

## Long Term Options for the Value Investor

Over the years value investors have sought different ways to leverage their ideas. Some have gotten into the business of acquiring companies whereas others have borrowed money to enhance returns. Warren Buffett used the float of an insurance business as a means of leverage. For the public investor, the use of long term options are an efficient way to leverage good ideas. However, leverage can be two-sided for the investor whose ideas are not good such leverage can be dangerous (or worse).

The starting point or considering use of options must be how good is your estimate of intrinsic value? This simple question is the core principle of all value investing. Knowing the correct answer generally requires years of experience and personal discipline. Put differently, you have to know what you know and know what you don't know. The market does not care that you own stock of a company all that matters is what it is worth. Leverage (options use) will magnify the return whether it is positive or negative. Thus, the conclusion is that options should *only* be used by the experienced and disciplined value investor. Additionally, the investor must analyze how good is the estimate of intrinsic value? The correct amount of leverage coincides with the quality of the idea (from a margin of safety standpoint). A litmus test that often proves helpful but is very difficult is whether the investor would put his net worth in the idea. This test is a effective means of determining the quality of the idea. In conclusion, great ideas with a margin of safety can be leveraged.

Leverage and why should value investors use it? Aren't value investors conservative? The answers to these questions are yes. Most value investors are conservative and yes a conservative value investor can use leverage. Leverage for the value investor is just a tool to enhance returns. However, it is a tool that enhances efficiency. For any investor enhancing efficiency increases alpha (or value added). Thus the value investor that does not consider all tools available will be at a disadvantage. Of course effective use of such (or any) tools is the key.

### For the Value Investor

Leverage is (can be employed) by buying in-the-money long dated call options. Most value investors will likewise prefer American options to European options. Given the pricing differential this won't always be the case, but the ability to execute a transaction on your terms (when you want to not just at maturity) is a core value investing principle.

The next question becomes why in-the-money versus out-the-money options? Again the answer lies in the nature of a value investor. Margin of safety is the most important concern or principle for all true value investors. Buying a dollar for less than a dollar is what value investors do. Buying at a wider discount is one's margin of safety. In-the-money options meet this criteria because the strike or execution price is below the current stock price. Of course this assumes the intrinsic value is in excess of the stock price. The only question is how big is the margin of safety? Also when calculating the intrinsic value which the most realistic value any investor is willing to pay for a company a worse case analysis is helpful. Since time is so important with options it is helpful to have a large margin of safety with a worst case scenario. Thus given the added leverage of options a worst case is often preferred value versus the intrinsic value. Likewise, the distribution of possible values often plays a role in the amount of margin of

safety. Most value investors want to make money under the worse case. Therefore, out-of-the-money options almost by definition don't (won't) meet this limitation. The only way is if the price to value is abnormality large (ie a huge margin of safety). In the vast majority of cases this won't happen and the value investor should be skeptical if he thinks such a case is occurring. Remember value investors are conservative by nature and it is rare to buy a dollar for 30 or 40 cents.

The long dating of options is simple but extremely important. The value investor must get time on his side. Anything less than one year is simply speculating on others time horizon. The longer the better is the rule. The time premium can be amazingly low given the way many options are priced. Given the perpetual nature of owning stock, two or three year are long date options but should be used with care. Again margin of safety is paramount. The question arises why are in-the-money long date options cheap (mispriced)? The answer is because they are not priced on fundamentals by value investors. Options are priced using mathematical formulas based on volatility, dividend yield, etc. often by a modified Black-Scholls option pricing model. Therein lies the opportunity. Rest assured over time such models will be artificially modified if value investors widely invest in such options and are rewarded large returns. However, since these options won't be priced fundamentally by value investors a major opportunity will continue to exist. Stocks are priced on emotion and options are priced mathematically based on the stock price.

Leverage and value added alpha are created by the value investor when they properly invest in long dated in-the-money options. They are a useful tool for the value investor.