Chapter 1

Alpha and Building Wealth

Can you beat the market?

Well, there's a doozie to start out with. As you can imagine, if the answer was a solid "no," I wouldn't have written this book. My answer is "yes." But it's a lot to unpack. In fact, we require a good part of a whole chapter to even understand the question well enough so we can properly ponder the answer.

First, allow me to pose a different question: what *is* the market? Then we'll be able to take a better look at why and how investors can beat the market and explore why it matters.

The Market

I make a distinction between trading and investing. Trading tends to involve shorter-term positions, which attempt to capture fluctuations in price movements, whereas investing consists of longer-term positions expected to appreciate in value over time. And sometimes

I refer to trading as the act of placing a trade and thus entering into or getting out of a position, which could be an investment or a trading position.

Anyway, in the context of trading and investing, the word "market" can take on different and distinct meanings. They're all sort of etymologically related. And it's important to understand this. So let's jump in.

The purest sense of the word "market" is a place to buy and sell goods or services—meaning a physical place or a virtual place (online). As for trading stocks, think about when traders would gather and stand under the famed buttonwood tree on Wall Street in the late 1700s. It was a marketplace for stocks and bonds. Soon after, that marketplace evolved into trading pits on an exchange floor. Then near the end of the past century, the exchanges took the market online. Evolution!

And some of the individuals under the tree or on the exchange (physically or virtually) *made/make a market*, which is the next evolution of the word: a person or firm that quotes both a buy price and a sell price for something. In our trader context, the price at which someone wants to buy is called the "bid," and the price at which someone wants to sell is the "ask" or the "offer." And the "something" in this case is a financial instrument—a "security."

The highest price any market participant wants to pay for a specific security is simply referred to as the "market bid," and the lowest price any market participant wants to sell it is the "market ask." Those two together are "the market" for that security.

These days the market(place) is mostly online, and anyone can get a market for any stock or individual option position from online brokers or other sources. There are many exchanges that all list the same securities, which is called "multiple listing." They are all fungible, which means if you buy it on one exchange, you can sell it on another. The markets for each individual stock or option are aggregated from each of the exchanges on which they are listed and disseminated as a single, aggregate market called the National Best Bid and Offer (NBBO).

That's the bid and the offer you see in an online brokerage account. In that regard, there are literally hundreds of thousands of fleeting "markets" that update on your screen, flashing by the millisecond (or however fast your data feed and infrastructure can handle).

But what people sometimes mean when they talk about "the market" often isn't either of those things. It's kind of an adulteration of those earlier contexts. The main way people use the word "market" is to describe a collective group (or "basket") of stocks, often called an "index."

One of the most common indexes people are referring to when they talk about "the market" is the Dow Jones Industrial Average (DJIA). This may strike many people as a bit odd, as this index has only 30 stocks in it, and yet still many people call it "the market." Seemingly, 30 stocks chosen by a committee with some discretion of which stocks they'll include in the index doesn't seem to be super representative of the whole market—the entire universe of stocks. But the DJIA was one of the first stock indexes ever created and followed widely, so it's sort of burned in the psyche of traders. I guess it's good to be first to market. There's that word again. . . .

Soon other indexes followed suit and published prices of their own baskets of stocks. The S&P 500, a market-capitalization-weighted index of 500 companies' stock prices, was eventually born and is accepted by the majority of investors as the gauge of the health of U.S. stocks overall—"the market."

This is a little bit of an overstatement as well. There are more than 8,000 stocks listed on U.S. exchanges at the writing of this book—though the number changes over time. The ones in the S&P 500 index are stocks selected by a committee of individuals. For all intents and purposes, these committee members are "stock pickers" like anyone else who curates a basket of stocks—though there is less discretion with which stocks qualify for S&P 500 index components.

Interestingly and remarkably, the DJIA and the S&P 500 track one another reasonably closely. So it's not a big stretch to call the

Dow the market. But I, and in my observation most market participants, prefer to refer to the S&P 500 as the market.

As far as these "stock pickers" who select the component stocks of such indexes go, one could argue that their motivations are somewhat different from big traders or investors who are picking stocks for their investment portfolios. Index curators are not including stocks in the index to profit from them, as traders do. Though they, or their companies, surely benefit by picking good ones. If they pick a lot of lemons and the index struggles to keep up with the majority of stocks out there—ones not in the index—well. . .that's. . .less than ideal. These stocks are the "industry leaders" as with the DJIA, or the largest U.S. corporations by market cap, as with the S&P 500.

What's the point? A big one, actually. Other stock pickers, i.e., individual investors, mutual fund managers, pension fund managers, hedge fund managers, and others, need a *benchmark*—something to measure their own results against. Thus is the role of these indexes.

"Did I beat the S&P 500?" "Did I beat. . .*the market*?"

Building Wealth in the Stock Market

This thing we call the stock market is designed to create wealth. For many people in Western Civilization, in a society born out of the tenets of the ideals of capitalism, those stock investments are a big part of one's wealth—wealth to fund retirement and other expenses during the latter part of life. Of course, there are also bonds, real estate, precious metals, collectibles, and what have you. But unlike most other investments, the stock market *creates* value. And that creates wealth for the investors in the stock market.

Those seem like pretty big statements: "creates value" and "creates wealth." But that is what stocks are intended to do, and empirically have done, for the long-term investor for centuries.

When there is division of specialized labor, skilled management, and economies of scale, a well-run corporation should be able to sell goods and services at a higher profit margin than a typical mom-and-pop shop. They get to use the equity capital they get from issuing stock. They can sell bonds to borrow money. Or just take out loans. And they can use that cash to capitalize on economies of scale. And they can hire experts, including and especially experts in hiring the right people—HR executives—who find the best talent. I've heard it argued rather compellingly that the value of a company is the value of the talent who works there.

The stock market is where equity capital is raised and transferred, and any individual can buy a piece of it and invest in these talented people running a proven, successful business.

The expertly talented people who know how to turn a profit. . .

Out of which the company will pay shareholders dividends. . .

Or reinvest those profits back into the company. . .

Continuing to put invested funds to good, profit-generating use.

They create goods or services and sell them at a higher price than it cost them to create. The best companies create value for the customer, value for the employee, and value for the owners (shareholders).

Consider corporations' (stock issuing companies') activities. Assembling component parts in a smart, cost-efficient way—adding value through synergy of components—the company literally creates value. Building a factory that runs more efficiently than could be done otherwise also creates value. Likewise, for service companies. Selling expertise to a person or company to make that customer more productive is a value-added/value-created activity.

If a company finds a way to create more value, like cutting costs but not output (or growing output and not costs), creating new solutions for problems people have sought solutions to (or problems they didn't know they had), finding the cure for cancer, or whatever, the company becomes more valuable.

A great way to measure that value is to look at the growth of the earnings of the company—their profits. The more profits; the more value to the shareholders. Shareholders become wealthier by owning shares in profitable companies.

Being that this discussion is in the context of the shareholder, this brings us to a couple of important, time-tested investment concepts: the buy-and-hold strategy and diversification.

The Buy-and-Hold Strategy

The buy-and-hold strategy is simple: you buy it, and you hold it. Aside from the observation that stocks—or really the corporations on which the shares represent ownership—create wealth, there are other contributing factors for why buying and holding stocks for the long term is a wealth-building activity.

Compounding Returns

A big justification for using the buy-and-hold strategy is the power of compounding. Here's how compounding works:

Imagine you invest $1,000 at a 10% annual rate of return. That means one year later, you will have $1,100.

But that doesn't mean you make $100 a year. You make more.

At the start of year two, you invest that $1,100 that you now have, at that same 10% annual rate of return. A year later you'll then have $1,210.

And so it goes. Year three, you invest that $1,210 at a 10% annual return. Then a year later, you have $1,331.

Year four, you invest that, and in a year you have $1,464.10.

Year five, you have $1,610.51.

Year six, $1,771.56.

Year seven, $1,948.71, almost double what you started with.

In year eight, you'd have $2,143.58.

In year nine, it's $2,357.94.

And in year 10, you have $2,593.74.

The yearly monetary return grows by a bigger amount each year. This is what is meant by compounding. Compounding leads to exponential growth and thus wealth that grows at an increasing rate.

Taxes

The buy-and-hold strategy also can benefit from tax law. In the United States, since the Revenue Act of 1921, long-term capital gains have been taxed at a lower rate than short-term capital gains. This of course is subject to change with the winds of politics. But as of this writing, it is still the case.

I speculate this is by design. It's in the public's best interest and the government's best interest for individuals to save a good portion of their wealth. Someone needs to provide funds for the needs of individuals as they get older. Western individualism suggests that should be the individual.

Buy stocks, hold them, retire one day.

From where I sit, the government should want to incent individuals to buy and hold—then they don't have to spend as much on elder care as citizens age. To this day at least, individuals in the United States get that incentive and benefit, tax wise, by holding stocks for more than one year, thus then paying a lower tax rate on the profits, making compounding ever more powerful. More money is kept and not taxed, so a bigger chunk can grow exponentially. It makes a big difference.

Diversification

We've all heard "don't carry all your eggs in one basket," right? Well, I'm about to scramble that metaphor. Recall that a basket of stocks is an index, meaning many stocks held at the same time. Well, when you hold a basket of at least 20 to 30 stocks, there's some magic math that happens.

The main thing is that your risk goes down. In stocks, risk is measured by standard deviation (σ). The math basically works like this: if Stock A's σ is X, Stock B's σ is Y, and Stock C's σ is Z, that basket would have a smaller σ than the weighted average of the 3 stocks' σs combined.

But the returns of the basket would simply be a straight weighted average of the returns of the components. So, the returns average out, but the risk is less than what would be the calculated weighted average.

In securities, the risk-adjusted return is often measured by what is called the Sharpe Ratio. The higher the Sharpe Ratio, the better the ratio of return to risk. A basket of stocks will have a higher Sharpe Ratio as a result of the previous math concepts. Diversification benefits investors.

But. . .

Warren Buffett is often quoted for this remark: "Diversification is protection against ignorance. It makes very little sense for those who know what they're doing."

So, now we're back to stock picking. . .*maybe*.

Pick Me a Winner

In late 2024, I screened 8,533 stocks listed in the United States (which at the time was all of them) for ones that had a positive profit margin. That dropped the number of results to 2,130. That means only about 25% of companies at that time were profitable—by that metric anyway. This percentage of winning stocks varies over time and among different indexes (small caps versus mid-caps. . .). But certainly not all companies make money. A lot of them lose.

So, not being at the skill level of Warren Buffett and other value investor masters, are you better off just buying a broad-based exchange traded fund (ETF) and then calling it a day—*err*, a decade?

Well, no. I'd say no, anyway. Then we're back to square one: can you beat the market? Do you even want to? If some folks already curated the market (the S&P 500) and it's a "good enough" return, should we even care?

It's a Wonderful Life (and Even Better If You're Financially Secure)

Every year my wife, Kathleen, and I (and the kids if they're around) watch the holiday movie *It's a Wonderful Life*. The topic of financial security calls to mind (for me anyway) the conversation between the main character George Bailey, played by James Stewart. George Bailey ran the local Building and Loan, and it was in deep financial trouble. The business was having an existential crisis. George was visited by a guardian angel, Clarence, who was sent down to guide him.

George, who was skeptical to the point of being annoyed with Clarence's attempts to help, finally broke down and asked him, "I know one way you can help me. You don't happen to have 8,000 bucks on you?"

Clarence told George: "No. We don't use money in Heaven."

To which George replied, "Well, it comes in real handy down here, Bub!"

Those of us who have been around the block a few times understand that money isn't everything. But it sure is better to have more than less. There are a lot of valid motivations for wanting to build greater wealth.

If you've had the experience of caring for, being around or yourself being an older person with health issues and care needs—depending on the country and the culture in which you live—the costs can be mind-bendingly astronomical. With more money, we can provide more for these costs.

And we can provide more for our families. Our education. Our kids' education or our grandkids'. We can give generously to people, causes, or religious organizations that we believe in. We can make a difference. I'm not going full-on Gordon Gekko here and asserting "Greed is good." But life sure is easier and potentially more impactful with greater wealth and when you have control over your wealth and how fast you grow it.

A quick digression:

While writing this chapter, I was talking with my son, Sam, when he came into town for the holidays. He was living in San Francisco at the time doing medical research. But he came home for Christmas and New Year's. He'd asked how the book was coming along. And I was telling him how someone suggested to me that because the book was called *Build Wealth with Options*, I should start out by making the case for why building wealth is important.

And he said, very decisively, "Yeah. That makes total sense." And the clarity and confidence in his voice led me to ask him, "Well, why do you say that?" I mean, I have my reason. But I was curious why he thought so.

He said: "These days, we have this gambling culture. Sports betting is really popular right now. And some people take that betting behavior into the market, betting on meme stocks, NFTs, crypto and such." And I don't remember his exact words. But that's the idea.

And he went on: "Some people even gamble on the stock market with options. But what you're talking about—and that's him talking about what he knows I'm writing about—what you're talking about is something different. It really is about building wealth."

And I was like, "Yeah! That's it, isn't it!?"

To grow wealth faster than the benchmark we call "the market," we need a measurable way to do so. This is called "generating alpha."

Generating Alpha

If this isn't your first exposure to educating yourself about investing, you may have heard the term "beta." Beta is how much a stock is correlated to a benchmark index like the S&P 500. It's the baseline. A beta of one means the stock rises and falls statistically about the same as the benchmark. A beta of more than one means it rises and falls more than the benchmark. Note that a higher-than-one beta doesn't mean that it statistically outperforms. It just means it has bigger swings up *or* down. And by that logic, a beta of less than one means it rises and falls less than the benchmark. Again, not underperforming, just smaller moves, or less volatility.

Conversely, alpha is a measure of the outperformance. Alpha is the outperformance of an investment strategy relative to a benchmark. That could be relative to the market as a benchmark. Or it could be a measure of outperformance of some other benchmark, such as how well the profits outperform what the strategy is expected to do based on a model or some other quantifiable expectation. An investment strategy is a methodology created and traded by an investor. So, a good way to think about alpha is it's the portion of the return attributable to the skill of the trader.

Consistency

Trading and investing are statistical endeavors. Not every position is a winner, even if it's a winning strategy. A winning strategy is one that makes money in the long run. This could be an investing strategy as simple as buying and holding the S&P 500. Or it could be a trading strategy that after many trades produces an overall profit. Some of the trades will be winners, and some will be losers, but being a winning strategy means that over time, the profits more than offset the losses.

This is what we mean by consistency when it comes to trading and investing. Not every day is an up day for the S&P 500. Not every week or month or even year is a winner for the market. But overall, statistically, on average, the market consistently returns about 10% a year. Likewise, not every trade in an ongoing, employed trading strategy is a winning trade. And some weeks or months are "draw down" periods where the strategy has too many losing trades in the period or too big of losing trades. But if the strategy is consistent, it can be relied upon to make money after many, many trades.

This book will help you learn to consistently generate alpha to beat the market on your long-term investing strategy by overlaying the buy-and-hold strategy with options trades. "What are options?" you may ask. That's the subject of the next chapter. Get ready to soak it all in. If you're already familiar with options, consider the next chapter a quick review and an opportunity to maybe pick up on something you don't already know.