EARNINGS AS AN ASSET CLASS

Directly trade and hedge financial statement metrics

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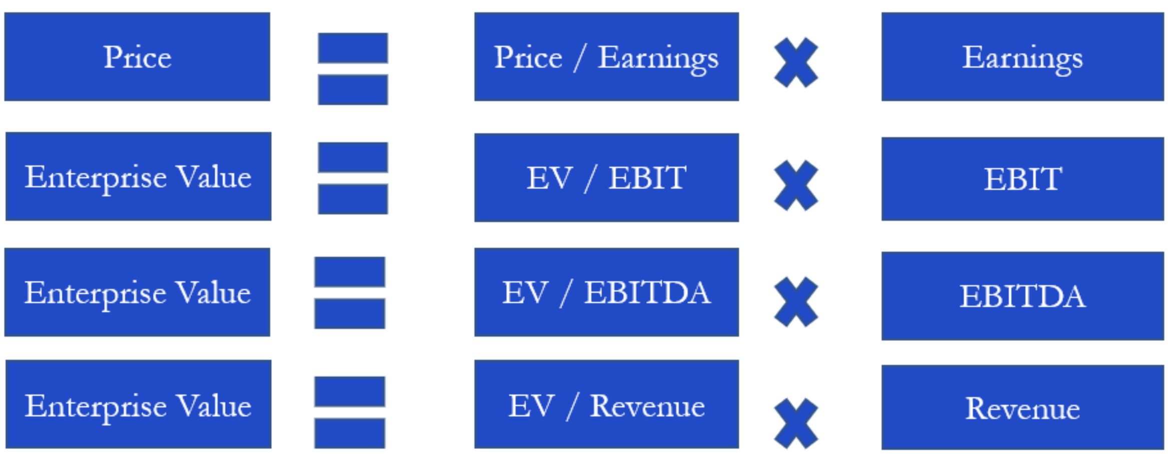
Earnings as an Asset Class

Investment analysts are intensely focused on quarterly earnings; yet the relationship between earnings and stock returns is volatile and inconsistent, especially over shorter time periods. At long last, Earnings Derivatives® turn earnings into an investable asset class. The same tool works for other financial metrics such as revenue, EBITDA, and operating income. This makes it possible to invest in value drivers individually or to hedge stock portfolios against earnings surprises. Earnings Power Indexing extends this tool to industries, sectors, and themes. Sophisticated investors will find myriad opportunities for alpha generation and risk management.

Drivers of Equity Returns

At the most basic level, investors can decompose the total return from any security into changes in corporate performance and changes in the valuation multiple placed on that measure by the market. Put differently, the price of a stock at any given time is equal to a fundamental operating metric, times the market's multiple on that metric. Metrics might go in and out of favor, and vary across industries, but the concept stays the same.



When purchasing a stock, you must express a thesis (either directly or indirectly) on both future earnings and future multiples. Yet earnings and multiples often trend in opposite directions for companies, industries, and the broader market. Historical stock market multiples have varied widely. Correctly predicting future earnings is of little value to an investor if multiples move in an unexpected direction. The trailing P/E ratio of the S&P 500 has ranged from 5.9 to 122, between 1927 and 2019. If investors expect earnings to decline, multiples will contract. Yet multiples are also driven by exogenous, non-fundamental factors.

Sometimes trends in equity value drivers cancel each other out. A company might meet earnings expectations, but then issue negative guidance. Or investor sentiment towards a sector might be negative in spite of stellar fundamentals of a particular company. On the other hand, sometimes a stock with weak business prospects will soar due to investor focus on non-standard metrics. How then can funds use their earnings insights to achieve higher returns?

Earnings derivatives make it possible to isolate investment exposure to underlying company fundamentals. Untangling individual value drivers into separate investment products creates myriad new ways to hedge risk and generate non-correlated returns.

How Earnings Derivatives Work

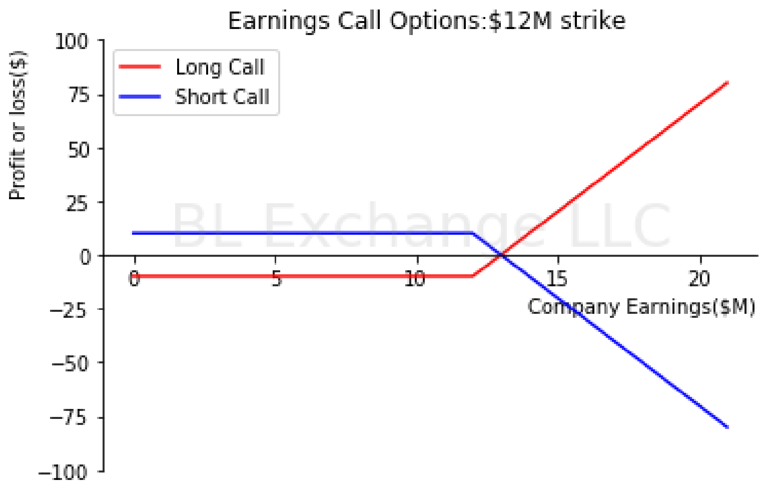
Earnings derivatives function as cash-settled options, with expiration dates that coincide with the release of company earnings reports.

Example (Call Option Investment):

John Jones is bullish on a company's earnings and wants to isolate his exposure to earnings growth. Sell-side analysts expect the company to report $10 million in annual earnings, but he believes it will be significantly higher. He can buy a call option on the earnings stream 20% above the projected earnings ($12m) for $10. This $10 option premium entitles John to "buy" $100 worth of earnings at $120. An investor with a bearish view or the need to hedge a stock position can generate income by selling the standardized option contract to John. The price of premiums, which represent the right to "buy" $100 worth of earnings at the designated strike price, will fluctuate based on supply/demand in the market as investors adjust expectations for company earnings.

- If earnings are $13m, John breaks even ($130 per $100 worth of earnings, less the strike of $120 and less the cost of $10).
- If earnings are $20m, John makes $70 in profit, a 7x multiple ($200 per $100 worth of earnings, less the strike of $120 and less the cost of $10).
- If earnings are less than $10 million, John loses the $10.

As with all options products, the long and short payouts are mirror images.



Metrics available for earnings options include the following:

- GAAP Revenue
- GAAP Operating Earnings
- EBITDA (standardized calculation)
- GAAP Earnings

Our patent pending methodology turns separate return drivers into individual tradable assets. We currently have several equity options and index products under development. Our methodology can also be used for futures and swaps.

Portfolio Use Cases

The dynamics of earnings trends create opportunities across asset classes. Generating alpha requires looking beyond basic equity positions to exploit the rich opportunity set in every earnings announcement. Earnings derivatives can be used by sophisticated investors as a tool for alpha generation and risk management.

<u>Investing</u>

Maximize Risk/Reward Tradeoff from Fundamental Analysis

Earnings derivatives are a pure, leveraged bet on business fundamentals. If one has a unique edge in predicting upcoming earnings, then buying a put or call on the earnings number might be a better choice than buying stock directly. By licensing our index products, you can implement similar views across entire industries.

See: Making the most of earnings surprises

Maximize Risk/Reward Tradeoff from Sentiment Analysis

If an investor wants to make an investment based purely on expectation of expanding multiples (i.e. improving investor sentiment), they can sell an earnings derivative to lower the cost of owning the stock. In this case, the investor would purchase the stock, and then sell an option on the earnings, thereby isolating their investment exposure to improving sentiment.

Invest in Earnings Growth while Avoiding Dilution Caused by Share Term Issuance

Many industries are notorious for diluting equity investors as they grow. Tech companies and resource companies, for example, typically issue large quantities of stock to employees. Consequently, even if the company grows revenue on a per share basis, early investors don't benefit. Since earnings derivatives based on single companies and on indexes use aggregate metrics, outside investors can effectively take part in growth while sidestepping dilution.

Separate Fundamentals from Sentiment

Investors can use earnings derivatives to express fundamental views on "battleground" stocks and sectors that trade on sentiment or non-standard financial metrics.

Make Granular Financial Statement Predictions

Imagine a situation where a company might beat on revenue and miss on earnings (or vice versa). In this case an investor can buy calls and/or sell puts on revenue, and buy a put and/or sell a call on earnings. In addition to investing directly in earnings, investors can also make predictions on debt paydown/interest cost, margins, write-downs, and sales growth, all which flow through to the earnings number. With a little bit of math, investors can use earnings derivatives to express views on granular financial statement insights related to regulatory changes or micro-level events. For skilled financial analysts, the possibilities for alpha generation are practically endless.

Global Macro Investing

Earnings Power Indexing applies the earnings derivative concept to select industries and sectors. BLX Global Indexes are calculated based on the aggregate trailing 12-month financial metrics of component companies. By trading options on these indexes, investors can express pure fundamental macro views.

Risk Management

Hedge Against Declining Fundamentals in Momentum Stocks

Popular momentum stocks can reverse dramatically following an unexpectedly negative earnings report. By purchasing puts on revenue, earnings, or other metrics, an investor can hedge more effectively than with options directly on the actual stock.

Hedge Short-Term Earnings Volatility

Great companies sometimes go through bad quarters. Important developments in business occur over many years and decades. Yet companies report financial information every quarter. Oftentimes, important company initiatives negatively impact short-term earnings, but lead to long-term company outperformance. This creates a paradox for investors that want to hold a long-term stock position for many years. Luckily, earnings derivatives allow long-term stock investors to hedge short-term earnings fluctuations.

By purchasing longer dated options on earnings, an investor is able to leverage the portfolio while minimizing portfolio volatility. Similarly, if you believe a company is going to perform well in the long term, but experience short-term earnings dips, you can use a put option on near-term company earnings to hedge. With earnings derivatives, it is a lot easier to support companies through turnarounds, and to back executives that make long-term investments in the growth of the U.S. economy.

Hedge Against Industry-Wide Slowdowns

A large portion of an individual stock's short- to medium-term performance is heavily impacted by market perceptions of its industry, and broader industry performance. Solid value stocks can be hidden in declining, out of favor industries, and perform poorly in spite of solid earnings since its peers' poorer performance drives ETF flows out of the entire industry. By pairing an individual stock position with a put on the earnings of the broader industry, an investor improves their risk/reward tradeoff. Companies can also use derivatives on BLX Global Indexes to hedge against industry downturns, potentially avoiding legal complications of taking short positions in their own stock, or the stock of their peers.

About BLX Global

BLX Global Markets develops and licenses innovative financial products. Our offerings are centered around Earnings Derivatives®, which allow investors to make direct investments in company earnings streams, and express granular views on individual value drivers. The ability to turn bottom line financial metrics into tradeable and hedgeable assets makes our patent pending system unique. We provide a full spectrum of index and derivative products for exchanges, investment banks, and asset managers around the world.

Our methodology and indexes can be used for the following:

- Structured Products
- Exchange Traded Notes (ETNs)
- Futures and Options
- Swaps
- Annuities and Insurance Contracts

Parties interested in licensing agreements or the creation of custom products should contact: jacob@blxglobal.com