Intro to Protective Puts with Cameron Smith

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Dave: [00:00:00] All right, folks. Welcome to investing for beginners podcast. Tonight, we're going to talk to a fellow contributor, Cameron Smith, who is also a CPA. He works with us on the investing for beginners blog. And he, as I mentioned as a CPA, is a very smart guy. And he's going to share with us some ideas about how to help mitigate losses. So Cameron, do, would you like to say hello to everybody? Yeah. Tell us a little bit about yourself.

Cameron: [00:00:27] Yeah, sure. Hi Dave. Hi Andrew. Great to finally get on the podcast then writing for you for a while now. So it was long overdue, sadly. It sounds like I just missed the 200th episode. So I'll have to come back for that one, maybe.

Dave: [00:00:41] Yeah. Sounds good. So I guess you tell us a little bit about what you got going on and what your focus has been on the blog, and some of the things you wanted to talk about.

Cameron: [00:00:52] Yeah. Sure. For anyone out there that's read some of my articles on Andrew's site. I'm a pretty frugal value investor and a pretty cautious guy. So one of the things that really has caught my eye in the last year, and I've started to experiment with it, has been protective put options, strategies.

It's something that I learned about while studying for the CFA. And I think it's. Overlooked a risk management strategy. That's pretty easy for your average retail investor to take a stab at.

Andrew: [00:01:21] So maybe let's start at why is a put, and let's just assume we don't know anything about options at all.

So what is it put and how does it. How does that help mitigate losses?

Cameron: [00:01:30] Sure. So pretty much a put option. It's an option to sell an underlying security. So that could be any security. It could be a market index as well. So you're buying the right to be able to sell that security at the strike price of the put option, and then, of course, you have the maturity horizon of the option as well. So at some point, it will expire worthless if it has never reached that strike price.

Andrew: [00:01:57] So you can think of it as like shorting a stock. And so I guess in the scope of the portfolio, what is the goal of we are trying to buy and sell quickly or, how does it function within the portfolio?

Cameron: [00:02:11] Sure. So I'll go back to it is a lot different than shorting a stock. Cause when you short a stock. You're you have potentially unlimited losses if that stock continues to go up, whereas, with a put option, all you can lose is the premium that you paid for the put option if it expires worthless.

So it has that good aspect to it as well.

Dave: [00:02:32] Okay. So I guess, so if we could back up just a minute for beginners, like me, with this kind of idea, can you give me a real-life example of maybe how exactly this would work. So if I was going to buy, I don't know, let's say Apple or a company like that.

How would this work?

Cameron: [00:02:50] Sure. So I got a couple of examples in the recent article that I've written for Andrew. One of them I used was JP Morgan, and the other was Tesla. Oh, perfect. Yeah. So with JP Morgan, so one of the underlying factors of any option price is volatility. So JP Morgan is obviously a lot less volatile than Tesla.

If we're looking at September maturity at the money, put options for JP Morgan you're only paying a 4.8% premium to hedge that position at the money up until September. So here we are sitting in June that's July, August, September, that's three months' worth of sort of insurance. You can think about it for that 4.8 insurance premium you're paying.

You can hedge a JP Morgan position for three months.

Dave: [00:03:40] Okay. Okay. And then, I guess, how would that work with Tesla then? Because it's there, they're a lot more like the level of volatility. So how would that work?

Cameron: [00:03:49] Very different ball game with that. So, Tesla, you're looking at a 24.8% premium for that at the money put option that expires in September. And when I say at the money, the strike price of the option is the same as the current trading price of the underlying security.

Dave: [00:04:08] All right. All right, so that makes sense. Okay. Thank you.

Cameron: [00:04:11] the way I do it with my portfolio, Dave I use what's called a cross hedge, and I have a long portfolio of various sectors and individual securities, and rather than buy, put options on the individual securities, I just buy, put options on the S and P 500.

So it's called across hedge because you're not matching exactly asset for the asset. But it still gives you that that protection to the downside. And let me just look up the number here for what your pay, what you'd be

paying for a September SNP put option. You'd only be paying a 3.4% premium to hedge a passive portfolio with a put option.

Andrew: [00:04:50] Can you explain exactly what that hedge would look like? So let's say you, you hedge the S&P and, the S&P_ crashes 20% by September; what does that look like? What did the hedge do for you as far as return and versus what you paid for the premium?

Cameron: [00:05:07] Sure. So in that scenario, so you've paid 3.4% for the to have the put option, the market's fallen 20% your net gain on that put option would be what is that? 16.6%. Yep. Yeah. Sounds about right. 16.6%. And then don't forget your stay long, your underlying portfolio as well. Because we're not talking about naked, put options, we're talking about protective put options.

So you're protecting your underlying position. So your underlying portfolio would have lost 20%, and this whole put option strategy would have gained 16.6%, so your net loss would be that difference there, which is, in effect, the premium that you've paid.

Andrew: [00:05:54] Yep. Yeah, that makes sense. So basically, the upside is if we have a market crash, I'm assuming, assuming that the stocks in your portfolio crash and the market also crashes, then you have protection on the downside and then.

It's like you said, like an insurance policy where if the market doesn't crash by September, you're out the 30% in premium.

Cameron: [00:06:18] Exactly. Exactly. So you're you always do have that risk of the option expiring worthless. And I've had that happen to me before. So it's probably been a year. A year and a half that I've been experimenting with this.

And it was actually quite fortunate. I started experimenting with it before COVID hit. So I was actually pretty much fully hedged when COVID hit, but of course never really thought COVID would get that bad and the market would do what it did. So I only probably sold my put options, protecting about 15% of the downside there.

It was still really nice to have. And sorta was the proving factor to tell me that it can work because yeah, looking back last year, the market was already expensive. Pre COVID. Now we're getting over COVID, and we were even more expensive than we were before.

Andrew: [00:07:10] Yeah. It's an interesting idea for sure.

And particularly if you feel very strongly about where valuations are and where the market is going, and it is interesting too as well, where, based on how volatile the market is, how much you'll have to pay for that insurance. And I guess when you're looking at for yourself.

Is this something that you plan to have a hedge for the rest of your investing life? A thing that would be. Part of the question okay. So how do you determine where to put a hedge?

Cameron: [00:07:40] Yeah, so I would say really in times of excess, like when we're sitting one, two standard deviations above historical market average levels, I'd say that would be a good time to put a hedge And the other thing cause like we're talking about volatility is such an important part of the pricing. The interesting thing that happens is as the market goes up and just melts up, as we call it, volatility always

becomes really low. So these options get really cheap. So the market doesn't even have to fall all that much, and volatility can pick up as well.

And these things also end up quite in the money. But yeah, not a strategy to do every year of your life, for sure, because it's really going to affect that compounding power of your portfolio. Cause on an annualized basis, you're looking at seven and a half percent to hedge, which really is the market return that you'd be expecting to get over the term.

So not something you want to be doing every year.

Andrew: [00:08:38] Like anything else, there's no free lunch. But to your point, if you feel strongly about where the market is, and you can have some potential upside to where, if the stocks in your portfolio happened not to fall as much as the market does now, you're gaining on both ends.

Yeah, exactly. Cause as I mentioned, I'm doing a cross hedge here as if my portfolio. Totally passive. But I'm probably 75% active, 25% passive. And as we it comes down to stock picking, can you pick stocks that are going to perform better than the market's going to perform? As well. Yeah,

Dave: [00:09:11] a specific loss, or is it more about trying to hedge the whole market?

Cameron: [00:09:15] Yeah, so for me, it's more about trying to hedge the whole market, but if you're an individual investor who Is a little cautious about one of their holdings, for sure.

You can just do one of the holdings, but that being said, the riskier that holding is, the more you're going to be paying for this put option, as we saw in the case with Tesla.

Dave: [00:09:33] Yeah. So would it make any sense to put these kinds of options on the company you don't

Cameron: [00:09:40] Yeah, you could do that.

For sure. That would be losing the protective put options strategy of it. It would become a little more speculative at that point. But yeah, you, for sure you, for sure could. Yeah. Okay. Because it has the benefit, unlike shorting a stock where you don't have unlimited losses, all you can lose is the premium that you paid.

Dave: [00:10:01] Okay. All right. That makes sense.

Cameron: [00:10:03] Yeah.

Andrew: [00:10:03] I think the big thing about it is that when you buy an option, like a call option or put option, it gives you basically effective control over a hundred shares. So when the stock moves like a percent, you could gain like 10%, so I like it magnifies.

It gives you the effects of leverage without needing to be leveraged. Cameron said you could only lose what you put in. And so that's how, like only paying 3% can give you a gain of 10%, 20%, whatever it is if the market goes down because of that kind of amplification factor. And I know where your mind's going, Dave, because when I first heard of this thing, I may or may not have dabbled as well.

And you instantly. Effectively short and buy puts against the stocks that are very expensive. But Cameron was saying in the example; those tend to be more volatile because they are expensive because they're this like these like really high, multiple stocks that have huge dropdowns. And that makes it really hard.

Make a profit when they do crash because that's what they do, and you're paying for that volatility. And so I think it is difficult to, like you said, Cameron, the, to pick stocks are they're going to go down because it can get speculative.

Cameron: [00:11:21] Yeah, for sure. For sure. But once again, it is a little safer than shorting the stock.

Dave: [00:11:26] So what's the time length of how long you can put these kinds of options on?

Cameron: [00:11:31] Yeah, that's a good question. It really depends on who's writing what options cause someone has to write this option for you to be able to purchase it. So right now, I've. I have seen the March 2022 option on the S and P 500.

And I've recently seen the December 20, 22 options spring up that people have started writing on. So we're looking out like a year and nine years or six months there. So yeah, so quite a long timeframe for myself; I try and keep it around a year. That is what I do. And then I roll it as it gets close to maturity to not let it expire completely worthless.

Dave: [00:12:10] And these do not have, do they have a monthly or an annual fee that they charge to put these on?

Cameron: [00:12:17] Nope. Nope. Okay. Yeah, just the time decay. Yeah. Of that maturity and premium expiring. All right. Then the other thing that I've I've noticed that's worth mentioning is with like most profitable companies and the index in general, the longer you look out in maturity, the cheaper you're paying per day for a put option because.

That company or the index is making profits and naturally going up in value. So your fixed strike price as you go out in the future becomes less valuable. So the longer you go out in maturity, the cheaper you're paying per day to hedge. So that's an interesting point that I've found out.

Yeah. There are some tidbits on that in the article that seem to be posted on Andrew's website as well.

Dave: [00:13:07] All right. So we've talked about put options and the insurance that can help with hedging your portfolio. Let's talk a little bit about the companies that you choose. So when you're looking at buying a company. What kind of, what is your process? How do you work through from finding the idea to pulling the trigger? What are those? What is the process for you?

Cameron: [00:13:32] Sure. I think screeners are a really important thing for every investor to use. Because screeners are where you're going to uncover the gems that you never knew about before.

If you're not using screeners, you're just going to be sticking with the same stocks that you read about in the news. And then everyone else is exposed to a bit of a herding mentality. So I think screeners are always a really important idea. And I have a couple of saved ones on my broker that I refresh on a weekly basis and see what's changed.

And if any new names have sprung up, that excites me. Go ahead. Sure. Yeah. And then after that point, I have sort of one metric that to me is it's the be all end all for that initial back of the envelope, math, and I have an article on investing for beginners on this, actually.

It was the first article I wrote for you, Andrew. If you recall, it's I've coined it. Investors adjusted return on and it's very similar to the Shiller PE, which takes ten years earnings and adjusted for inflation. But here I'm looking at ten years, average return on equity as a percent.

And then I'm multiplying that by the price to book value that you're paying for that equity so you can think about it in terms of an equation where you have a return on equity and price to book value. And if you combine those together and cancel out likes and likes, you have an earnings yield, and that will quickly give you an idea of, okay.

If I hold this stock for ten years, I can expect an average return of 10% at this price to book value. Now it doesn't work for every company, especially tech companies. Who really don't trade there accordingly to book value and companies that repurchase a lot of shares, but it does still tell you quite a lot about what you're paying for books value and what the return on equity is of that business.

Andrew: [00:15:26] So can you explain the return on equity for a beginner as an awareness of the concept and also why it's. A useful tool when looking at companies.

Cameron: [00:15:36] Sure. Return on equity is the net income of the company divided by the equity of the business. So you can think of it as the owners of the business have contributed all this equity.

And how much are they earning per year on the equity that they've contributed? Yeah. And then what the, like the Shiller PE does and my own sort of investors as it looks at that average over ten years, so that you get the business cycle in it as well. So as a long-term investor, I'm fine with a couple of bad years, and it might even be a great opportunity to buy.

Dave: [00:16:14] So do you have a, do you have a threshold that you look for when you're looking at that kind of thing?

Cameron: [00:16:20] Yeah, so I'm generally looking for like that, that 10%. So what would a passive investor be getting over a long-term time horizon, and that's my, my, my hurdle rate.

Dave: [00:16:31] All right. So after we find a company that passes your hurdle rate, where do we go from there? What do you? Where do you take the next step?

Cameron: [00:16:40] Sure. So after I find a company that sort of meets that initial hurdle, I'll take it a step further, and I'll really start analyzing the financials. I'll look at the balance sheet income statement, cashflow. I'll look at it on a historical basis.

I'll look for things like share buybacks, good return on equity. Good return on invested capital good debt levels. And then I'll make a start making projections into the future. And I use a model to do this. I've actually started selling it on Investing for Beginners with the help of Andrew, which has been great.

And it's up there for anyone to purchase. And pretty much you can plug in a couple of years of historical financials. It'll calculate various ratios for you to help you project into the future. And it's all pretty

automated. Once you punch in those couple of years, you can then play around with growth levels, with different debt levels.

And it'll really spit out a bunch of different valuation metrics for you from Discounted cash flows to forward PEs, Gordon Growth model. And yeah, I really it, I developed really six, seven base valuations, and then I'm looking at an average so that it's aimed small, miss small when you got that average valuation.

Andrew: [00:17:49] So this is something that I use as well as one of the tools I use for my stocks, particularly with the DCF model. So whether the DCF has a stands for discounted cash flow, and it's basically how Warren Buffett analyzes the valuation of a company. And, Cameron, you mentioned you're studying for the CFA.

That's something they teach in the various classes on valuation there.

Cameron: [00:18:13] And for sure, a CFA university class, the DCF is it's really your golden boy in terms of valuing a company because, at the end of the day, it's all about the cash flows to investors.

Andrew: [00:18:25] And so I guess, Basic inputs. You have to make an assumption on what you think the growth rate is and how risky you think that growth is going to be. And then how much cash flow a company makes. And that's how you're trying to come up with it. Estimate how much a company is worth. And so it can be, it can pinpoint you more than comparing like a price to earnings or price to book would because you're building these different things in and I, I.

I liked the model just for the DCF part. And I like, I, I've customized it and made it into my own where I can use it for the companies I'm looking at. Yeah.

Cameron: [00:19:07] Customize them a little bit.

Dave: [00:19:09] The thing that I like about it, and one of the things that have really been helpful for me is you can see I like the way that it projects future; differently, it projects, different metrics as well as different items from the financials into the future, so that I can look and see.

How realistic my projections are. So, in other words, if I'm looking at a company and I am projecting that, Hey, it's going to grow 10% over the next ten years, then I can see how much that really is going to be. And then I can, in my head, look at it and go, is that really a realistic number for the revenue?

And one thing that I started doing. If it's a smaller company, let's say it's a smaller market cap company, and it's in a, it's in a market that has a couple of big players in it. Then if I look at that projected revenue growth over ten years and compare it to some of the big boys in, the sector and it's blowing them away, then I can go away.

Maybe that's not realistic. So that can help give me a sense of whether I'm a little bit too enthusiastic or not.

Cameron: [00:20:22] Yeah. And especially when you're looking at smaller companies that are growing and comparing them to bigger guys in the industry, you can look at things. How their gross margins are operating margins will change as they get bigger and develop into one of those big players and see I'm okay.

Is that already built into the valuation that the market is giving it, or is there still an opportunity there to be had?

Dave: [00:20:46] Yeah, I agree. And the other thing I liked about it too, is the ability to adjust things so that you can. Try to find a range of values, as opposed to just trying to find the one perfect price, because sometimes, you can make small adjustments so you can see.

What does having a bigger impact on the value of the company, whether it's the debt load or whether it's the revenues or whether it's the margins, all those things have an impact on how you value a company. And it's kinda cool to see with the model. It weighs everything out, so you can see it. I'm a visual person.

And so I like to see that stuff, and that's very helpful.

Cameron: [00:21:27] Yeah. Yeah. You have a lot of sensitivity analysis that you can do there with all the different inputs that play

Dave: [00:21:33] So how long did it take you to create this thing?

Cameron: [00:21:36] Oh, it took me. A couple of weeks to create it and in a year to perfect it, I would say yeah, kept on adding in sorta more evaluation metrics as I got, because once you get the projected financials, you can build in a bunch of different things.

So as I kept learning different valuation metrics through the CFA and my other studies, I just kept on adding it. More evaluation metrics. So that football field of valuations that we give on the front tab there builds into that average.

Dave: [00:22:06] Yeah. Yeah. That's very helpful. So when you're using this kind of model, is there a, is it, was there company types or styles of industries that you felt like this was a better fit for?

Or is this kind of a one size fits all kind of model? Is that, is, was that kind of your hope for them?

Cameron: [00:22:24] Yeah, I would say it's really a one-size-fits-all. Cause it gives a lot of flexibility in terms of. What you're looking at and how you want to look at it. So if it's a company that's financially distressed right now, you can be paying close attention to the cash flow projections and how bad are things going to get in a year and two years and what they need to do to turn it around, and how realistic that is.

And if you're looking at yours, one of your big mega-caps that's a steady grower. You can look in, so how much of that's already being priced into the valuation as we look out in time, and what's the chance of them beating that from your perspective. Yeah, they're very flexible in terms of what it can be used for.

Dave: [00:23:07] Nice. So let's say that you find a company that you really like, and you go through all of this. Is there anything, is there anything in particular that you look for that is maybe a red flag that would make you go, Nope, we're done here and move on. Or are there things that you'll work through and maybe normalize over a longer period?

If you see something that's lumpy, for example,

Cameron: [00:23:30] Couple of red flags for me are always, and normally this I'll catch these before I even get to. The point of putting it into the model. But I always, first off, I'm looking at a return on invested capital that's a really above and economically appropriate level.

So when we talk about return on invested capital, we're talking about the returns to both debt and equity. We were talking about return on equity before, but there we're looking at just the equity people. So return on invested capital, both debt, and equity. And that needs to be an economically sound level.

And I typically look for something about 7% depending on the industry, which gives it the potential to be levered up so that your equity holders are getting that 10% return that I look for. So that's the first rule of thumb that I look for is a 7% return on invested capital.

And then the second thing that I always look for is share issuances. I find that can be a real red flag. If a company's issuing shares on a constant basis, it proves that they can't grow under their own weight a bit. Yeah. And I don't like my equity being diluted.

Andrew: [00:24:39] Who does,

Dave: [00:24:43] who does? No, that's that? That's awesome. All right. So let's say it passes all the tests then. Are you a margin of safety kind of guy, or what is. What would hold you back from pulling the trigger? Is it? Do you go through the financial part of it? And do you start looking at maybe some of the quantitative or the qualitative started looking at some of the qualitative types of ideas as well?

Cameron: [00:25:08] Yeah, I'm probably more of a quant guy. Dave. Okay. But I definitely have to like the industry and the long-term prospects. I'm not too much concerned with the industry. Like I'll go anywhere and do anything. If I can get that valuation and investors adjusted Roe that I want. So yeah, I'd say I'm really more heavily on the quant side.

One other important thing, whenever you're doing a DCF or evaluation is the WACC the discount rate that you're going to discount the cash flow is that, and that's something we've built into the model as well where you can go and grab the specific figures for the company that you're analyzing.

And just, you gotta be really careful there. Really using a conservative discount rate, or else things can easily start to look very rosy when really they're not. And you're just a little aggressive with that discount rate. So I tend to really keep my discount rates stable around 8%, 7%.

And really, don't get too aggressive with it.

Andrew: [00:26:08] I guess that's where the value of you having multiple models in there comes up because then if your DCF is like through the roof and all your other valuations are telling you that's not the case, then you're like maybe it was my discount, right?

Cameron: [00:26:23] Yeah, exactly. And yeah, I will go lower for really great companies. Like, I'll go down to five and stuff, but that's very rare.

Andrew: [00:26:32] Yeah, I have a similar kind of mindset to that too. Thinking about somebody who's maybe just starting out, they're wanting to dip their toes into looking at evaluation models, looking deeper into the financials.

If you could kinda go back in time and think about when you were first digging into that, would there be something you would say. Past version of yourself to help him along the way of not getting too overwhelmed because there's a lot of jargon and a lot of parts to financial statements.

Cameron: [00:27:03] Yeah, sure. I had one teacher back at university. I think she, she told us to sorta Google one word every day and slowly continue to build your vocabulary and your knowledge and don't get overwhelmed and yeah. Read the business section and stuff as well. But yeah, just be curious and explore and yeah, do it until your brain hurts and then take a break.

Andrew: [00:27:28] I like that philosophy, then goes outside and take a walk.

This has been great. A lot of good ideas on the show tonight, Cameron; we definitely want to thank you for coming on and sharing with us, from having the portfolio hedge, to digging deeper into companies and trying to find value in a. Arguably overvalued market always a tough sell, something that people who are in the trenches trying to find stocks, we're dealing with that all the time.

And it's good to hear your thoughts on that. And some ways that people can try to navigate that. So tell us about, if there were interested in more of your work, how can they find out more about you and the model that you've been doing?

Cameron: [00:28:07] Sure. So my model is available on Investing for Beginners under the products page. And you'll find, I also have quite a few articles up there as well. I think over the years, it's probably crossed the 50 point mark for sure at this point.

Andrew: [00:28:21] So I guess we, we can search for you your name, Cameron Smith, to be clear. It's not the Australian golfer. Who's on TV all the time. It's Cameron Smith. The finance guy. Yeah.

Cameron: [00:28:33] Cameron Smith, the finance guy, often confused with the Australian guard.

Andrew: [00:28:36] Yeah. Do you have a similar haircut? No. Don't rock the mullet. No,

Cameron: [00:28:40] no, not

Andrew: [00:28:41] anymore.

Dave: [00:28:42] Same handicap.

Cameron: [00:28:44] Same handicap though. Yeah.

Dave: [00:28:47] Wow.

Andrew: [00:28:50] Awesome. Yeah, I definitely think people are interested in checking out the blog posts you did. You can go on the website,

Cameron: [00:28:56] protective put option. Yeah.

Andrew: [00:28:58] Okay. To protect the put option, you can read all about the hedge.

If you search investor-adjusted Roe or return on equity, you should be able to find the other posts that we referenced and all good stuff. And hopefully, we can talk to you.

Cameron: [00:29:14] Thanks a lot, guys, and congrats on nearing your 200th show next week.

Dave: [00:29:19] Appreciate it. Thanks. Thank you very much, Cameron.

We really appreciate you taking the time to come talk to us tonight. It was awesome.

Cameron: [00:29:28] Thanks a lot again, guys.