, no further upside opportunity is available to the call writer. So the *Target Price* is really a metric of potential risk: opportunity risk. The greater the distance between the *Target Price* and today’s price, the less the chance of the stock reaching the *Target Price* and therefore, the smaller the risk (and also cash flow).

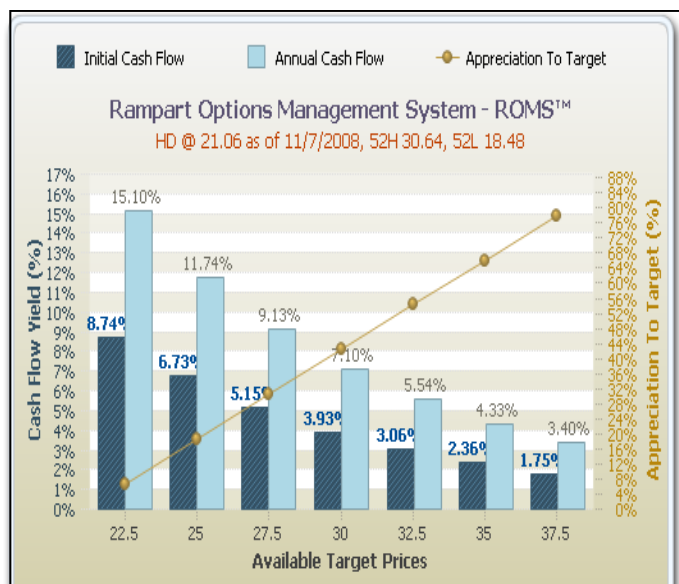


Chart 5. For illustration purposes only. These projections do not include fees or expenses and presume current implied volatilities and interest rates which will change. There is no guarantee that these projections can or will be met. Neither the information, nor any opinion expressed or implied, constitutes a recommendation to purchase or sell a security, or to provide investment advice.

Source: Rampart, Bloomberg.
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Conversely, the closer the *Target Price* is to today's price, the greater the probability of the stock reaching its *Target Price*. For that increased opportunity risk, the writer is compensated with a greater cash flow. For example, looking at a Home Depot *Target Price* of \$25 (a 19% upside potential from \$21.06), if the writer is willing to forego, at least temporarily, the opportunity of participation above \$25, an incremental cash flow of 11.74% is projected over the next 12 months. With a *Target Price* of \$27.50 (a 31% upside potential), ROMS projects a potential 9.13% cash flow for the next 12 months. By comparison, exactly one year ago, when volatilities were much lower, an upside potential of 19% would produce only a 3.80% potential annual cash flow.

This type of covered call writing strategy can be provided against a single concentrated position or an entire portfolio of stocks. Additionally, for those investors who are interested in downside protection as well, one can use the proceeds from an equity call writing program to purchase stock or index put options to provide a measure of downside protection for the stock or portfolio using a collar strategy. The collar or *hybrid collar* (which uses equity calls and index puts) strategies offer interesting payoff potentials across a broad array of performance projections.

Closing Remarks

The recent market upheaval has resulted in unprecedented levels of option premiums. Whether you are an owner of a concentrated stock position, an investor looking to try a new, more conservative equity strategy or a foundation or pension fund manager seeking to find ways to improve cash flow, a

customized option program may offer solutions to fit your specific needs. Rampart has been designing and employing various options strategies on behalf of its clients since 1983. We have worked with investors of all types to write options on underlying assets across global markets. We understand how to make the most of this volatile time, and we want to share our capabilities and technology with you.

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Footnotes:

¹ Rampart Investment Management contributed to the development of the CBOE S&P 500 BuyWrite Index (BXMSM) and was the first licensee of this product. Furthermore, (i) the CBOE S&P 500 BuyWrite Index is a service mark of, and is being used with the permission of CBOE; (ii) the methodology of the BXM Index is owned by CBOE and may be covered by one or more patents or pending patent applications; and (iii) CBOE, and not S&P, calculates and disseminates the BXM Index. Moreover, it shall be made clear that neither CBOE nor S&P in any way sponsors, endorses, or is otherwise involved in the Management Services provided by Rampart and that CBOE and S&P disclaim any liability to any party for any inaccuracy in the data on which the BXM Index is based, for any mistakes, errors, or omissions in the calculation and/or dissemination of the BXM Index, or for the manner in which the BXM Index is applied in connection with the Management Services provided by Rampart.

² The CBOE S&P 500 BuyWrite Index (BXMSM) is designed to represent a proposed hypothetical buy-write strategy. Like many passive indexes, the BXM Index does not take into account significant factors such as transaction costs and taxes and, because of factors such as these, many or most investors should be expected to underperform passive indexes. Transaction costs and taxes for a buy-write strategy such as the BXM could be significantly higher than transaction costs for a passive strategy of buying-and-holding stocks. Past performance does not guarantee future results. Source: www.cboe.com/bxm

³ Source: www.cboe.com/bxm