ITB - iShares Homebuilders

Nov 20 2015 $26 Short Puts

Welcome to the ***Leveraged Investing Club Limited Downside Letter*** for September 27, 2015.

This week we take a look at one of the few areas of the market that hasn't broken down - homebuilders.

But first, as we've been doing lately, let's take closer look at the health and condition of the broader U.S. stock market.

S&P 500

In last week's Limited Downside Letter, after we drilled down on the broader market, I concluded that, "This will probably be a good week to be cautious."

And when all the dust settled, that turned out to be pretty spot-on - while the DJIA lost just 0.43% for the week, the S&P 500 traded 1.36% lower and the Nasdaq and Russel 2K dropped even more (2.92% and 3.49% respectively).

So how do things stand now?

Let's start with that late day/intraday chart I put together back on September 9th that really summed up the market's situation and challenge:

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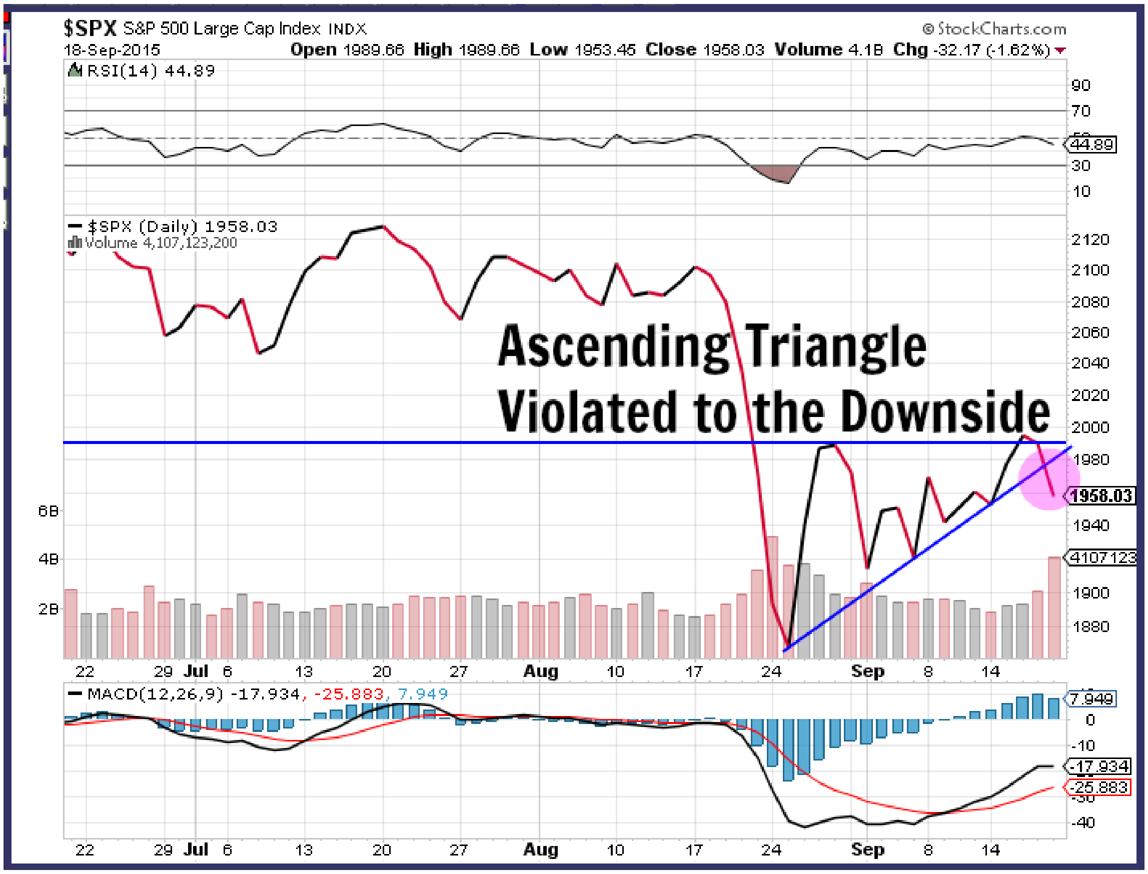
Here's that same chart updated now through last Friday (September 25, 2015):

We also spent some time last week discussing ascending triangles (and the semantics involved - pretty exciting stuff, right?), and I shared the following charts and views:

> *Clearly, I think the likeliest move in the market this week is a continued move down, but as I mentioned last week, I'm beginning to find myself a little skeptical that the market "must" re-test those late August lows.*
>
> *Maybe it's the contrarian in me, but the more consensus builds for one specific outcome to take place, the less faith I have in the inevitability of that outcome.*
>
> *Let's look at two more charts - super simple and clean 3 month charts that use closing price lines vs. intraday candles.*

The first one shows the ascending triangle that Murphy previously identified and shows that last week's price action very clearly violated that triangle to the downside:



Obviously, not a good sign, but does that mean a re-test of the August low is inevitable?

I don't believe a re-test is inevitable. It could certainly happen, of course, but that same chart, drawn from a slightly different perspective suggests we could find support in the roughly 1920-1940 area:

OK - that's a lot of charts to process.

I don't believe the sky is falling, but I wouldn't expect a lot of strength in the markets next week, at least in the early going.

Fast forward a week, and while the cautious stance last week was indeed validated, the jury is still out regarding the re-test question.

Here's the updated version of last week's 3-month chart:

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The **$SPX** is currently right in that - let's call it - 1910-1960 zone that could end up being the support that stops the slide (last week, I estimated the bottom of that potential support range as 1920 - clearly this is an art as much as it is a science).

If not, if ~1910 doesn't hold, then it really does begin to look likely that we trade down to that 1867 level once again.

So with that as a backdrop, let's talk home construction . . .

ITB – iShares Dow Jones U.S. Select Home Construction Index

From **Yahoo Finance**:

The investment seeks to track the investment results of the Dow Jones U.S. Select Home Construction Index composed of U.S. equities in the home construction sector. The fund generally invests at least 90% of its assets in securities of the underlying index and in depositary receipts representing securities of the underlying index. The underlying index measures the performance of the home construction sector of the U.S. equity market. The fund may invest the remainder of its assets in certain futures, options and swap contracts, cash and cash equivalents. It is non-diversified.

The Case for Homebuilders

The housing and homebuilder sector has been one of the few areas of the market that's held up over the last couple of months.

TOL (Toll Brothers) is usually my go-to stock among the homebuilders because, as a luxury homebuilder, their customer base is the most well off financially.

(Businesses that cater to a budget-conscious segment of the population can be great investments – **WMT**, **ROST**, dollar stores, etc. – but my bias has always been in favor of businesses whose clientele have plenty of money.)

While homebuilder sentiment was recently reported to be at a 10 year high, there is some indication that **TOL** is having difficulty continuing to raise prices.

The TOL Earnings Call

And the most recent quarterly conference call was insightful as well – not for what was said, but for how it was said.

It was a very one-sided presentation. You expect that to a degree during the opening presentation during a conference call and then you get a more balanced view of the company's performance during the back and forth with the analysts on the call.

But I found the **TOL** call to be striking in how aggressively selective management was with information and stats. You really had to read between the lines to get a more accurate view of the quarter.

It was a solid enough quarter, of course, and I don't doubt management's optimism, but I still felt there was a serious disconnect between the quarterly results and the impression management sought to leave investors with (i.e. that it was all ponies, rainbows, and gold coins falling from the sky).

[**Full disclosure** – I do have a relatively small calendar spread position/series of trades on **TOL** in my personal account which I initiated on 2015-08-21 – and while the stock is down 10.32% since then – and the current mid-point price on the January 2017 calls I paid $8.50/contract for is down to $5.65/contract, I have still managed to extract/rebate 13.75% of the original purchase price of the 518 day LEAPS through selective short call trades through next Friday, or in just 42 days – and on a sidenote, we'll soon begin adding individual trading case studies to the **LEAPS Value Course** in progress.]

ETFs VS. INDIVIDUAL STOCKS

Normally, I prefer selling puts on individual companies, but with the homebuilders, while they obviously do tend to move in tandem, there can still be company-specific variations of performance based on demographics, regional exposure, individual execution, etc.

And often, when you work with an index or ETF, you sacrifice something in the pricing. That may be true to a degree here, but there’s still plenty of implied volatility priced into the iShares homebuilder ETF – **ITB**.

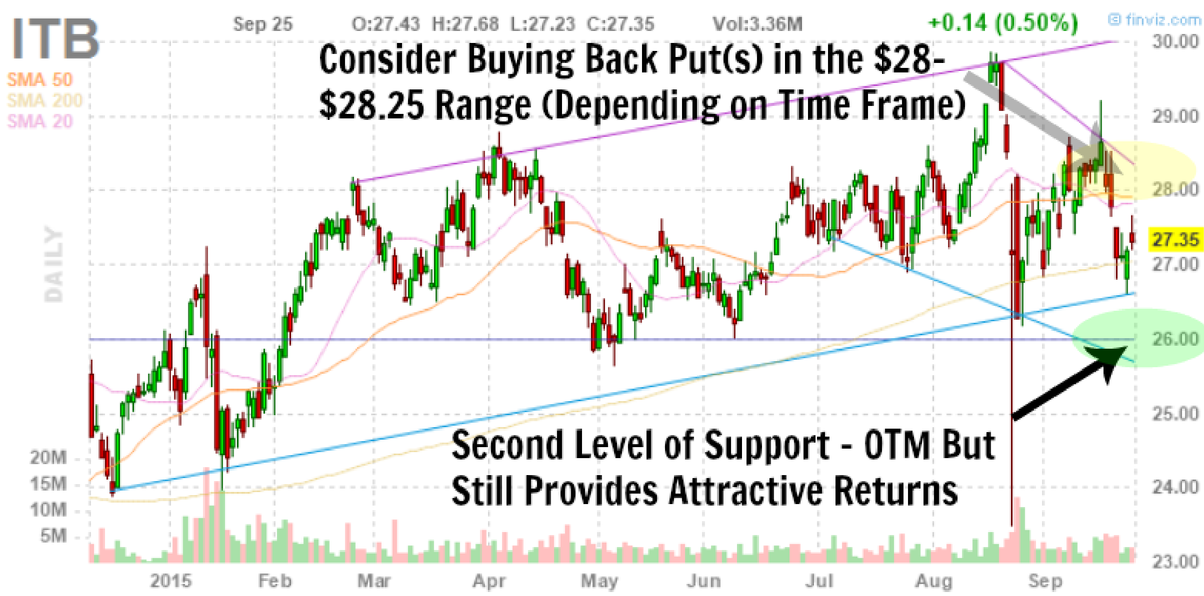
ITB is also attractive in that there are both weekly options and monthly options with narrow strike prices (the weeklies are priced in $0.50 increments and the monthlies are priced in $1 increments).

It’s not the most widely traded ETF, so the bid-ask spreads can get a little wide at times, but with patience and limit orders, you should still be able to find attractive entry points.

Specifically, I’m looking at the **ITB November 20 2015 $26 strike for an attractive put writing opportunity**.

THE ITB CHART

Here’s a chart on **ITB** from Friday’s close:



I like the $26 strike because it's two support levels away and it still provides attractive terms on an annualized basis.

Based on Friday's closing numbers, my best guestimate is that the November $26 short puts should provide something in the 14-16% annualizd range (see option chain below).

If I entered this trade myself (unlikely since my capital is fully utilized at present), I would keep an eye on the ETF and re-assess if it trades into the $28-$28.25 resistance area noted above.

Depending on how much time remained until expiration, I might consider closing the trade early and locking in a higher portion of the profits in a fraction of the time.

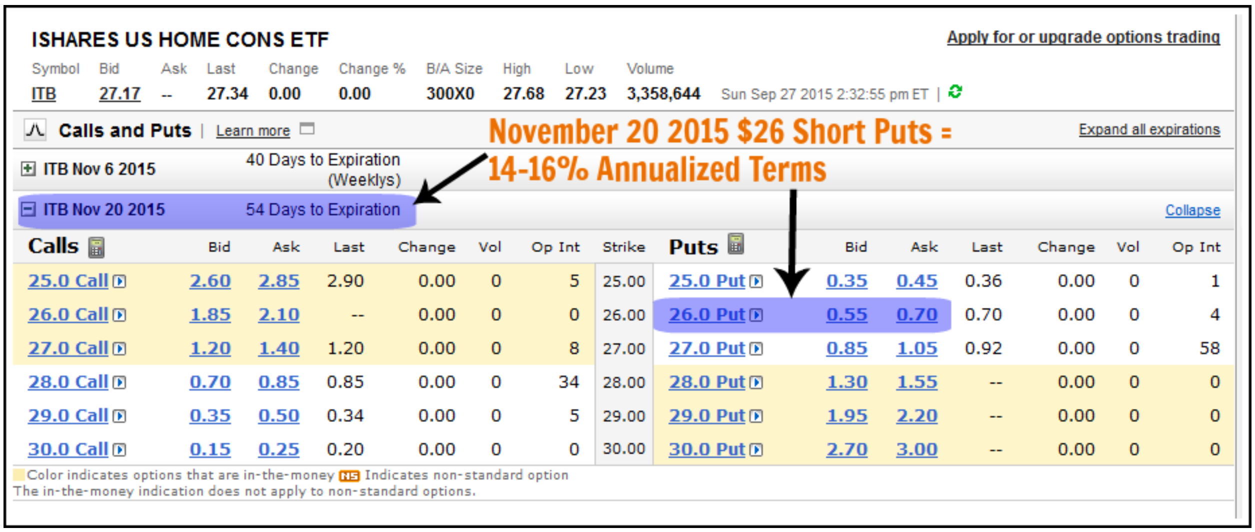
(As always, it's a case by case deal, and you would need to run the numbers and re-evaluate the technicals at that time in order to make your own best informed choice.)

Even if the index is unable to trade through that resistance zone, that doesn't mean that it's going to immediately trade down to and threaten the $26 support level.

But it is something to be aware of. And we have had success in the past (e.g. **MET**) where we sold at support, bought back at resistance, and then re-entered the trade again shortly thereafter once the stock was trading back down at support – in effect, ringing the register twice.

PRICING

Finally, here are the closing option quotes from last Friday:



Symbol	Bid	Ask	Last	Change	Change %	B/A Size	High	Low	Volume
ITB	27.17	--	27.34	0.00	0.00	300X0	27.68	27.23	3,358,644

Sun Sep 27 2015 2:32:55 pm ET

Calls	Bid	Ask	Last	Change	Vol	Op Int	Strike	Puts	Bid	Ask	Last	Change	Vol	Op Int
25.0 Call	2.60	2.85	2.90	0.00	0	5	25.00	25.0 Put	0.35	0.45	0.36	0.00	0	1
26.0 Call	1.85	2.10	--	0.00	0	0	26.00	26.0 Put	0.55	0.70	0.70	0.00	0	4
27.0 Call	1.20	1.40	1.20	0.00	0	8	27.00	27.0 Put	0.85	1.05	0.92	0.00	0	58
28.0 Call	0.70	0.85	0.85	0.00	0	34	28.00	28.0 Put	1.30	1.55	--	0.00	0	0
29.0 Call	0.35	0.50	0.34	0.00	0	5	29.00	29.0 Put	1.95	2.20	--	0.00	0	0
30.0 Call	0.15	0.25	0.20	0.00	0	0	30.00	30.0 Put	2.70	3.00	--	0.00	0	0

As I mentioned earlier, the bid-ask spreads can get a little wide, but in this example, with a $0.55-$0.70 spread, I'm very confident a trader could've gotten filled last Friday with a $0.60 limit order.

Reminder - I'm not a licensed financial advisor and I'm not officially advising or recommending any specific trade - I'm simply sharing with you with as much transparency, honesty, and detail as I can what goes into my own trade selection and thought process. Only you can decide whether any specific trade I discuss is right for you.