Cherry Picks

tastytrade's Quantitative Newsletter for Traders

June 12, 2018

Options involve risk and are not suitable for all investors. Please read [Characteristics and Risks of Standardized Options](#) before deciding to invest.

REITs

Over the past few months I've received a few questions on REITs – I'll explain **(1)** what they are, **(2)** how they may add diversification to your account and **(3)** how to use options to lower your theoretical risk and increase your odds of success and **(4)** lastly how a covered call strategy can offset some interest rate increase risk.

What are REITs? A REIT is a "Real Estate Investment Trust." In other words, they allow investors a way of investing in "income producing real estate" and receive a portion of the income. They tend to have relatively large dividends, making many investors see them more like bonds than stocks. Correlation-wise though, they currently have a higher relationship to stocks then to bonds; 0.52 vs. 0.15 respectively.

A few of the more popular REITs are listed below:

Symbol	Description	Dividend	Implied Volatility
IYR	iShare Real Estate REIT ETF	3.1%	11.6
AMT	American Tower REIT	2.2%	16.5
SPG	Simon Property Group REIT	4.7%	17.5
CCI	Crown Castle International REIT	4.0%	19.0
PLD	Prologis REIT	2.9%	19.8

	S&P 500 (SPY)	Bonds (TLT)	IYR	AMT	SPG	CCI	PLD
S&P 500 (SPY)	1	-0.29	0.52	0.27	0.47	0.15	0.56
Bonds (TLT)	-0.29	1	0.15	0.15	0.07	0.06	0.08
IYR	0.52	0.15	1	0.47	0.79	0.39	0.81
AMT	0.27	0.15	0.47	1	0.26	0.67	0.31
SPG	0.47	0.07	0.79	0.26	1	0.19	0.58
CCI	0.15	0.06	0.39	0.67	0.19	1	0.17
PLD	0.56	0.08	0.81	0.31	0.58	0.17	1

Diversification. The idea behind diversification is to smooth account volatility by combing weaker performing assets with positive performing assets and vice versa. How can we do this? First we can increase our diversification by trading stocks, ETFs and REITs with historically low levels of correlation (see the 3-month correlation of returns below). And lastly we can use options and dividends to lower our overall breakevens and create cash flow.

For example, IYR. The 3% dividend provides cash-flow, which is ideal for investors on fixed incomes. **We can accentuate this even further by writing calls against the stock.** Look at the 81 call which has an approximate delta of 30. By selling the August call for $0.57, we are providing roughly a 3.9% increase in the cash-flow. This provides a 3% Div. Yield + 3.9% Theoretical Covered Call Yield.

The math:

=Credit Received / Stock Price * 365/Days Until Expiration

=0.57 / $79.44 * 365/66

=0.039 = 3.9% annualized increase in the cash-flow by consistently selling the call.

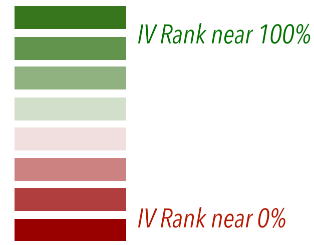
This covered call cash-flow provides a buffer against potential rises in interest rates.

Michael Rechenthin, PhD
research@tastytrade.com

Reading this Report

Expected Range Cone. The colored cone represents a 30-day expected theoretical price range that is calculated from the options' implied volatilities. If the implied volatility is relatively high, then the market is expecting a larger price change in the underlying stock or ETF. From this we can derive the market's 1 standard deviation theoretical expectation of where prices might be in the future. In other words, the market is expecting, with a 68% theoretical probability, that prices will fall within the boundary of the cone at the end of 30 days.

Cone Color. The color of the cone is significant. The darker the color, the more "extreme" the implied volatility (IV) which is represented by implied volatility rank (IV Rank). This information can help you decide on a trading strategy.



Glossary

IV. Implied Volatility is the estimated volatility of a security's price derived from its option price; the higher the IV, the more expensive the option and therefore the larger the expected price move. IV is an annualized number of volatility, e.g. a IV of 27 means the option's market is pricing in an annualized price range, either plus or minus, of 27%.

IV Rank. IV by itself doesn't tell us if if the volatility is high or low - but IV Rank does. An IV Rank of 70 means that the IV is 70% between its low and high IV over the past year. The higher the IV Rank, the higher the security's IV is compared to its past year. We provide six levels to make evaluating easier:

- **Extremely High:** IV Rank between 90 and 100
- **High:** IV Rank between 75 and 90
- **Moderately High:** IV Rank between 50 and 75
- **Moderately Low:** IV Rank between 25 and 50
- **Low:** IV Rank between 10 and 25
- **Extremely Low:** IV Rank between 0 and 10

Option Liquidity. At tastytrade we have our own theoretical measure of option liquidity, Poor, Moderate, Good, or Great. It examines the options' bid/ask spread, open interest, and the number of strikes with non-zero bids.

Correlation with S&P 500. Correlation is a statistical measure of how strong a relationship two securities have with one another. A correlation of -1 means the stocks are perfectly negatively correlated (they move in opposite directions), while a correlation of +1 means the stocks are perfectly positively correlated (they move in the same direction). A correlation of 0 means there exist little relationship.

Earnings. The earnings date of the security. In practice we tend to see stocks have a larger amount of implied volatility (IV) nearer to earnings as the market is pricing in the fear of the upcoming earnings announcement. In parenthesis, is BTO or AMC; "Before the Open" or "After Market Closes", respectively. Upcoming earnings dates do sometimes change.

Disclosures

Options involve risk and are not suitable for all investors. Please read Characteristics and Risks of Standardized Options before deciding to invest in options: https://www.theocc.com/components/docs/riskstoc.pdf

tastytrade content is provided solely by tastytrade, Inc. and is for informational and educational purposes only. It is not, nor is it intended to be, trading or investment advice or a recommendation that any security, futures contract, transaction or investment strategy is suitable for any person. Trading securities can involve high risk and the loss of any funds invested. tastytrade, through its content, financial programming or otherwise, does not provide investment or financial advice or make investment recommendations. Investment information provided may not be appropriate for all investors, and is provided without respect to individual investor financial sophistication, financial situation, investing time horizon or risk tolerance. tastytrade is not in the business of transacting securities trades, nor does it direct client commodity accounts or give commodity trading advice tailored to any particular client's situation or investment objectives. Supporting documentation for any claims (including claims made on behalf of options programs), comparison, statistics, or other technical data, if applicable, will be supplied upon request. Multi-leg option strategies incur higher transaction costs as they involve multiple commission charges. tastytrade is not a licensed financial advisor, registered investment advisor, or a registered broker-dealer. Options involve risk and are not suitable for all investors. Please read Characteristics and Risks of Standardized Options before deciding to invest in options.

Futures accounts are not protected by the Securities Investor Protection Corporation (SIPC). All customer futures accounts' positions and cash balances are segregated by Apex Clearing Corporation. Futures and futures options trading is speculative and is not suitable for all investors. Please read the Risk Disclosure for Futures and Options prior to trading futures products found in Disclosures under the Documents tab.