

Implementing a strategy that combines stocks with options, rather than traditional bonds, represents a significant advancement in investment methodology. Over the past five years, I have consistently applied this approach to my own portfolio and will continue to do so. In this article, I will outline the qualitative trade-offs of this strategy and provide a summary of my investment performance.

Disclosure to readers - I am not a professional financial advisor or stockbroker. I am just an experienced individual investor and a veteran retired computer engineer. I am sharing what I have been able to achieve with my innovative strategy to motivate others to start thinking of new ways to invest to achieve better returns and/or lower risks. I also provide personal finance and investment apps that I developed for myself at myfingita.com for others.

Traditional investment strategies, as commonly recommended by financial advisors, typically involve constructing a portfolio of stocks—often through ETFs and mutual funds, including international holdings—and bonds with varying maturities and interest rates. Investors regularly rebalance these portfolios, usually on an annual basis, to optimize long-term returns. However, this approach has inherent limitations that can restrict overall performance.

- Portfolios are often excessively diversified, with ETFs and mutual funds typically holding hundreds of stocks. While diversification reduces risk and volatility, it can also limit returns, which generally remain below 10% annually over a five-year period.
- Bond yields are modest, usually less than 5% per year in the U.S. market and may decrease further if interest rates decline. Additionally, bond income is subject to taxation, further reducing effective returns and often failing to offset stock losses.
- Determining the optimal allocation between stocks and bonds is challenging. Allocating a higher percentage to stocks increases exposure to market downturns, while a lower allocation limits potential gains, as stock returns historically outpaced bond yields.

So, is there a better investment strategy? Answer is YES.

Invest in few well performing large cap stocks (recommend 10) with options on those to reduce risk. With stocks spread across sectors you get decent diversity. You invest in stocks over long term while adjusting options on them more frequently based on market changes. Transaction costs for options are minimal—just \$0.65 per 100 shares—making frequent adjustments both practical and cost-effective. Rolling positions between

expiration dates or strike prices is straightforward, further enhancing your ability to optimize returns. This flexibility, when approached with discipline, enables you to actively manage risk and volatility, rather than passively accepting market swings.

Some key features of options in US stock market.

- Options empower you to profit in both rising and falling markets, acting as a dynamic multiplier/adder on stock returns. With the right strategy, you can confidently navigate bull markets by buying calls or selling puts and protect your portfolio in bear markets by selling calls or buying puts. Selling works better.
- The U.S. options market offers unmatched agility: positions can be adjusted at any time before expiration, allowing you to buy back or roll contracts with ease—often by simply paying the premium difference. This means you can respond quickly to changing market conditions, maintaining control over your investment outcomes.
- Unlike bonds, option prices move in close correlation with their underlying stocks, providing a more direct and effective way to hedge or amplify returns. While many investors use options for leverage, a different approach can use options as a powerful tool for downside protection, ensuring your portfolio returns are robust.
- Option premiums routinely outpace bond interest rates, with at-the-money contracts for well-known large cap stocks often yielding 10%–20% annually. These premiums are paid up-front and can be realized across by selling options, offering immediate and substantial returns that bonds simply cannot match.
- By combining stocks with options, you create asymmetric returns: capturing most of the upside when markets rise, while safeguarding your capital when markets decline. This strategic edge gives you a distinct advantage over traditional investment methods. My investment performance summary at end illustrates this.
- Finally, reallocating between options and stocks is not only more effective but also more tax-efficient than shifting between stocks and bonds, as options generate capital gains or losses rather than taxable income.

There are some limitations for using options instead of bonds.

- While an options-based investment strategy offers compelling advantages, it does require a meaningful initial commitment. Because options contracts are traded in lots of 100 shares and leading stocks are typically priced in hundreds of dollars, this approach generally calls for an investment of \$100,000 or more.
- Selecting the right stocks is important, but with today's advanced screening tools and analytics—such as those available on myfingita.com/app/myfinvar, as well as many other online platforms—identifying stocks that are likely to outperform sector benchmarks and ETFs in near future is more accessible than ever.

- It's also important to note that while there may be a modest reduction in returns when liquidating your portfolio, this impact is minimal for long-term investors holding positions for five years or more. The strategic benefits and enhanced performance of combining stocks with options far outweigh liquidating penalties, making this approach a powerful alternative to traditional investing.

To evaluate the effectiveness of this strategy, I divided my investments into segments initiated at various times, to evaluate if strategy provides consistent performance across different market conditions. Returns are normalized to annual rates for clarity. In the accompanying chart, the X-axis represents returns from stocks alone, while the Y-axis shows returns from stocks combined with options.



Some key observations. First let us look at stock returns without options which are along x-axis. Annual returns are mostly between 10% and 50% significantly higher than 10%-15% for the benchmark, S&P 500. Average of all returns is about 30%. Very few negative returns. All negative returns here are over recent investments (invested for less than 6 months) so it takes time to stabilize.

Now let us look at the impact of options on the stock returns, values along y-axis. Note how effectively options cover when stock gains are negative. For example, worst stock return of -30% is 0% with options (left most dot). Models show performance will be better than 80% of portfolio in cash. On the other hand, positive stock returns are slightly reduced with options when returns are high, up to 20%. So, performance is better than 80% portfolio in stocks. This reduction in stock return is the 'insurance' you pay to protect against losses.

Investment performance data above illustrates the ability of options to mitigate downside risk and capture most of upside, resulting in more stable and attractive annualized returns compared to stocks alone. Returns of 30% are about double that of S&P 500. About 20% of the portfolio are reinvestments from option premiums so overall returns on original investments are even better than the chart shows.

Detailed simulations of my strategy further validate the results above over last 5+ years and gives insight into the strategy. Details of the option tuning algorithms are not yet publicly available or used by any investment funds. At myfingita.com, we are tuning the strategy and algorithms further.