Sentinel Trust Company

On Watch

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In This Issue:

Covered Call Strategies: Useful Tool but No Free Lunch

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WOULD YOU FOREGO THE POTENTIAL FOR UPSIDE APPRECIATION IN A STOCK THAT YOU OWN?

It sounds like a silly question because, aside from dividends, the obvious reason for owning the stock is to benefit from potential appreciation. But selling off potential upside is at the heart of a strategy that reduces risk and, thoughtfully applied, can increase returns. Plus, it can be used to reduce taxes.

The strategy is called "writing (or selling) covered calls" and here is how it works. A "call" is a contract by which you (the "writer" or "seller") give the buyer an *option* for a limited period of time to buy shares at a stated price (the "strike" price). Since the option seller owns shares in the underlying stock, the option is "covered," as the stock collateralizes the obligation inherent in selling the call.

Story continued inside ...

YOU ARE AT RISK
From Social Media

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Did you know that your personal and financial information may be broadcast on the internet, potentially exposing you to embarrassment, theft and even personal harm? Even though you may not use email or the internet, family members, friends and employees might be compromising you without your knowledge. Your treasured anonymity, and your treasure, may be at risk.

The continuum of social media is vast, ranging from social sharing sites, such as YouTube and Flickr, to social networks, like LinkedIn, Facebook and Twitter. The information contained within them lives on and can spread with lightening speed around the internet and even into more traditional media.

Sample risks, with language cleaned up so that we oldsters can understand it, include:

"My parents are heading to Aspen through Labor Day"

— a youngster on Twitter unintentionally telling potential thieves who might access the information that her parents' home will be vacant.

"My classmate Kelly was so upset with her parents she sent this x-rated video of herself to embarrass them"

— a teenager on YouTube.

"I looked up all of my classmates' home values (on the property tax appraisal website). I am going in tomorrow with two stickers to place on my classmates' lockers: 'rich' and 'poor'"

— a high schooler on Facebook.

"*You* would never write something like this?" Of course not, but what about your children and grandchildren, their friends, or others who can access your information? Would *they* ever?

What can you do? Talk with your family members, friends and employees to alert them to the risks of what they "say" on social media and in emails. Remain vigilant. When is the last time you searched for your name on Google?

We're not security experts, but we have a list of websites with tips and ways to maintain and protect your privacy. There are ways to reduce the damage, but preventing it is always better.

For additional information, please contact Anthony DeToto at adetoto@sentineltrust.com or 713.559.9578

ADDITIONAL RISKS

Personal technology devices including computers and smart phones are subject to:

Malware - software designed with malicious intent

Spyware - a program that monitors and reports back the actions or data of a device user

Phishing – communications that appear to be from legitimate institutions asking for account information, usually by clicking an embedded link that directs you somewhere else

More serious risks can compromise your personal information and safety:

tracking information from the "unique fingerprint" on your device

location-based services like the GPS in your car, phone or computer

Story continued from front ...

For example, suppose you own 100 shares of XYZ stock currently worth $100 per share. You might sell a 9 month option with a $110 strike price. The buyer pays you (let's say $8) for the option, and you pocket that money. Subsequently, two things can happen:

- XYZ's market price remains below the $110 strike price - The buyer will not exercise the option, so it expires worthless. You profited from the $8 premium and still own the 100 shares. The premium cushions any decline in the stock price, thereby reducing your risk of continued ownership during the option period.
- XYZ's market price rises above the strike price - The buyer will exercise the option, in which case you will have to sell the shares for $110 each. You keep the $8 premium plus receive $10 of appreciation, but you have given up any appreciation over the $110 price. So, if the price rises above $118 during the option term, you would have been better off not writing the call.

Risk Reduction

Generally speaking, selling covered calls is a defensive move that lowers the risk (and return) of a portfolio. Relatively speaking, a covered call strategy works very well when the stock or the market in general is flat, slightly up, or slightly down because it increases your return by the option premium. It reduces your risk of loss when the stock or overall equity market declines because the premium offsets part or all of the decline.

Value and Volatility

Covered call strategies work best when equities appear expensive *and* volatility levels are high, yielding higher premiums. Conversely, the strategy is least suited to markets where valuations appear cheap *and* volatility levels are low, yielding lower premiums. The only time the strategy will be a big drag on performance is when the stock goes up significantly, as the upside in a stock has been sold off in exchange for receiving what turns out to be an insufficient call premium. So, the strategy can work well for a stock that you believe has limited upside over the relatively short term (9 months in our example) and it can work well throughout your portfolio if you believe the market in general has limited upside.

Why Continue Ownership?

But, that begs a question. Why might you want to continue to own a stock (or remain in a sector or market) that you think has limited upside? Reasons include:

- No one has a perfect crystal ball, and even well-informed judgments may be wrong. Modern portfolio theory suggests that maintaining diversified portfolio exposure is important for risk reduction purposes;
- A taxable investor might want to continue ownership to meet the 12-month holding period for long-term capital gain treatment;
- A taxable investor with a substantial position in an appreciated security simply may not want to trigger the capital gains tax, but wants to enhance returns and reduce risk over time, and/or
- Some might want to continue ownership because the company is a cherished family legacy.

Free Lunch?

Marketing efforts that represent covered call strategies as "yield enhancement" tools are misleading. Unfortunately, there is no free lunch. If nothing else, they require a detailed understanding of option pricing dynamics and characteristics. We find that successfully implementing the strategy requires its use as a part of a more sophisticated domestic equity management approach, specifically one that is valuation sensitive. Conceptually, an ideal stock for a covered call is one with a current market price approaching what you believe the stock is inherently worth, at least during the term of an option. This is easiest to understand in the extremes:

- The price of a wildly *undervalued* stock is more likely to rise above the strike price, in which case your option premium is unlikely to exceed the foregone upside. You probably shouldn't sell the call.
- Conversely, the price of an *overvalued* stock is more likely to decline, in which case the option premium will help reduce your downside, although you might well be better off selling the stock rather than an option.

Valuation is Key

A sound *stock* valuation methodology is key to determining whether and how to implement the strategy most effectively. Valuation of the *market* as a whole also provides a general view of what you believe the overall market direction might be, with its resulting potential impact on the specific stocks that you own.

In our client portfolios, we generally increase covered call activity when a certain sector or even the overall equity market is overvalued, especially when the pricing of options is inflated. Based upon our valuation work, we are selling calls when we judge there to be limited upside in a particular name or in the sector or market as a whole.

While most option-writing strategies are tax-disadvantaged (since unexercised options are taxed as short-term capital gains at expiration), such gains can be offset through the opportunistic repurchase of options held at unrealized losses.

A covered call strategy can work quite well. Indeed, we view it as an important contributor to achieving the objective of outperforming the market at lower risk, and in a tax-efficient manner.

For additional information, please contact Anthony DeToto at adetoto@sentineltrust.com or 713.559.9578

How Big Should Your Umbrella Be?

D. FORT FLOWERS, JR., CFA
President and CEO

Fear of loss is a great motivator to buy insurance. But, have you ever thought about the possibility of a catastrophic loss that exceeds your other policies' limits? An "umbrella" policy can be just the right thing to protect your assets, but how big should your umbrella be?

An umbrella policy provides coverage for the types of risks insured by home and auto policies. It typically has a very high deductible. Therefore, it is important to have high enough limits on the home and auto policies to avoid a gap in coverage before the umbrella kicks in.

The structure, coverage and limits of an insurance plan should be determined in consultation with a qualified and trusted insurance agent or broker. The answers to the following questions will be helpful in determining the amount of coverage:

How likely is it that you might have a large claim?

While simple everyday activities like driving a car can lead to large claims, owning higher risk assets and participating in higher risk activities can certainly increase the possibility that you will need larger limits.

Multiple homes (especially when some may be unoccupied), many cars (especially with young or elderly drivers), and hazardous "toys" like all-terrain vehicles or watercraft are fairly obvious risk raisers. Less obvious risk increasers include a large staff of personal employees, serving on non-profit boards, and frequently entertaining large groups.

Risky professions, like doctors and officers/directors of public companies, require other types of insurance (e.g., professional liability or directors and officers liability coverage).

Are you an attractive target for litigation?

Plaintiff lawyers focus on cases where they believe the defendant can make a large payment if found liable. A sizable net worth makes you an attractive target; having it be *well known* that you are wealthy makes you an even more likely target. Living in an affluent community, having a high-profile job, or being prominent in social and charitable circles create more risk. Ironically, having a large umbrella policy can make you a more attractive target.

How well are your assets protected?

If much of your net worth is protected by creditor-proof trusts or some other asset protection mechanism, then you become a less attractive target for litigation. Conversely, if your risky activities are contained in a corporation or other limited liability entity that shields equity owners, you presumably are a less attractive target for those risks. Your lawyer can address these structures' effectiveness at protecting you.

What is the bottom line?

Umbrella liability insurance is surprisingly inexpensive, which suggests that the actual risk of a substantial loss is quite low. Coverage of $5 million to $10 million or more might cost less than a few thousand dollars annually. Consequently, many high net worth individuals opt for as big an umbrella as they can find. It provides peace of mind just in case there is a rainy day.

Sentinel Trust Company provides custom integrated planning, investment, fiduciary and administrative solutions to affluent families and their closely held businesses and entities.

Founded in 1997 as the successor to two 40-year old, investment-focused family offices, today Sentinel offers the stability of an institutional firm, the entrepreneurial spirit of a young firm, the personal feel of a family office and the in-house technical skills of independent planning and investment management firms. **For further information**, please contact Anthony DeToto, Senior Vice President, at adetoto@sentineltrust.com or 713.559.9578.

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