

The January Effect: + Early 2019 Index Option Trading Themes

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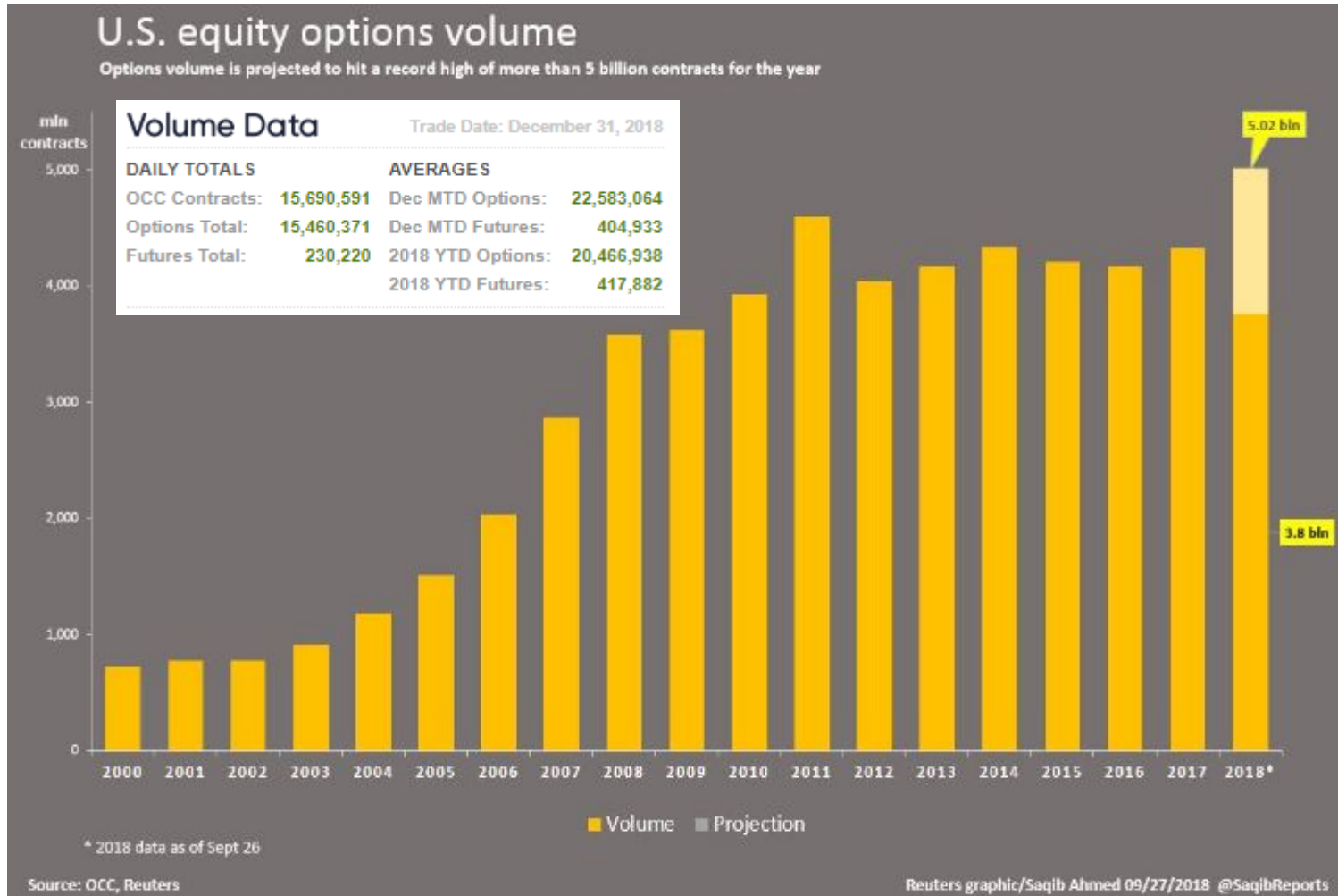
January 2019

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When the Industry was 45...It Was a Very Good Year!



The January Effect

- ❖ Sidney Wachtel “observes” in writing 1942
- ❖ 1925 – 1941: Tendency for stocks, particular small cap and value to outperform in January (often early in the month)
- ❖ Wachtel argued that tax considerations (tax loss sales) played a meaningful role in the “seasonal” returns
- ❖ Rozeff and Kinney (economists) in 1976 – Evaluate 1904 – 1974 and “confirm” the “January Effect”
- ❖ January Effect debate rages on, but an investment thesis based on specious “seasonality” claims are NOT advised



Small....Maybe Micro Cap Names (Global)

- ❖ Eugene Fama (U of C) and Kenneth French (Dartmouth) did global research (2011) that states: *“there are value premiums in average stock returns that, except for Japan, decrease with size”*

January strength quite restricted

Average gains per month since 1926



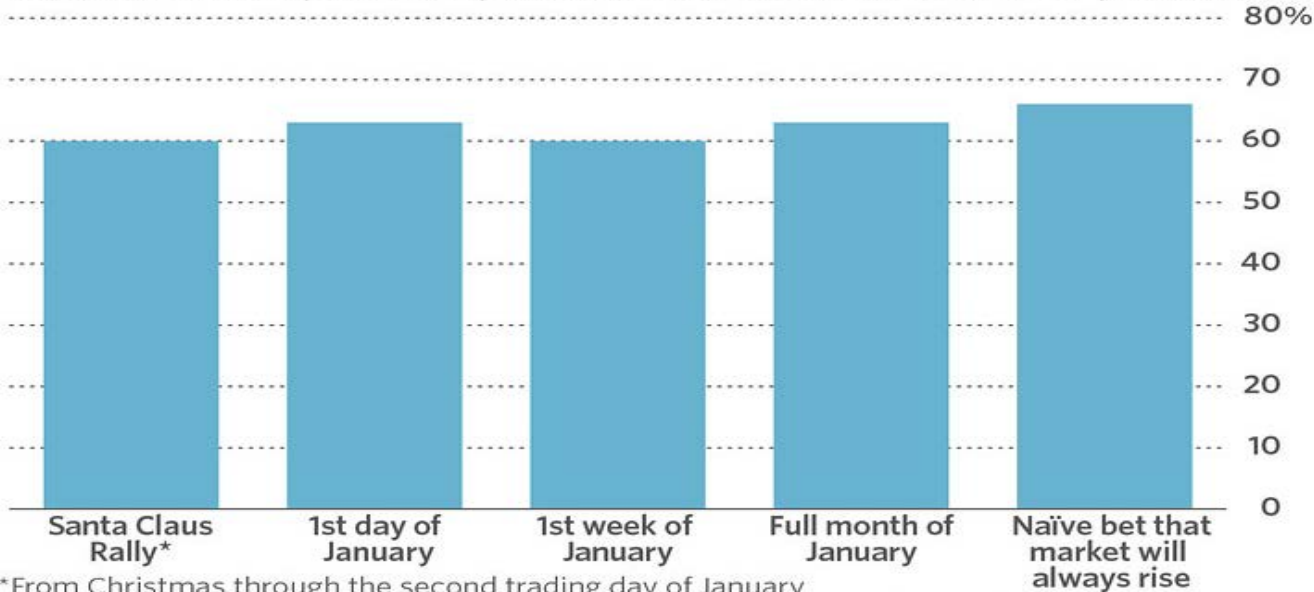
Data: Eugene Fama, Kenneth French

Your Predictive Powers - Questionable

- ❖ Many “systems” conflate general market tendencies with predictive powers
- ❖ Or the age old – Correlation or Causation
- ❖ In any event – don’t “bet the farm” (ever)

Nothing special about January

Historical accuracy of January seasonal bets on stock market's full-year direction



*From Christmas through the second trading day of January

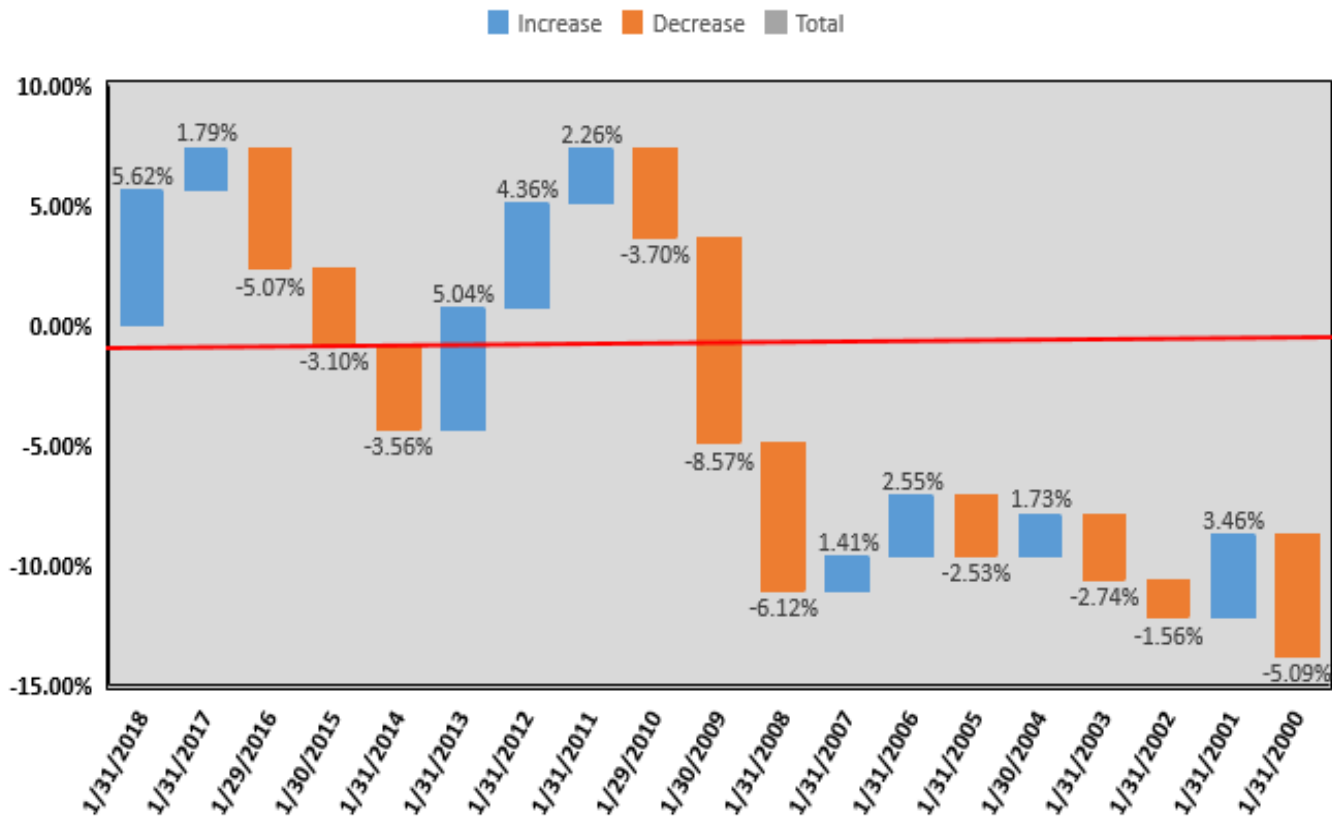
Note: Success rate of using DJIA's direction during specified period to predict market's direction from then through end of December; 1896 to 2017 Source: HulbertRatings.com

Source: Hulbert Ratings & MarketWatch



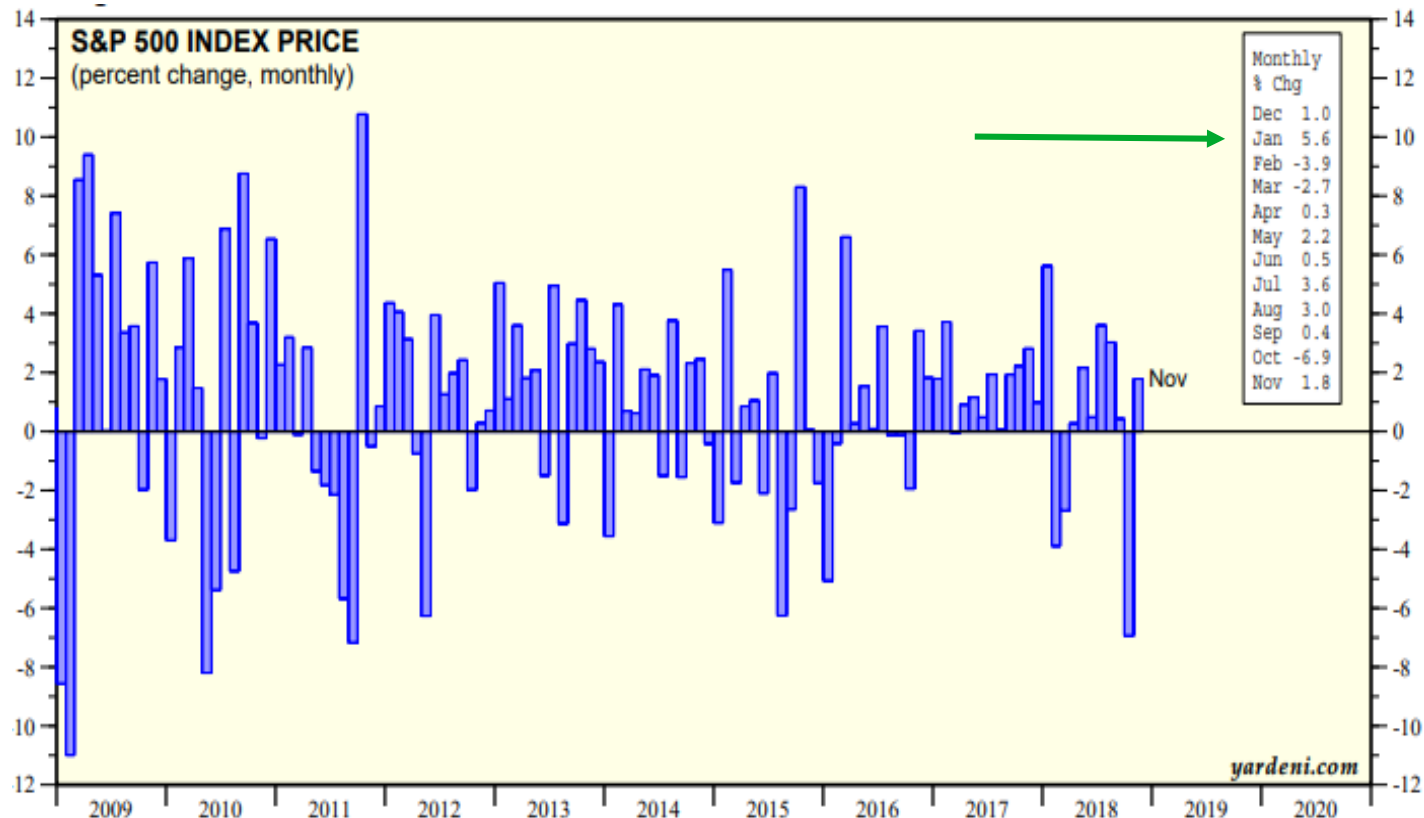
❖ Jan Avg. SPX performance (2000 – 2018) = (0.99%) – What Jan. Effect?

January SPX (TM) Performance (2000 - 2018)



Post Global Financial Crisis

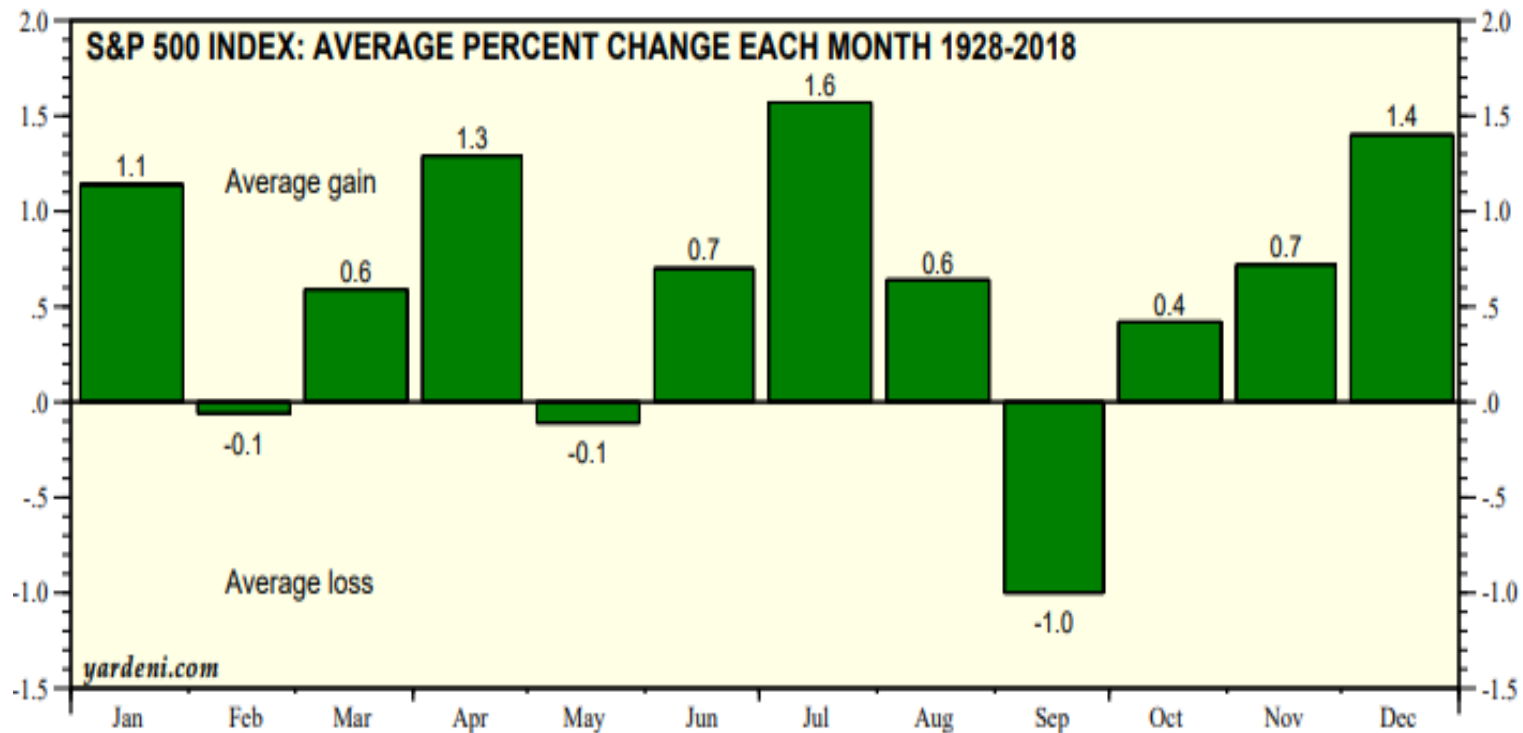
- ❖ Jan 2018 was **unusual** with a 5.6% gain (up 7.5% on highs) – Tax Bill
- ❖ S&P 500® Index TR has been positive on annual basis every year since 2008*



Source: Yardeni Research + S&P

Through the Looking Glass

- ❖ S&P's Jan performance over 90 years = Average +1.1% (4th best month)
- ❖ S&P 500[®] Index Jan Average +1.1% (1928 – 2018)



Source: Yardeni Research + S&P + Haver Analytics

SPX since 1950

- ❖ S&P 500[®] down Dec during 17 of 67 years (not including 2018)
- ❖ Of the 17 lower Decembers, 10 were followed by lower Jan (avg. +/- 5.6%)
- ❖ Avg. Jan when Dec is higher “only” =/-3.6% (Vol begets Vol)

Year	Dec Perf	Jan Perf	Year	Dec Perf	Jan Perf
1955	-0.07%	-3.65%	1983	-0.88%	-0.92%
1957	-4.15%	4.28%	1986	-2.83%	13.18%
1966	-0.15%	7.82%	1996	-2.15%	6.13%
1968	-4.16%	-0.82%	2002	-6.03%	-2.74%
1969	-1.87%	-7.65%	2005	-0.10%	2.55%
1974	-2.02%	12.28%	2007	-0.86%	-6.12%
1975	-1.15%	11.83%	2014	-0.42%	-3.10%
1980	-3.39%	-4.57%	2015	-1.75%	-5.07%
1981	-3.01%	-1.75%	2018	???	???

Source: @RussellRhoads

- ❖ Argues for small cap (RUT?) outperformance in the month of January
- ❖ Also potentially argues for Global Market exposure in January

“Of all the calendar-related anomalies, the January effect has been the most publicised. From 1925 through 2012, the average arithmetic return on the S&P 500 Index in the month of January was 1.00 percent, while the average returns on the small stocks came to 5.36 percent. The 4.36-percentage point excess return of small stocks in January far exceeds the difference in annual returns between large and small stocks. In other words, from February through December, the average returns on small stocks have fallen short of the returns on large stocks. On the basis of history, the only advantageous time to hold small stocks is the month of January.

When researchers turned to foreign markets, they found that the January effect was not just a U.S. phenomenon. In Japan, the world’s second-largest capital market, the excess returns on small stocks in January came to 7.2 percent per year, more than in the United States.⁴ As you shall see later in the chapter, January is the best month for both large and small stocks in many other countries of the world.



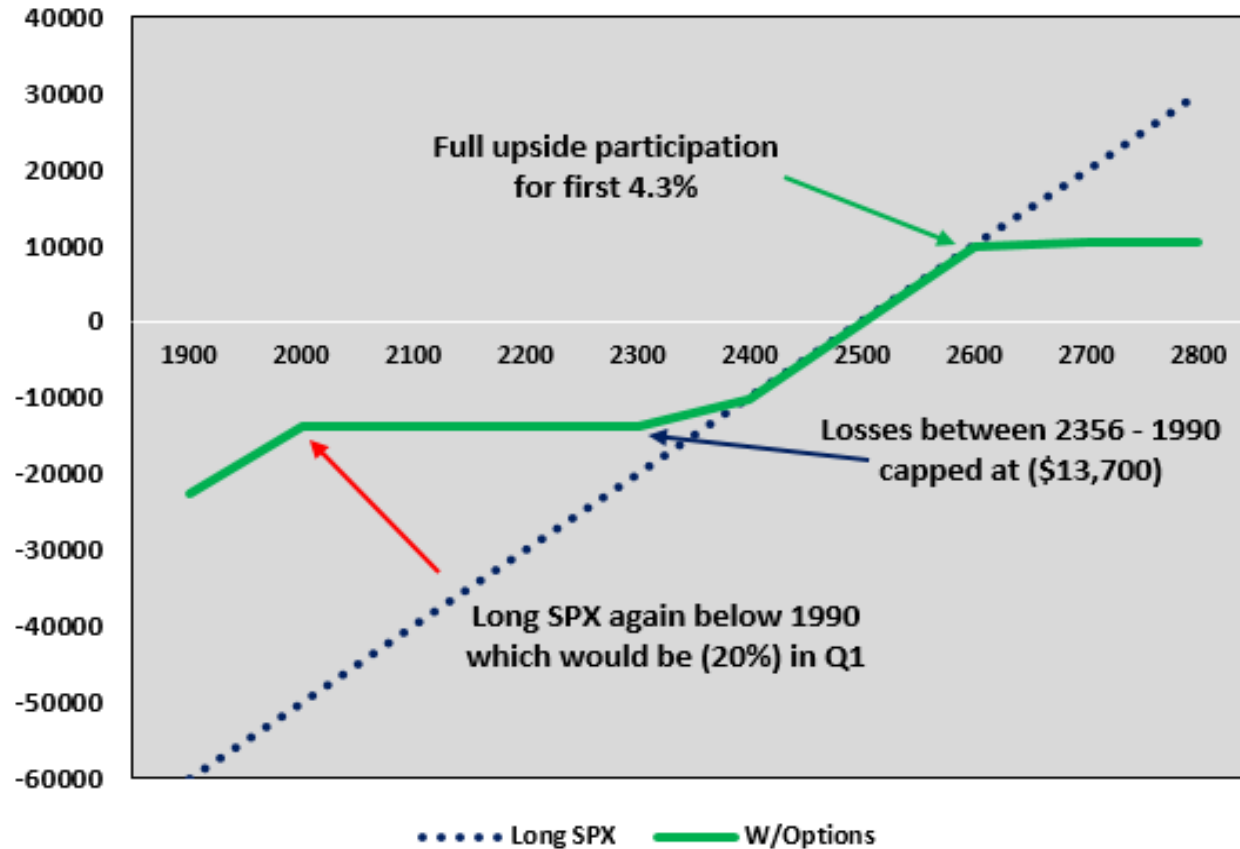
SPX Trading: Dec 31st w/ Index @ 2500

^SPX	SPXW(Q) Mar29 2,605.00 C	9,764	50.90	CBOE	Spread
^SPX	SPXW(Q) Mar29 1,990.00 P	9,764	10.90	CBOE	Spread
^SPX	SPXW(Q) Mar29 2,365.00 P	9,764	63.80	CBOE	Spread

❖ This is one approach to potentially protect a portfolio between (5%) and (20%) until the end of Q1 2019

- Assuming Long the Put spread (52.90 Debit)
 - Bought 5%OTM Put/Sold 20% OTM Put
- Assuming Short the Call (50.90 Credit)
 - Sold 4.3% OTM Call
- 3 Way Protection Spread for Q1 for 2.00/Position (\$200)





- ❖ Insurance against an SPX decline between 5% & 20% in Q1
- ❖ “Cost” of protection: Forgo Q1 upside beyond 4.3%*

*The strategy executed for a 2pt debit or 8/100 % of SPX value

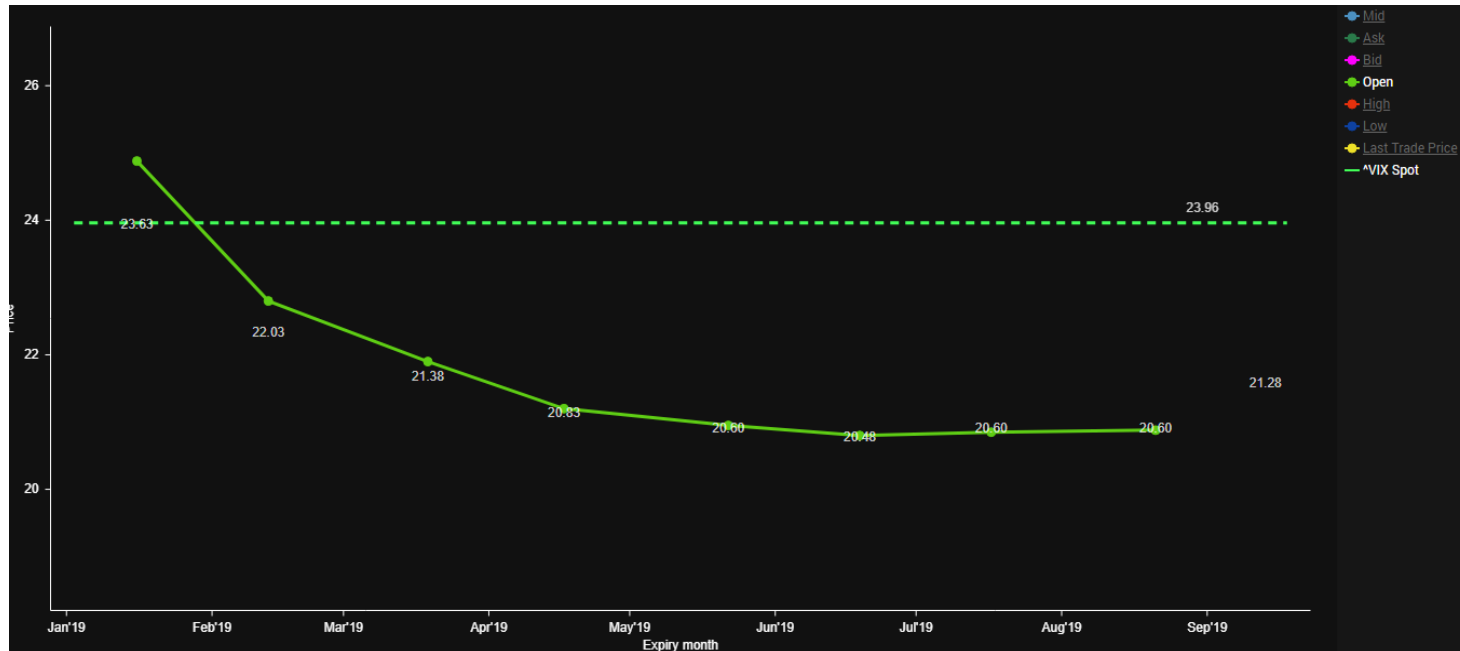
SPX v. VIX™ 2018



Average VIX in 2018: 16.64
Average VIX in 2017: 11.09

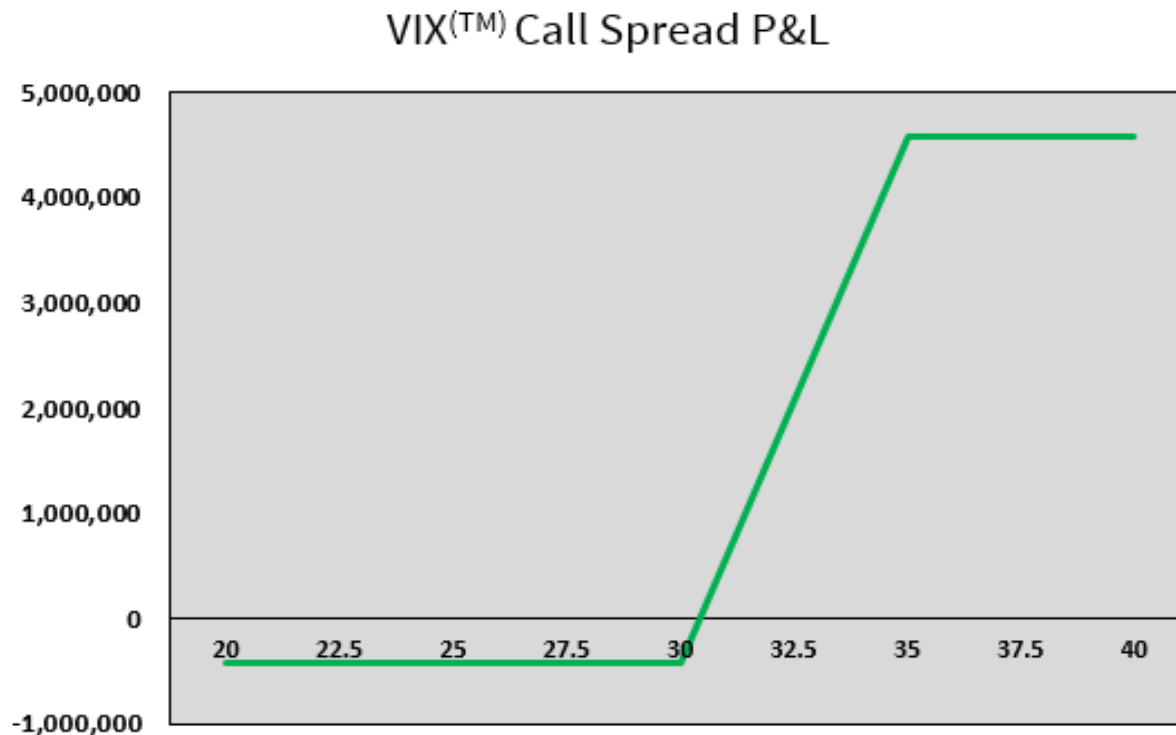


VIX Futures Term Structure Matters – Understand It



- ❖ VIX options price off of indicative future
- ❖ **Backwardation/Inversion** – Fear driven market (persistent since early Dec)
- ❖ **Contango** – much more typical term structure





- ❖ P&L like any other \$5.00 wide call spread
 - ❖ Where is SPX if Jan VIX settles 35+?
 - ❖ How would that impact my portfolio?

*** Just because you own insurance doesn't mean you want to find out how it works**



RUT Trading: Jan 2nd w/ Index @ 1350

^RUT	RUT(AM) Mar15 1,400.00 C	160	35.50	CBOE
^RUT	RUTW(W) Jan31 1,460.00 C	480	4.30	CBOE

❖ Likely an attempt to finance some longer dated upside exposure to Small Caps

- Assuming Long 100 of the Mar 1400 C (35 delta) (35.50 Debit)
 - Long 3500 deltas & \$355k in OTM call premium
- Assuming Short 480 of the Jan 31st 1460 C (8 delta) (12.90 Credit)
 - Short 3850 deltas & \$206k in OTM call premium
- Risk pivots (becomes defined) at Jan 31st expiration

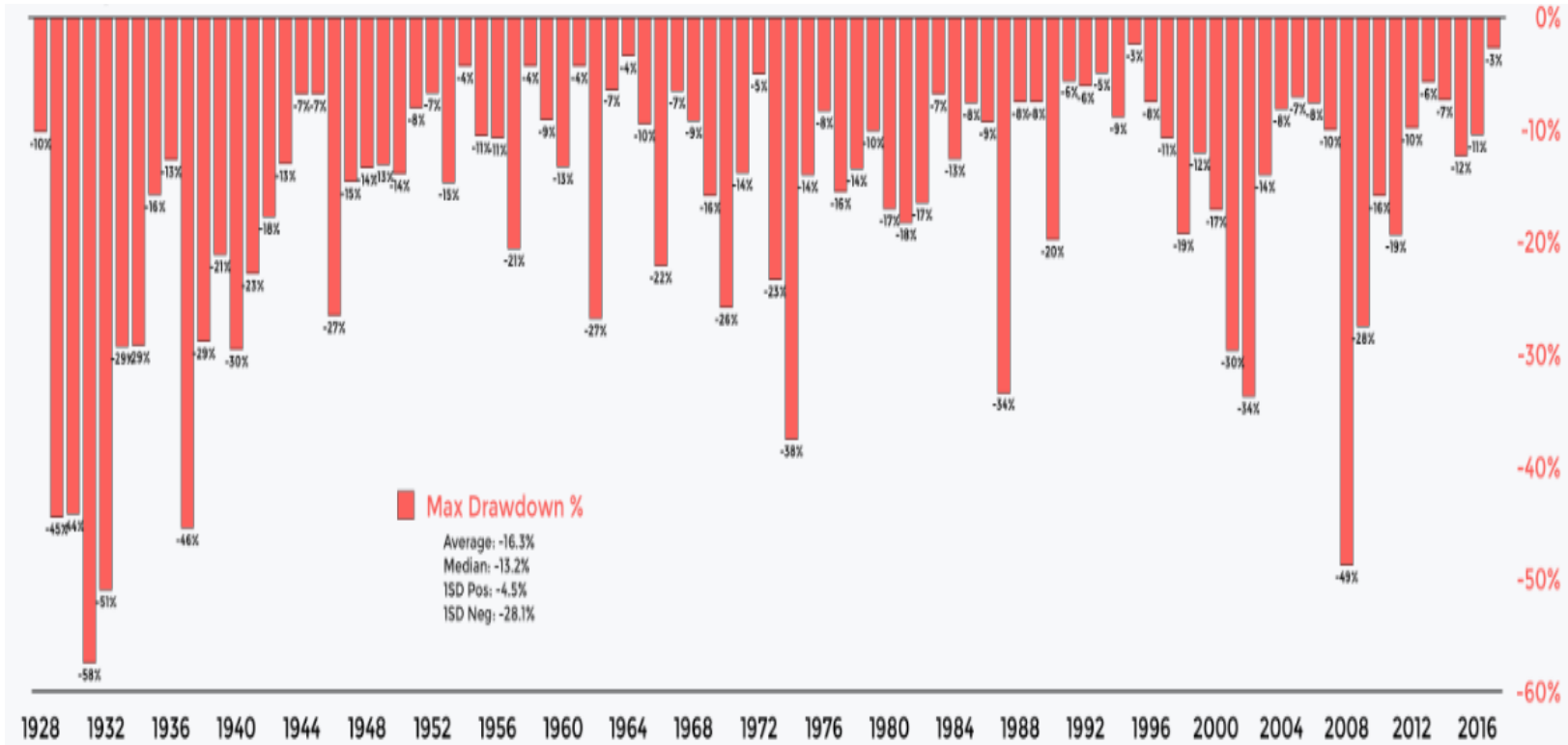


- ❖ Long diagonals in Index products is a common strategy
- ❖ Assuming the option trader owns time (longer dated options) you're able to maintain a directional bias and potentially finance via sale of (multiple) shorter dated options
- ❖ Risk is undefined (as a result of overwrite) until short dated options expire
- ❖ At which point the trader may look to sell (oversell?) Feb cycle options
- ❖ In an ideal scenario, the trader would end up long options (March exp) for \$0 premium or possibly a credit
- ❖ Ideal scenarios rarely come to pass



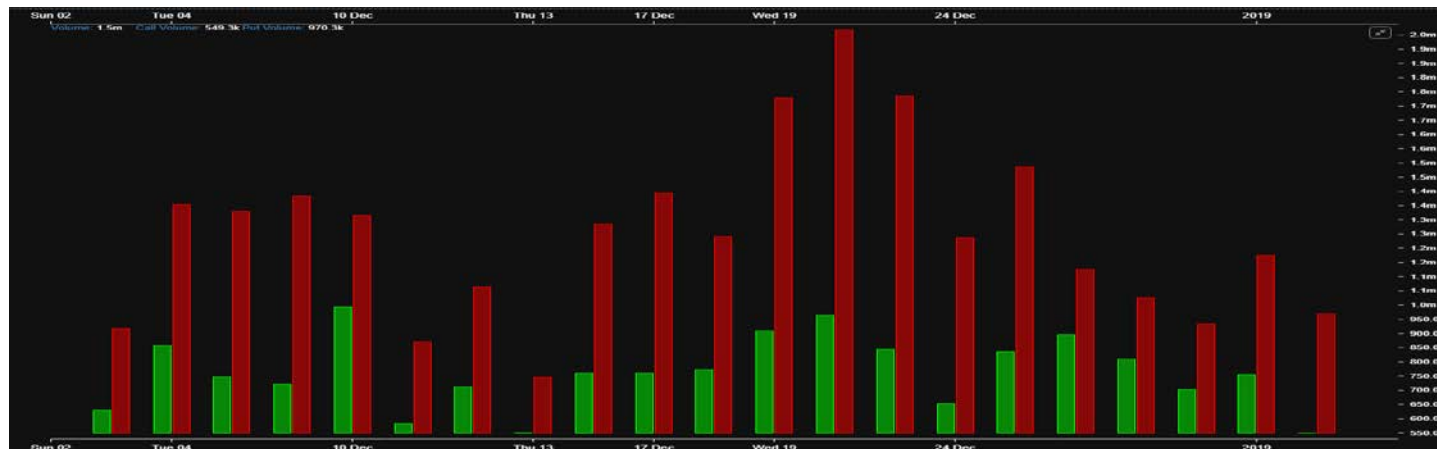
Education not Recommendations

2018 Peak-to-Trough move: 20%
The Volatility of 2018 was ~"normal"
Avg. Max Drawdown (1928 – 2017): 16.3%



Conclusion

- ❖ The “January Effect” may make headlines, but has a tenuous statistical underpinning at best
- ❖ Historically the “influence” has been greatest in small & micro cap stocks
- ❖ On the whole, January tends to be a fairly strong month for SPX (+1.1%)
- ❖ Much of the early Index Option activity has been “typical” – SPX put call ratios have been in line (1.6:1) or slightly put skewed
- ❖ VIX call put ratios have also been in line (2.2:1)
- ❖ Much Index Option activity is hedging/offsetting preexisting price risk





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