Why Home Capital Group Inc. Put Options Are the Play of the Year

Description

This is a follow up article to my March 13 piece outlining a potential put options strategy for **Home Capital Group Inc.** (TSX:HCG), and a response to Ryan Goldsman's most recent article in which he describes Home Capital as the "stock of the year."

Since April 21 has come and gone, let's see how the first two rounds of puts would have performed (please check my article hyperlinked above for the dates and costs associated with the puts – these trades do not exist today).

In this article, I recommended a staged approach to puts against Home Capital, staggering them throughout the year, with the expectation that, at some point throughout the year, the stock would likely test its 52-week low, and would likely go substantially lower.

I should take the time to clarify here that I do not have a long or short position in Home Capital (stocks and/or options), and have recommended that investors look at this potential options strategy as a way to hedge the downward exposure Home Capital clearly exhibited at the time of my previous article.

I remain objective with respect to this stock, however I note that I have also remained bearish on Home Capital for some time and for good reason; it appears the market is now starting to pick up the same sentiment.

How has this strategy worked out?

As we can see, this staggered strategy has already begun to pay off, since the first round of March puts were not in the money at any time before expiration, and thus were deemed worthless, a 100% loss.

The April puts, however, have seen a substantial increase in value. In the money at $25.30, the total profit on each put purchased would amount to $6.05 as of the April 21 closing price of $19.25, however the stock did trade as low as $17.43 in the session meaning the options were in the money for a brief period of time for as much as $7.87.

To put this in perspective, a $1000 investment in the April puts (excluding trading fees, typically in the $10 range for such a trade) would now be worth $4,558.82. The combined investments in March and April puts, assuming the same amounts were invested in each of the options, would have amounted to a 228% return in one month alone.

The June, September, and December puts are now all in the money, and are worth substantially more than one month ago. Prices will likely to continue to vary over the coming months, however an investor with a long-term bearish position on Home Capital ought to consider the long-term risks and potential upside to hanging onto these puts to expiration.

Bottom line

This staggered strategy for using put options over a long period of time, instead of simply going short a stock, carries with it a massive potential for profit in a short amount of time, should the company be truly overvalued and the market correct itself within the given time frame (in this case, a nine month window). This strategy does, however, carry with it a tremendous amount of risk in that a 100% loss is very likely if said company's stock price does not go into the money within the window.

That said, an investor who shorted Home Capital as of March 13 would now be up 30% instead of 228% if that investor had gone long on March and April puts.

Where the future lies, nobody knows, but this put strategy has proven to be a great lesson for how options can have a massive effect on a portfolio in a short period of time, relative to short positions.

Stay Foolish, my friends.

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