First Solar: A High-Return Strategy For The Long-Term Investor

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Disclosure: I am long FSLR. **(More...)**

Buy and hold in combination with an Option-Strategy, in order to profit from the asymmetric risk profile of $FSLR.

Profit from the high volatility through selling of cash backed naked puts and/or selling covered call options.

Summary

- FSLR has an asymmetric risk profile – a low possibility 30% downside but a more likely 2X to 3X return.
- FSLR quarterly earnings are likely to be highly unpredictable and erratic due to the nature of its project business.
- A savvy long-term investor can exploit the above two dynamics to increase investment returns.

We have made the case in our earlier articles on why we believe solar energy is a high-growth industry for the next decade and how First Solar Inc (FSLR) is well-positioned to benefit from the growth in the solar industry.
Fundamental to the investment thesis in this article is the conviction that FSLR's downside is limited. With a strong balance sheet and substantial amount of cash and project assets on hand, we believe FSLR has an asymmetric risk profile - a low possibility 30% downside but a more likely 2X to 3X return. In this article we review some strategies that comprehend this risk profile and help maximize the return of your FSLR investment.

Buy and hold: This is the simplest and most basic of the investment choices and we believe offers the best returns for passive long-term investors. Investors can enter FSLR by starting with a small position consistent with portfolio and progressively add to the position over time. We expect FSLR to be an excellent investment until FSLR fails to execute and loses its competitive edge or until solar industry growth mellows down. Either of those events would be a natural exit point for the investment.

While simple buy-and-hold is by far the best investment strategy for most investors, a savvier and a more active investor must consider using the volatility of FSLR to his benefit. The reason for this has to do with the nature of FSLR's core project business.

Due to the high risk of delays and the lumpiness of project business, FSLR quarterly earnings are highly unpredictable and erratic. A delay in a big project can adversely affect quarterly earnings. On the other hand, an unforecasted upside in the module business can cause a significant jump in the earnings. Consequently, FSLR stock has a large tendency to jump or nosedive after the company announces earnings. While these short-term swings may be of no concern to long-term holders, they create excellent wealth creation opportunities.

Let's start by looking at the volatility metrics of FSLR. The first observation is that the historic volatility of FSLR tends to be in the 0.5 to 0.6 range - this high volatility number clearly makes FSLR a good candidate for implementing options-based strategies. The second observation is that the implied volatilities of FSLR options are even higher - especially around earnings time and analyst days. Typical volatility before major news for FSLR options tends to be in the 0.7 to 0.9 range and sometimes higher. With a bit of planning, it is easy to exploit the short-term options market for an additional income stream or to build a lower cost long-term position.

To exploit this options volatility and the resulting options premium, here are two simple and basic FSLR investment strategies to consider in addition to buy-and-hold. These two strategies, while seeking to exploit short-term imperfections in the market, are not speculative, and consistent with long-term investing:

Entry through cash backed naked puts: A great time to enter FSLR or to augment FSLR position would be through selling cash backed naked puts. Based on past options history, an entry point about a week before the earnings date would afford the seller a high volatility premium. A good rule of thumb for right time to sell these puts would be when the implied volatility on the desired option crosses the 0.7 mark. The strike price can depend on the investor's desire for low-risk income versus the investor's desire to enter the stock position.

If the put gets exercised, the investor would have FSLR at lower cost basis than he would otherwise have had. If the put does not get exercised then the option trade can be repeated.

Investment Philosophy	Timing of the option		
	Away From Earnings	Close To Earnings	Close To Analyst Day

Build Position	Strike Price Close to Market	Strike Price 5% Below Market	Strike Price 10% Below Market
Low Risk Income	Strike Price 5% Below Market	Strike Price 10% Below Market	Strike Price 15% Below Market

Desirable Strike Price Matrix

Income through recurring covered call: Once again, it is FSLR's high volatility that makes this an attractive option. This strategy may not be ideal for long-term investors who are looking to protect their position from being called away and are concerned about protecting long-term capital gains rates. However, this strategy can be attractive for investors who are willing to create a core long-term position and a parallel income-based position.

The ideal time to sell covered call options for FSLR is about a week before the expected earnings announcement or about a week before the analyst day. Again a good rule of thumb for the right time to sell these calls would be when the implied volatility on the desired option crosses the 0.7 mark. Given the high level of uncertainty and the asymmetric risk of FSLR, the chances of the underlying position getting called away are high if the strike price is close to the trading level of the stock. Depending on the need for income versus the need to protect against losing the underlying position, investors can consider the following strike price possibilities.

Investment Philosophy	**Timing of the option**		
	Away From Earnings	**Close To Earnings**	**Close To Analyst Day**
Aggressive Income	Strike Price Close to Market	Strike Price 10% Above Market	Strike Price 20% Above Market
Protect Position	Strike Price 10% Above Market	Strike Price 20% Above Market	Strike Price 30% Above Market

Desirable Strike Price Matrix

The above strike price targets give the investor a good chance of benefiting from the continued run in the stock while generating income. If the stock makes a big move and the underlying position gets called away, then the investor can rebuild the entry by selling cash backed naked puts.

The above option strategies can give a committed long-term investors a higher return on investment than a simple buy-and-hold strategy. Considering asymmetric FSLR's risk profile, savvy long-term investors can use the unpredictable nature of FSLR quarterly results to enhance their returns with relatively small downside risk.

Note: These investment strategies are based on personal experience and are not recommendations. The strike price examples are not based on precise mathematical calculations but more on a general view of FSLR option behavior. The options strategies mentioned in this article, though basic, require an active investment style and a deep understanding of options. These strategies are not advisable for most investors. For most investors, a simple buy-and-hold strategy would give the best long term returns.