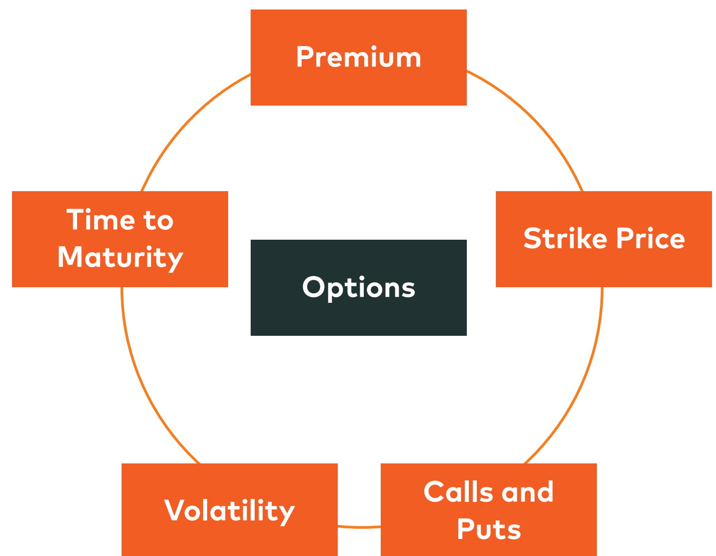
AGF | Investments

Know Your Options – Navigating the Option Overlay

Winning the Loser's Game

One of the core recipes for long-term investing success is avoiding material drawdowns, or, in other words, winning the loser's game. For certain investors, that means it is crucial to be prepared for market volatility and work with strategies aimed at mitigating losses while staying invested.

Strategies that implement options-based overlays as part of the investment process can potentially help effectively manage portfolio risk, generate premium yields, and produce enhanced risk-adjusted returns.



What are Options?

Options, which are a type of derivative security, are financial instruments whose value is "derived" from underlying securities. Options operate as a contract between two investing parties, offering the buyer the right to buy or sell an underlying asset at a certain price (Strike Price) within an agreed upon time frame ending on a specified date (Expiry Date). The seller of the option – the writer – will charge a premium in exchange for this right. These contracts offer investors the opportunity to bet on the price movements of securities such as stocks, without directly owning the security itself. Simply, options are a way to invest based on how you expect the price of a security will change by a specified expiration date, at a set strike price.

Two Types of Options:

Options come in two major types: Call Options and Put Options.

Call Option

Call options are contracts that grant the purchasing party the right, but not the obligation, to buy the underlying security at a locked-in strike price at any time throughout the life of the contract. With calls, if the buyer exercises their right, the writer must sell the security at the strike price. Regardless of whether the contract is exercised, the writer receives the option premium.

Put Option

Put options are contracts that grant the purchasing party the right, but not the obligation, to sell the underlying security at a locked-in strike price at any time throughout the life of the contract. With puts, if the buyer exercises their right, the writer must buy the security at the strike price. Regardless of whether the contract is exercised, the writer receives the option premium.

Option Based Overlays

Investors can think of options like insurance policies. Just as insurance markets allow purchasers to protect against uncertain events, option markets allow investors to protect their portfolios from volatility. Option overlays are investment strategies that use the value of the underlying portfolio holdings to collateralize the writing of options for additional income potential and downside protection offered through the option premiums generated. Portfolios that employ option-based overlays have the potential to offer an income-generating edge with a favorable risk profile, and often employ two common overlay types: Covered Calls and Cash-Secured Puts.

Key Benefits of Covered Calls and Cash-Secured Puts

Using an option overlay strategy can provide investors with the opportunity to earn a higher level of income while also managing portfolio risk. Option overlays can benefit investors by:

Ability to generate higher yield: As options are written and premiums are collected, the overall portfolio yield generated increases.

Downside protection: During market downturns, call options are further away from being in-the-money and thus the chance to collect the full amount of premium without the call option being exercised is higher. Conversely, the likelihood of put options being exercised increases during market downturns, allowing the manager to collect the full amount of premium and buy the underlying security at a desired price point in the case of assignment. The premium collected goes directly into the Fund. This additional income works as a cushion; boosting performance when underlying holdings may be down or flat.

Volatility reduction and improved risk-adjusted returns: The option overlay strategy may also lower the overall level of volatility of the Fund, potentially enhancing risk-adjusted returns.

Covered Calls

A call option is considered to be covered if the writer owns the underlying security that the contract is based upon. By holding the underlying security, the seller is protected if the buyer exercises the option.

By writing out-of-the-money call contracts, the portfolio retains the ability to capture capital appreciation on the underlying stock up until the strike price while also receiving the premiums paid on the options, enhancing the overall income generated within the portfolio on a tax efficient basis. If the option goes unexercised, the portfolio retains its position in the security, earns the premium on the options, and is free to write more options against the position. Should the underlying security decline in value, the premium generated on the option can help offset portfolio losses, therefore protecting the fund from downside risk and elevated market volatility.

The potential downside of this strategy is that the writer of the covered call option may forego further upside potential in the price of the underlying security if the value exceeds the strike price and the buyer of the contract exercises the option.

Cash-Secured Puts

Cash-secured puts work similarly to covered call options, except that in selling a put option, the writer inherits the obligation to buy the underlying security at the strike price on the contract. A put option is considered to be cash-secured when the writer sets aside the capital needed to purchase the security should the option be exercised. For funds employing a cash secured put, the capital is set aside and held either as cash or in risk-free treasury bills and is only deployed to purchase the security from the option holder should they choose to exercise their option.

By writing out-of-the-money contracts, the portfolio inherits the obligation to purchase desired shares at a discount to the current market price while simultaneously earning premiums paid on the options, enhancing the overall income generated within the portfolio.

The potential downside of this strategy is that the writer of the put option may be required to participate in the drawdown in the underlying stock price if the value falls below the strike price and the buyer of the contract exercises the option.

Summary of Overlay Strategies

	Covered Calls	Cash Secured Puts
In Simple Terms	Agreement to sell existing underlying stock at a price (strike price) and date (expiry date) selected by the manager. As the option writer, the manager receives a premium from the option buyer.	Agreement to buy a stock at a price (strike price) and date (expiry date) selected by the manager). As the option writer, the manager receives a premium from the option buyer.
Market Considerations	Outperforms equivalent long-only portfolios in flat or down markets. Relative performance can be mixed in up markets depending on the degree of price change of the underlying stock relative to the strike price.	Outperforms equivalent long-only portfolios in flat or up markets. Relative performance can be mixed in down markets depending on the degree of price change of the underlying stock relative to the strike price.
Getting Called or Assigned	The manager sells the underlying stock at the strike price, but retains the premium earned on the contract.	The manager buys the underlying stock at the strike price, while retaining the premium earned on the contract.
Costs/Risks	If the stock appreciates in value after being called away (exercised), upside potential and future gains are forgone.	If the stock price falls well below the selected strike price, manager is required to buy the stock at the strike price.

AGF Funds with Option Overlays

The managers of several AGF strategies employ an option overlay strategy for yield enhancement and risk-management purposes. The option overlay is either employed as a core part of the investment process or added as a complement to the core strategy which works to generate additional premium income and produce enhanced risk-adjusted returns.

The portfolio manager regularly evaluates the opportunity to write options for eligible holdings in the Fund. The decision is made using a quantitative derivative model coupled with qualitative fundamental analysis. The quantitative option model screens the Fund's holdings for factors such as volatility, momentum, and pricing, among other things, and highlights opportunities to write either calls or puts. From there, the portfolio manager analyzes the option model's suggestions, evaluating them based on other fundamental factors and practicality.

AGF Funds That Employ Option Overlays	Fund Codes							
	MF	F	T	V	FV	Q	W	ETF
AGF Enhanced U.S. Equity Income Fund		5041						AENU
AGF Canadian Dividend Income Fund[1]	799	185	2121	3027	2503	1226	1433	
AGF North American Dividend Income Fund[2]	967	826	4200	3002		1242	1431	
AGF Global Real Assets Fund[3]	333	645						

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Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated.

[1] AGFiQ Canadian Dividend Income Fund was renamed AGF Canadian Dividend Income Fund on January 27, 2023

[2] AGFiQ North American Dividend Income Fund was renamed AGF North American Dividend Income Fund on January 27, 2023.

[3] On April 18, 2019, the Fund's investment objective was changed to offer increased flexibility to allocate the Fund's capital to real assets beyond those companies operating in the precious metals and natural resources sectors. Performance prior to this date would have been different had the current objective been in effect.

Series F securities can be purchased under the simplified prospectus only through a registered dealer who has obtained consent of AGF to offer Series F securities.

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