**B Capital SA**
**Rue Jean-Calvin 14**
**1204 Geneva**
**Switzerland**

Tel +41 22 317 7823
Fax +41 22 545 7714

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**Positioning For A Rebound: Case Study**

The S&P500 Index has traded down to around 2500 today (-22% year to date) after President Trump stumbled through an ill-prepared TV address that spectacularly failed to convince markets that the US Government is reacting appropriately. In Europe this afternoon, an ECB meeting left rates unchanged but Christine Lagarde did announce QE measures that reminded investors of the complex bank central operations last seen during the European debt crisis. Unfortunately, everyone is looking for political leadership and not banking jargon to fix the problem.


**Chart 1: S&P500 Index Moving Averages 50/100/200 (Relative Strength Indicator)**

With the S&P500 Index crossing below the 200 moving average today, we have started to receive questions about how to play the eventual rebound. It is hard to make the decision to buy when 'the Street' is in widespread risk-off selling mode, however buying low amongst panic-selling is often the best way to make money. Blood on the streets etc.

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We have been looking at the most beaten-up stocks for specific client enquiries (airlines, travel agents, luxury goods, cruise liners, retail) but for a more liquid and potentially lower-risk trade, we suggest looking at out-of-the-money S&P500 Index call options.

An example is **SPX US 03/19/21 C3050**. A call option gives the right to buy at a given strike, in this case 3050 on the S&P500 Index, at a future expiry date (March 2021).


**Chart 2: Price Graph of S&P500 Call Option with Strike 3050 and Expiry in March 2021**

The price of the option is linked to the price of the Index which gives it its 'intrinsic value' and combines with the amount of time until the expiry of the option, known as the 'time value'. As you can see from the graph above, the option price has more than halved in the last two weeks but the Index has fallen by much less than this. This demonstrates the increased volatility of the option compared to the underlying Index. What it means for investors is that smaller amounts should be applied to the option to manage the risk, employ less capital and to use it as a tool in conjunction with strategic asset allocation. If used to play a rebound it is speculation and comes with the health warning that if the market does not rise then a call option may very well expire worthless.

The option in this example costs $33'000 for 3 contracts at $100 representing c.$1m SPX Index exposure. The maximum loss is the cost of the option (the premium). The maximum return is unlimited. The strategy would be to buy the call option and sell it with the maximum amount of combined intrinsic and time value for the best price increase. An Index rise of say 10% in the next couple of months would result in the option price rising by a multiple of this.

For those who are satisfied with their asset allocation plan this market volatility should be concerning but not overly worrisome and there is no need to add risk by buying a call option (ie no recommendation is made).

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The Covid-19 situation will pass and it may be months before the markets stabilise but in the end they will. This update is to demonstrate ways to play a rebound in markets with smaller amounts of capital and with a diversified underlying index in place of individual stock risk. Options are traditionally employed for reducing risk as an insurance plan but we recognise that clients still want to explore risk-on opportunities when markets move down significantly. I hope that it is interesting and welcome any further discussion regarding the current market volatility.

**Lorne Baring**
**Managing Director**

**B Capital SA**, Rue Jean-Calvin 14, 1204 Geneva, Switzerland. Tel +41 (0)22 317 7823, Fax +41 (0)22 545 7714.