How to Trade Dollarama Inc. After Earnings

Description

Analysts were expecting discount retailer **Dollarama Inc.** (TSX:DOL) to deliver third-quarter earnings of $0.86 per share. It did six cents better, thanks in part to the company's implementation of higher price points in August.

While lower-priced items continue to drive its business, Dollarama is clearly excited by the customer uptake from this latest initiative to keep it growing. "Customers are responding positively to the offering; however we do not expect these price points to have a significant impact on current year results," Dollarama CEO Neil Rossy told analysts December 7 in its Q3 2017 conference call.

The good news from earnings will likely keep Dollarama stock moving higher as we enter the final trading days of 2016. Up 25.6% year-to-date, the stock is working on its seventh consecutive year with total returns 20% or higher; since its IPO in October 2009, shareholders have never had a losing year.

In fact, if you were lucky enough to pick up some of Dollarama's shares when it first went public at $17.50 per share, you've achieved a cumulative total return of 1,053% over the seven years it's been a public company.

That's pretty awesome.

Dollarama's latest results seem to point to the party continuing, but before you get on board, you might want to consider an alternative trading strategy before pulling the trigger on its stock.

Have you ever heard of reversion to the mean? *Wall Street Journal* columnist Jason Zweig does a good job explaining its importance.

"From financial history and from my own experience, I long ago concluded that regression to the mean is the most powerful law in financial physics: Periods of above-average performance are inevitably followed by below-average returns, and bad times inevitably set the stage for surprisingly good performance." Zweig wrote in a column in 2013.

Dollarama's annual total returns between 2010 and 2015 have been 28.8%, 55.2%, 33.5%, 50.5%, 35.4%, and 35.2%, respectively. By every standard, these returns would have to be considered above-average in nature. Reversion to the mean suggests Dollarama's future returns won't be nearly as substantial.

What should you do? Consider writing put options on Dollarama stock.

Currently trading around $100, the average target price of the 15 analysts covering its stock is $110 with $122 on the high end and $90 on the low end.

If you want to own Dollarama stock at $90, for instance, you can do one of two things. First, you can enter a buy trade with a $90 limit price on Dollarama stock with a "Good Till Cancelled" order that leaves the order open until manually cancelled or for 90 days, whichever comes first.

The second course of action is to write a put on Dollarama stock with a $90 strike price at some point in the future. Should the stock price fall to $90 at expiry, you would be required by the buyer of the put to purchase the stock at $90. However, your actual cost per share would be reduced by the premium received for selling the put in the first place.

So, you get paid to wait for the stock price to drop—something the limit order doesn't provide.

However, it's important to remember that these are cash-secured puts; you must have the cash in your account to cover the cost of the shares should they be put to you in the future. Also, it's possible that Dollarama's stock will continue to rise and you'll miss out on the upside, but that's a chance I'm willing to take.

Bottom line, the last price for the $90 DOL put option with January 20, 2017, expiry was $0.65. This means you would receive $65 in premium to write that put. Should it not get exercised, your annualized return would be 6%.

If you want to own Dollarama stock, but believe in the fundamental soundness of reversion to the mean, as I do, you might want to consider writing put options on its stock.

Earlier this year, Dollarama stock dropped by 20% to $71. Corrections do happen, even to the best stocks; at some point in the coming year, it will likely hit $90, or perhaps lower.

Why not get paid to wait for that to happen?

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1. TSX:DOL (Dollarama Inc.)

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