“Long Straddle” on American Express (AXP) ahead of Q3 Earnings – Cassel Robson

Overview of American Express

American Express is a stock I have been following for a while, a prominent player in the credit card industry, and has several strengths, including a substantial market share (13.3% in 2021, second to Chase Bank, based on purchase volume), and a focus on prime and super prime borrowers and business customers. The company has diverse revenue sources, the main being discount revenue, primarily represented by earnings on transactions that take place with partner merchants, but it also generates revenue from cardholders' membership fees, interest on outstanding balances, and conversion fees. AMEX uses a model aimed at growing the number of overall transactions on its cards through special offers and relatively low fees. Additionally, the recent acquisition of Kabbage (2020) extends its reach into small business lending.

Activity surrounding past earnings calls

I am pitching a “Long Straddle” on American Express (AXP) before their October 20th Q3 earnings call. The firm has been hit or miss on earnings estimates with earnings surprises of 2.7%, -9%, -7%, and 2.8% on their last 4 earnings calls from Q2 of this year to Q3 of last year. After the release of earnings, the share price has moved anywhere from -14.08% and 10.57% at maximum, and 4-5% at minimum, quite randomly and in either direction with no correlation to the earnings surprise, therefore it is difficult to predict what direction the underlying stock will move after the earnings call, only that the volatility of the stock has increased significantly after each earnings release over the past year. A long straddle is effective here as by buying both a call and a put option at the same strike price and expiration date, you create a delta-neutral position as their respective delta values cancel each other out.

Looking at the IV30 (30-day implied volatility) of AXP options before earnings calls historically, the values have ranged from 40.8 - 25.4, days before the last 4 earnings calls, and dropped significantly after the call. However, if we're not confident that the price move will be enough to cover the premiums, we can sell the option before earnings call and cover our losses with the rise in implied volatility as the earnings call approaches and the value of the options increases at the rate of their respective vega (v) rates.

Execution of the straddle

Execute 7 days before Q3 earnings call (Oct 13, 2023) – takes advantage of the build-up in implied volatility

Buy an ATM call option on AXP exp. October 27th – expiration 7 days after the earnings call minimizes theta decay

Buy an ATM put option on AXP exp. October 27th

Monitoring the Position

If the underlying share price has moved significantly in one direction during the time between the purchase of the options and the earnings call, you can consider rolling one or both of your options to a strike price that is closer to the new ATM level.

If the underlying stock has moved strongly in one direction during the time between the purchase of the options and the earnings call, and there is sufficient evidence that it will continue to move in that direction after the earnings call, may choose one leg of the straddle, and delta hedge. For example, if there is evidence that the stock is going to continue to boost positively after the earnings call, we can short the underlying stock to hedge our call option which would be in-the-money. But we would hedge here because the share price has been unpredictable after earnings historically in an attempt to limit the directional risk of the position.

Exit

With this kind of position, it is important to closely monitor the share price and implied volatility before and after the earnings call. The goal is to exercise the in-the-money option, whichever that may be, shortly after the earnings announcement, when the target intrinsic value of the dominant leg of the straddle has been reached, as implied volatility drops substantially after earnings events. A bearish target may sit around 4% change in the underlying share price, a bullish target would be in the range of 10-14% based on activity surrounding past earnings calls.

The risk with this position is limited to the premiums paid for the options, which can be substantial in some cases. If the underlying stock holds steady after the earnings call, the options will lose their value quickly.