

# Option-Enhanced Equity Investing

The Option-Enhanced Equity Portfolio seeks the return potential of equity investing with the ability to control risk with option strategies.

Most investors understand that equities provide superior returns over the long run. In these uncertain times, many are trying to determine whether they want equity exposure and if so, how to get it. The Option-Enhanced Equity strategy is designed for those who want equity exposure with less risk than most long-only equity products. It combines stock picking by a seasoned professional staff with options strategies designed to preserve profits and mitigate tail risk. The Option-Enhanced Equity product is designed to generate consistent returns in a variety of market environments and is intended to be a core holding for equity investors.

Markets have changed and so has the pathway to finding returns.

Investors are shaken by the volatility of the last decade. Many are justifiably afraid to re-enter the markets. As investment professionals, we see a silver lining. We've entered a stock picker's market: A market where dislocations and inefficiencies create investment opportunities – a market where seasoned stock pickers can excel. But it's not enough to merely pick stocks. Assets must be protected. By "wrapping" equity portfolios with an options hedging strategy, profits can be preserved and tail-risk mitigated.

Our stock selection process entails buying quality companies that are temporarily out of favor and shorting companies where expectations are excessive. Through quantitative and qualitative fundamental research, we find companies where there is a wide differential between stock price and a company's intrinsic value. We invest where we are confident the valuation gap will close over a reasonable investment horizon .

We then "wrap" options strategies around our equity portfolio with the purpose of preserving profits, protecting against loss and hedging the portfolio against specific exposures. Broad-based equity index options are used to protect against general market declines. Portfolio concentrations in particular sectors can be hedged using sector ETF options or cash index options while company-specific hedges can be implemented using options on individual stocks.

## **EQUITY INVESTING** – Stock Picking

Investable opportunities occur where there is a disconnect between perception and reality.

These days, with billions of investment dollars managed by "scientists" running computer programs ("quant" models); the term *stock picker* seems out of date. Some believe "quants" have found the holy grail of investing – a money machine. We beg to differ. One need only look at the performance of many "quants" in 2008 and early 2009 to understand that they are at least as fallible as humans when it comes to managing money. We consider this portfolio a stock-picker's portfolio: performing qualitative, as well as quantitative, research on companies and making investment decisions based on our findings.

Our stock picking approach attempts to profit by investing in a manner that is different from conventional opinion. In general, markets tend to price stocks correctly, but individual stocks can become mispriced during times of extreme optimism or pessimism. We attempt to profit by taking advantage of these mispricings. From time to time, widespread pessimism about a company can temporarily depress its stock price to a level that overstates a company's inherent risks. At this point, the investing public may overlook longer term positive attributes and focus on temporary, short term issues.

Conversely, investors can grow so optimistic about a company's prospects that they become complacent, ignoring warning signs of impending disappointment. Through unbiased and unemotional fundamental research, we often find that investors have overreacted, driving the stock price to unreasonable levels and presenting astute investors with compelling investment opportunities. As markets become more rational these stocks typically revert back to more normal levels, generating profits for investors.

The advantage of investing at the "extremes", buying out of favor stocks while shorting outperformers, is supported by numerous academic studies. One of the most famous is "Does the Stock Market Overreact?" by Werner DeBondt and Richard Thaler published in The Journal of Finance in July 1985. Debondt and Thaler used data beginning on December 31, 1932 to construct 46 separate experiments whereby they compared the performance of two portfolios over time. The first portfolio contained the 35 best performing New York Stock Exchange stocks over the previous three years. The second portfolio contained the 35 worst performing stocks over the preceding three years. The experiment was run 46 times for portfolios constructed each year beginning in 1932 and continuing through 1977. Portfolios of the previously worst performing stocks outperformed portfolios of the previously best performing stocks by a wide margin:

*"Over the last half-century, loser portfolios of 35 stocks outperform the market by, on average, 19.6%, thirty-six months after portfolio formation. Winner portfolios, on the other hand, earn about 5.0% less than the market, so that the difference in cumulative average residual between the extreme portfolios [ACARL,36 – ACARW,36] equals 24.6%".*

## Investment Process

We take positions in companies at prices that we believe misstate their intrinsic value. We require investments, both long and short, to have a "margin of safety" or significant divergence from intrinsic value in an attempt to protect from losses. To determine the intrinsic value of a company, we review company fundamentals, its hidden or franchise value and management's capabilities. We also require that a catalyst be in place that will close the gap between the company's stock price and its intrinsic value.

## Corporate Fundamentals

Stocks react to unexpected changes in fundamental factors. When investors' opinion of a company is clouded by pessimism due to short term, transitory issues, the market can temporarily price a stock at a discount to a company's true value. Likewise, markets can overprice a company's stock when investors become too optimistic. To take advantage of opportunities, our research focuses on uncovering divergences between market perception and reality and determining whether those divergences will be resolved over a reasonable time horizon. We review publically available information for quantitative and qualitative details and form a view of the company and its industry. We then interview a variety of sources to further solidify our findings.

### **Hidden Value/Franchise Value**

Occasionally, investor pessimism leads the market to ignore or severely discount a company's valuable assets. These can be physical assets like land, buildings or natural resources. They can also be intangible assets, like brand names, dominant market share or a large captive customer base. Investment opportunities can occur when the market ignores these asset values and instead focuses on temporary issues.

Investors can also overstate a company's future prospects when sentiment becomes too optimistic, driven by overexposure in the popular press or Wall Street research. Valuation can become unrealistically high and impending fundamental deterioration can be overlooked, creating opportunities to profit by shorting the stock.

During the fundamental research process we assess all tangible and intangible assets, calculating their values using a variety of methodologies and forming an actionable investment opinion.

### **Management Capability & Motivation**

While quantitative methods are useful in analyzing companies, understanding corporate management's capabilities and motivations are crucial to determining the direction of fundamentals into the future. After all, a company's management is responsible for making decisions that ultimately drive future growth and profitability. Furthermore, we assess the Board of Directors to determine whether it is composed of capable individuals with relevant experience. During our analysis, we review management's quantitative and qualitative aspects. Management ownership, insiders buying or selling of stock and compensation structure are among the quantitative items we review. We also assess management's experience, capability and passion to determine whether or not they are in a position to drive shareholder value.

### **Catalyst**

A crucial step in our investment approach is determining how and why the gap between a company's stock price and its intrinsic value will close. It can be driven by company specific catalysts that lead to improving/deteriorating fundamentals; developing industry dynamics like changes in the competitive landscape, divergence in supply/demand relationships or merger and acquisition activity; or external events, like evolving government policies or changing regulatory regimes. We also assess the timing of catalysts. Near term events, those expected to occur in the next twelve months, are given priority to those expected to occur in the distant future.

### **Portfolio Construction**

Equity portfolios typically contain 30 to 50 of our best ideas. Fundamental corporate developments for each holding are monitored over time and adjustments are made as needed. Portfolio characteristics are tracked with sensitivity to a variety of risk factors including sector and position exposure, volatility and tracking error.

## OPTIONS ENHANCEMENT – A Hedging Strategy

Stocks can be volatile. Downside volatility can lead to permanent impairment of capital. Because of this, we “wrap” this portfolio with options hedging strategies designed to protect profits and mitigate tail risk. We use a variety of options to construct a type of “protection policy”. Broad-based equity index options are used to temper the risk of a general market decline. Sector ETF options or cash-settlement sector index options can be used to hedge sector exposures or concentrations while options on single stocks can be used to hedge against event risk associated with a specific company.

Under normal circumstances, the equity portfolio will be hedged relative to broad equity market downside through the purchase of out-of-the-money equity index puts. Puts can protect the portfolio from significant market declines that occur over a short period of time. In addition, out-of-the-money equity index call options and secured put options can be sold to fund all or part of the protective put purchase. Selling options can also reduce the portfolio’s volatility, provides cash flow and contributes to portfolio returns. Because the premium received from selling options can offset the cost of the long put, the investor is obtaining downside put protection at a smaller net cost than the cost of the put alone.

This strategy offers the protection of a put, but will also dampen appreciation potential in a rising stock market. It is intended to provide investors with the majority of returns associated with equities while potentially exposing investors to less risk than other equity investments.

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