Summary of Wal-Mart "Bond Replacement" Investment

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Key Take-Aways

- The bond replacement investment structure we highlighted in an October 14, 2015 IOI Tear Sheet using a short put struck at $60 expired in-the-money (ITM).
- Despite expiring ITM, Wal-Mart is presently trading at $60.43, implying a gain of around $2.78 on investment principal of $60 – a 4.8% period return or 30.8% on an annualized basis.
- Investors in this structure have several choices of how to manage the position – roll, close, or gain upside exposure. This article offers a model of framing these choices in a portfolio context and discusses how to visualize ranges of exposure for bond replacement investment structures.

Investment History

The investment structure in Wal-Mart WMT that we recommended on October 14 matured on December 18. The structure we highlighted made use of a put option sold at a strike price of $60. Because Wal-Mart was trading for less than $60 at expiration, investors in this structure now own shares of Wal-Mart at an effective buy price (EBP) of $57.65.

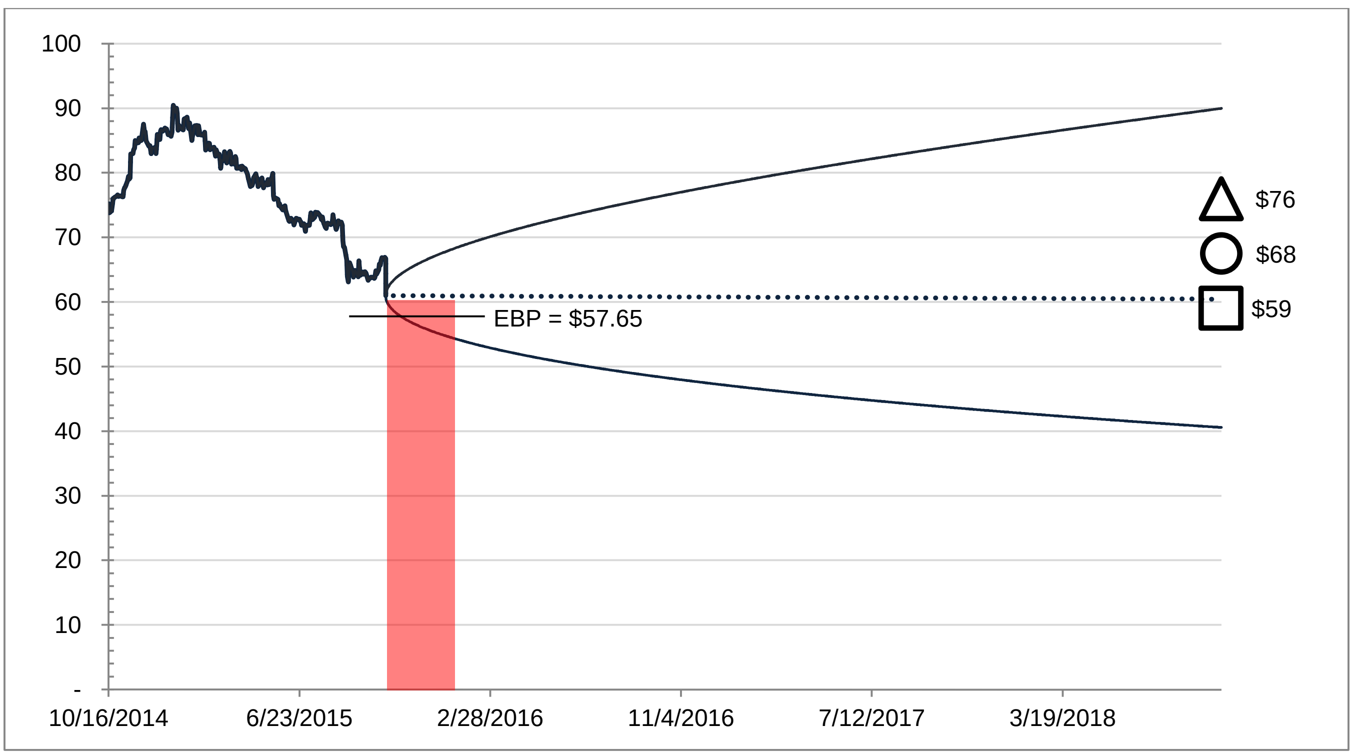


Figure 1. Source: YCharts data, IOI Analysis

At the time of this writing, Wal-Mart's shares are trading at $60.43. This price represents a 4.8% increase over our Effective Buy Price (EBP), which is, thanks to our ownership of the stock, better than our original return expectations for this structure. Because the duration of this investment was a mere 64 days, the annualized return works out to be 30.8%.

Selling options that allow an investor to accept downside exposure in return for a cash payment have a similar risk profile as bonds; hence, the term "Bond Replacement"

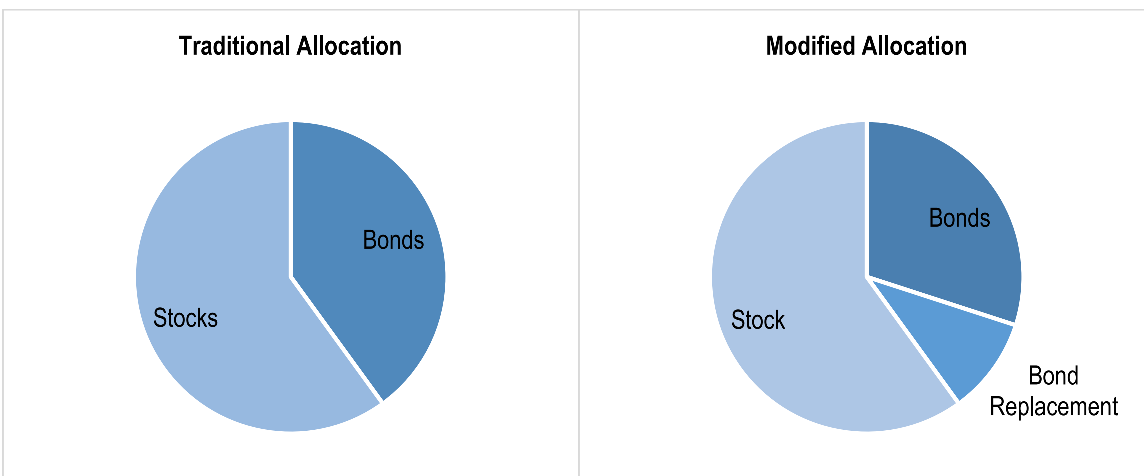
Option strategies allowing an investor to accept exposure to the downside potential of a stock is similar to the risk exposure of a bond investor. It is for this reason that we term these structures "bond replacement" strategies. Also worth noting is that Wal-Mart's $1 billion worth of bonds expiring on April 15, 2015 yield a mere 2.8%. In other words, by accepting downside valuation risk using options, we are able to generate significantly higher yields than are available in the bond market. In addition, if the options expire ITM, as is the case for Wal-Mart, we automatically hold the shares and thus gain exposure to subsequent capital gains. Combined, this investment structure is similar to that of an investment in a warrant.

Investment Choices

Because the option expired while the stock was ITM, an investor in this structure has several choices regarding future investment strategy. These choices are:

- Roll: Carry on with the same risk / return structure as the original investment.
- Close: Realize profits on the position.
- Gain Upside Exposure: Continue to hold the stock in expectation of capital gains.

In thinking about the allocation of these types of investments in a portfolio, we like to think of them as replacing a certain percentage of our fixed income allocation as shown below.



Similar to the bond and stock allocation, the bond replacement allocation should be appropriately diversified. Assuming 10 securities in each allocation bucket, position sizes for the bond replacement portion of a portfolio will be smaller than those in the stock or bond buckets simply by virtue of the size of the bucket itself.

Each choice of how to handle the new stock position essentially represents a portfolio rebalancing selection.

When an option position expires ITM, the value of the new stock position shifts out of the Bond Replacement bucket and into the Stock bucket. Selecting any of the three choices mentioned above essentially represent a portfolio rebalancing exercise. Rolling the position allows the sliver that shifted from Bond Replacement to Stock shift back into the Bond Replacement bucket. Closing the position generates cash, which can either be left in the portfolio, used to purchase another investment (either in bonds or stocks), or withdrawn to make a planned expenditure. Gaining upside exposure simply means that the sliver that shifted from Bond Replacement to Stock is kept in the Stock bucket.

ROLL

The easiest way to roll a short put that expired ITM is by selling a call option overlaying the new stock position – a covered call. In the case of Wal-Mart, the range of exposure diagram for the rolled position (assuming a sale of the 60-strike call option) would appear as in the figure below.

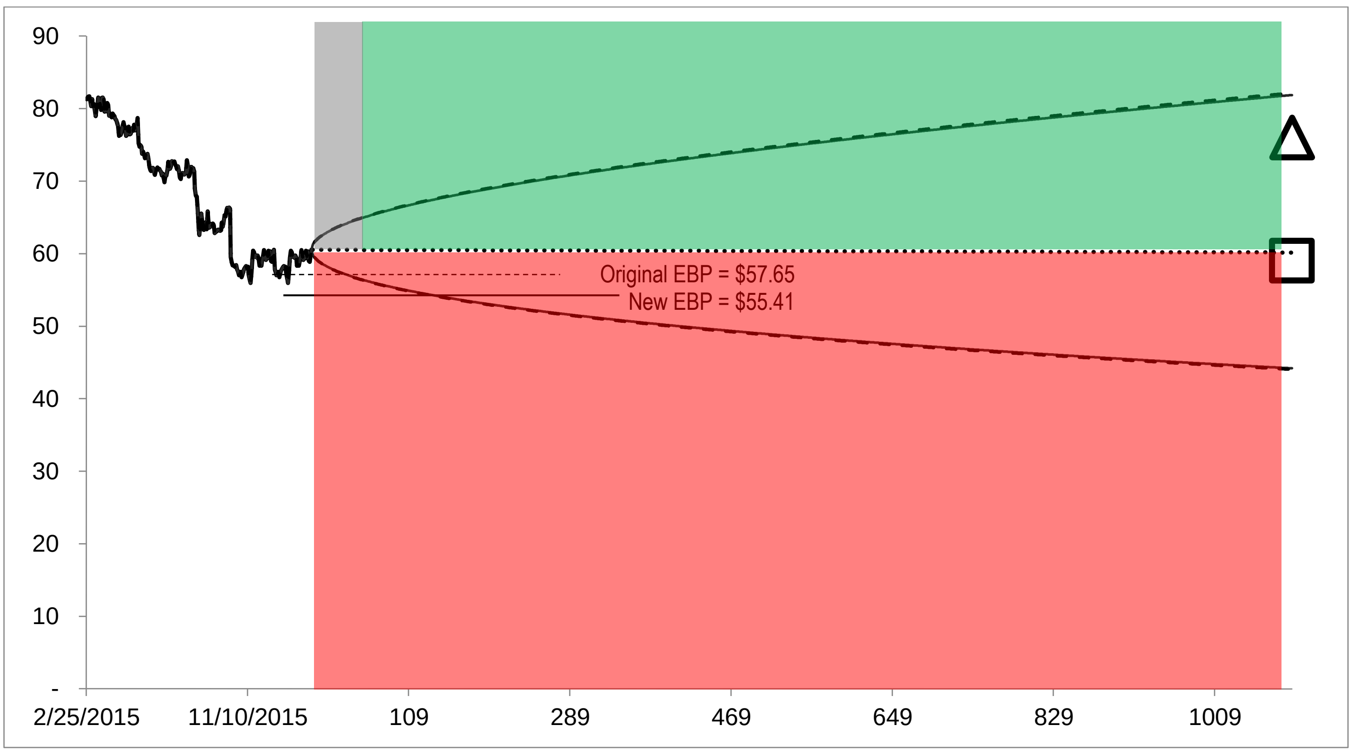


Figure 2. Source: YCharts data, IOI Analysis

An investor accepts downside exposure at the $60 strike price and runs the risk of realizing a capital loss if the price falls under the original EBP ($57.65 in this case). The ATM call expiring in February 2016 is trading for $2.24 / share. As shareholders, we have the right to receive a dividend on the shares, but the record date for dividend payment was December 4, 2015, and since the put expired after that, we are ineligible to receive the

January 4, 2016 dividend. (If we had sold a covered call rather that a "naked" put in October, we would be eligible to receive a dividend of $0.49 in January.)

The additional option premium places our new EBP at $55.41. As such, were we to make this transaction and Wal-Mart closed above $60 on February 19, 2016, we could calculate our return as ($60.00 / $55.41 – 1 =) 8.3% over 128 days, implying an annualized return of 25.4%.

CLOSE

Closing the stock position now would pay $60.43 / share and would allow you to use the cash to either reinvest in an attractively priced security or to withdraw as income. Note that if you select this choice, your Bond Replacement allocation has grown smaller, so all else held equal, you will not be able to expect as much income.

GAIN UPSIDE EXPOSURE

More than gaining upside exposure, one is actually "maintaining" upside exposure if one continues to hold the stock after being put the stock at expiration.

The decision to gain (maintain) exposure to Wal-Mart should be made in light of considerations related to diversification, position size, and relative attractiveness.

The decision whether to gain more exposure must be made in consideration of how the stock will fit into your portfolio's equity allocation and whether or not it is attractive on the basis of other equity investments you might otherwise make.

In other words, if you had already allocated some portion of your equity portfolio to retailers and grocery stores, the inclusion of a new position in Wal-Mart would reduce the diversification in your portfolio. Also, continuing to hold Wal-Mart after it has been put to an investor is an implicit "vote" by the investor that the Wal-Mart investment is more attractive than other potential investments.

Another consideration is one of position size. Earlier in the article, we had assumed that our modified portfolio consisted of 10 equities, 10 bonds, and 10 bond replacement options. When one of the bond replacement options transforms into an equity position, its size in proportion to other investments is thus relatively small. If Wal-Mart is indeed an attractive security compared to other potential investments, it is worth considering investing more in it (by buying more stock or by buying stocks and options in a levered long position) so that the allocation to Wal-Mart accurately reflects your opinion on the attractiveness of the investment.