NOTOS GROUP

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SEIZING OPPORTUNITIES BY TRADING OPTIONS ON SHIPPING STOCKS

SPECIAL: SEIZING OPPORTUNITIES BY TRADING OPTIONS ON SHIPPING STOCKS

Shipping stocks differ from other broad market stocks in terms of volatility as shown by the table below.

SHIPPING STOCKS WITH HIGH VOLATILITY

INDEX	VOLATILITY P.A. OVER LAST 250d
MSCI WORLD	10.2%
NOTOS SHIPPING INDEX	16.3%
NOTOS BULKER INDEX	28.0%
NOTOS OFFSHORE INDEX	29.9%
NOTOS GAS INDEX	20.5%

Besides the fact that the underlying 'physical' shipping markets are highly volatile, shipping stocks very often have a limited market capitalization and comparatively thin liquidity. Due to this increased volatility and lower liquidity, options on shipping stocks are more expensive and have larger bid-ask spreads than options on traditional stocks or indices. Thus, buying call or put options on shipping stocks is a costly affair.

EXTRA RETURNS THROUGH WRITING OPTIONS

On the contrary, since buying options is costly, writing options could be the means which offers accretive returns. In this article, we describe the strategy adopted by us of repeated options trades around existing long-position in shares of GasLog Ltd. However, this should only be seen as an example and it does not constitute any recommendation on the Gaslog stock or its options.

The graph to the right shows the development of the share price of GasLog Ltd. between 04 January 2016 to end-March 2017. The coloured areas cover the period starting with the day the option has been written until its maturity. The height of the bar reflects the aggregate of the strike price and the option premium received. Hence, these areas reflect the break-even levels at which the options could be executed without a loss.

TRADE 1 - SHORT PUT

As an example, on 04 March 2016 the stock traded intraday at a level of USD 10.33. A put option with maturity 20 May 2016 and a strike price of USD 7.50 was sold for 25 cents. The option holder now had the right to sell one GasLog share for USD 7.50 until maturity. As the current share price at that time was higher than the strike price, such attempt would not have made any commercial sense, meaning that the option was 'out-of-the-money'. The writer of the option had to assess the likelihood of a potential price drop. If the share price had remained unchanged at USD 10.33 until maturity, the option would have expired worthless, and the premium received by the option writer would have been a pure return.

If the share price had fallen to USD 7.50 or below, the option would have started to generate a positive intrinsic value. If the share price had dropped to USD 5.00 for example, the owner of the option would have exercised the option and sold the share to the option writer at the pre-agreed strike price of USD 7.50. Writing such an option makes sense only when the writer has a positive view on the stock and will be able to buy the stock for the agreed price until maturity.

What return levels can be achieved? In our example, USD 7.50 had to be kept aside as cash collateral for the short position as a requirement of the transacting bank. A return of 25 cents for an investment of USD 7.50 provided a yield of 3.3% for a period of 77 days or 15.8% on an annualized basis which we regard as fairly attractive.

TRADE 2 - SHORT CALL

Few days later, at the stock price of USD 11.71, a call option with maturity 20 May 2016 and a strike price of USD 15.00 was sold for 30 cents. In this case, the writer of the option would have been able to fulfill his contract by delivering the actual share if the buyer had exercised the option on or before the maturity date i.e. if the share price had climbed above USD 15.00. So again, this option was 'out-of-the-money'.

GASLOG LTD. SHARE PRICE WRAPPED BY 'OUT-OF-THE-MONEY' OPTIONS

Source: Notos Group 04/2017

Writing call options is the right strategy in case the writer has a negative or only a slightly positive view on the underlying stock. In this example, the writer had to hold the share in GasLog as a collateral in his deposit which meant an investment of USD 11.71. A premium of 30 cents over USD 11.71 yielded 2.6% for a period of 74 days or 12.6% on an annualized basis.

The cherry on the cake - the writer of the option will receive any dividends paid during the holding period.

CONTINUOUS OPTION SELLING IS KEY

As displayed in the previous graph, we repeatedly sold out-of-the-money calls and puts. The break-even bands for these positions wrapped the actual share price like a frame. We preferred not to sell any options with a maturity of over six months in order to allow for more flexibility. The table on the next page summarizes the gains of the seven trades incurred over the past 15 months.

We started the transactions by buying one Gaslog share for USD 10.33 on 04 March 2016. Up to now, the stock appreciated by 43.8% to USD 14.85. During this period, we received 70 cents dividends, and we sold two call options at USD 15.00 and one at USD 17.50 respectively. In total, we received USD 1.20 in option premiums, which gave an additional return of 11.6% on top of the already earned 6.8% from the dividends. Thus, writing call options worked as a yield-enhancer.

In parallel, we sold subsequently four put options on Gaslog for USD 7.50, USD 10.00, USD 15.00 and USD 12.50

TRANSACTION	SHORT CALLS		SHORT PUTS	
COLLATERAL	10.33 USD		11.46 USD	
PERIOD	390 days		509 days	
APPRECIATION	4.52 USD	+43.8%	n.a.	
DIVIDENDS	0.70 USD	+6.8%	n.a.	
PREMIA	1.20 USD	+11.6%	2.80 USD	+17.5%
TOTAL PROFIT	6.42 USD	+62.1%	2.80 USD	+17.5%

Source: Notos Group 04/2017

respectively. On average, we needed to place USD 11.46 as a cash collateral for a total period of 509 days, as the latest option matures in August 2017. These transactions yielded an average return of 24.4% or 17.5% on an annualized basis, which we regard as a good risk-adjusted return

IT IS ALL ABOUT TIMING

In retrospect, all the transactions so far went fine with sold options becoming worthless upon maturity. However, such returns are not always easy to achieve. The call option with a strike price of USD 17.50 was very close to being executed in January this year. In order to realize a good price for the option, the timing is crucial as shown in the graph.

We always closely monitor technical indicators on the stocks to identify opportune entry points to implement our strategy to achieve accretive returns. However, investors should bear in mind that these options are extremely illiquid. So far, we chose to stay in the options until maturity. Problems might arise once there is an unexpected event in the market, or bid-ask spreads widening further, causing a negative market value in the option. For example, the sudden price peak in the shares of Dryships last year triggered such an event. Therefore, we cover all short positions - by owning the underlying shares in the case of short calls and putting aside the required cash in the case of short puts. Furthermore, you should keep in mind that all aforementioned yields were before transaction costs. Hence, broker fees are another influential factor.

PUBLISHER

NOTOS CONSULT GMBH
BALLINDAMM 17
20095 HAMBURG
GERMANY

CONTACT

T +49 40 6094 550 – 0
F +49 40 6094 550 – 92
INFO@NOTOS-GROUP.COM

REGISTERED OFFICE: HAMBURG
REGISTRATION COURT:
AMTSGERICHT HAMBURG | HRB 120813

MANAGING DIRECTORS:

DR. JENS ROHWEDER
DR. CHRISTINA STAHN