

Turning stocks into bonds using options

The search for yield is strong and rational

The search for yield is stronger than ever as exhibited by the flows into bond funds, the rapid decline in bond yields, and the recent outperformance of dividend paying stocks. In our view, the search for yield is rational given our economists' expectations for below consensus US GDP growth and the non-trivial risk of recession or deflation. We believe there is an equity market alternative for investors in search of the fixed-yield, reduced-risk profile offered by bonds.

Bond-like risk/returns with stock and options

We explore a simple options overlay (put-spread-collar) which allows stockholders to generate yield and gain downside protection. We show how this combined position is similar to that of a bond from a theoretical perspective and how the risk/return has been similar over the past 15 years. In fact, we find that this simple overlay strategy allowed investors to achieve risk-adjusted returns that were higher than bonds and nearly double that of the stocks over the period.

Yield in equity market is higher than bonds

We are focused on this opportunity now because we find that yields harvested from the equity market are attractive relative to bond yields in the current environment. Equity implied volatility remains at above average levels, but corporate bond yields are at 40-year lows. For the average stock in the S&P top 50, we estimate you can collect 20% more yield than the bond market while still maintaining full of downside protection for up to a 24% decline in the stock.

Attractive bond-like opportunities today

We identify companies where our analysts rate the shares Buy, with upside to their price targets and options prices are unusually elevated. We highlight the specific strikes that can be used to target 20% more yield than the bonds while maintaining a large degree of downside protection on the stock.

co.	Yield	Protection	co.	Yield	Protection	co.	Yield	Protection
T	5.9%	14%	ABC	4.6%	19%	UPS	3.8%	24%
MMM	5.4%	15%	DIS	4.5%	23%	LOW	3.7%	31%
AMT	5.4%	16%	HAL	4.0%	35%	WMT	3.6%	16%
GE	4.9%	24%	EOG	3.8%	29%	UTX	3.5%	27%

Goldman Sachs Research estimates, see page 8 for other all opportunities.

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