LISTED OPTIONS

No Place Like Home

OIC The Options Industry Council

Investing habits are formidable.

And you trust what you know—ETFs, mutual funds, the universe of structured products and more—because they've consistently performed.

Naturally what's new or different in the market can seem scary. Risky. Mysterious. So you mentally tuck the more esoteric stuff behind the curtain where it's easy to ignore 'cause day by day you're dealing with a million flying monkeys. And of course there's a lot at stake should you risk more and earn less (your clients and reputation, for starters).

The world naturally exhausts itself pursuing alpha. Clients long-term prefer some ideal yellow-brick-road scenario while the market often delivers tornadoes. Are the returns you desire inevitably over the rainbow? Must you use every last frequent-flyer point to reach just the right investing protocol? At the closing bell is the stuff behind the curtain really that weird?

MUNCHKINS NEED LOVE, TOO

As a class of investment solutions, structured products have helped to carry the water for some time. Some solutions promise the ideal formula—enhanced returns, greater diversification, low vol. Yet no investment is just right for everyone. And because some structured vehicles are generally not liquid, carry longer maturity, and can involve counter-party risk, a growing class of advisors are taking the time to investigate listed options, which leverage similar risk-reward dynamics minus the leaks.

Best of all, listed options play well with others. They align easily with diverse strategies and over time may be cheaper and safer. In theory, merged investing approaches can deliver better results. Structured products alone are sometimes ideal. But in many cases, adding listed options to the mix can support the hunt for alpha in myriad ways. But first, a bit of aeronautics.

STRUCTURED PRODUCTS: CAN STOP FLYING HOUSES

First created for institutional investors, structured products are available to the high net worth, financial advisors, and in some cases, retail investors. Sometimes called structured investments, historically they've helped investors diversify and potentially enhance returns. They're often marketed by the issuer or distributor, have no exchange listing, and are not cleared through central parties.

Typically, a structured product's core asset is a CD or bond linked to an option on a second underlying asset or assets—i.e., equities, fixed income, currencies, commodities, or interest-rate products. Some structured solutions promise full or partial principal protection in exchange for capped upside in the underlying portfolio. Others offer limited or no principal protection, but greater participation if the growth component of the structured investment outperforms.

Risks and rewards for structured investments can vary widely. In a period of low interest rates and lots more alpha pressure, the perks of structured investments have been appealing to both advisors and their clients. Indeed, solutions exist that suit nearly every level of risk tolerance.

While structured products often make sense on the surface, not all flying balloons are created equal.

1. LIQUIDITY. Structured products can have "lock-up" periods that keep investors from their funds beyond the initial investment. Even after lock-up expires, maturity periods can be long. And since many structured products trade in illiquid, over-the-counter markets, investors might encounter high trading costs should they want to sell prior to maturity.

2. COSTS. Excess costs stem from the way a product is "bundled" or "packaged." At issuance, a structure value is estimated or calculated based on assets. The issuer generally raises the value by a spread to arrive at a product's offering price. Over the product's life, the spread price paid by the investor captures hedging costs, as well as the issuer's profit. But buyer beware. According to FINRA, "the hidden costs of purchasing virtually any structured product include the possibility that you could have assembled a similar bundle of investments on your own at a lower cost—and potentially with higher returns."

3. RISK. An issuer typically guarantees a structured product, while principal protection hinges on the issuer's ability to pay at maturity. A given product name might sound reassuring— "principal protection," "absolute return," "minimum return," and "capital guarantee." Yet structured products are not risk-free. Repayment depends solely on whether the issuer is creditworthy. In other words, an investor can lose it all if the issuer runs into financial problems or goes bankrupt, as we saw dramatically in 2008.

While structured products certainly have their virtues, their limitations might be reason enough to explore alternatives for risk-averse clients. In many cases, listed options can be a strong addition to a structured portfolio so investments are not compromised, and that crazy upside-down hourglass is never in the mix.

RUBY SLIPPERS: LISTED OPTIONS IN ACTION

According to recent trends, growing numbers of financial advisors are pursuing alpha through listed options. And they're doing so thoughtfully. The options world can feel overwhelming. Sub-advisors are a class of specialists with deep expertise to whom advisors are turning for guidance as they grow more comfortable with options strategies broadly. And thanks to more public awareness and greater financial literacy, clients themselves are asking advisors to engage options in their portfolios.

For example, an investor with a large concentration in a single stock from an employer, an inheritance, or even a buyout of their business by a publically-traded firm might want to structure trades around that position rather than liquidate it. A "collar" is one way to help that client structure a protective position around the stock holding. This strategy involves selling an out-of-the-money call (where the strike price of the call is above the stock price) and buying an out-of-the-money put (where the strike price of the put is below the stock price). (See Figure 1.)

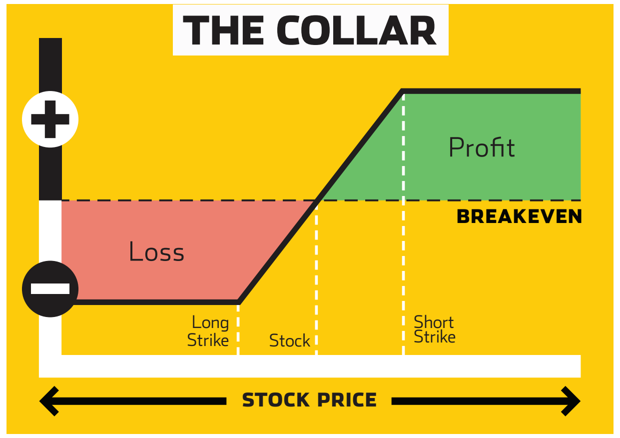

Figure 1: The Collar. When your clients are overweighted in a single stock, with the use of options, the protective collar caps the loss while leaving room to run—for next to nothing.

The strategy combines two options strategies around a stock to hedge risk and enhance returns. The investor typically buys a put on the underlying stock with a strike price below the stock's share price, which offers downside protection if shares fall. This strategy itself is sometimes called a "protective put." To fund that protection, the investor sells a call option with a strike price above the current share price. That, in turn, is called a "covered call." The degree of protection depends on the strike price of the put. The potential upside will be limited by the strike of the calls, as shares will be sold or "called" away if the stock moves beyond that level. Income can be generated when the premium from the call is greater than the cost of the put. The investor collects any dividends along the way as well.

STORMING THE GATES OF THE EMERALD CITY

If you're wondering if your peers are working with listed options, according to a May 2014 Bellomy Research study commissioned by The Options Industry Council, the number of advisors using options has risen from 48% in 2011, to 61% in 2014. The study included more than 600 advisors from wire houses, banks, insurance companies, fee-only planners, and independent research investment advisors. Why the shift? Two-thirds of those surveyed said low interest rates coupled with the expectation of rising rates played a part. In a second question, 48% of respondents said they planned to increase their use of options, that number up from 44% in 2011.

Obviously there are myriad ways options can help you manage risk and gain exposure to certain asset classes. It's also possible to "bundle" options with other investments to create risk-reward scenarios that mirror structured investments.

For instance, a structured note offering principal protection might include pairing a zero-coupon bond that pays neither interest nor principal until the bond matures, with an option or other derivative product whose payoff is linked to a second underlying asset. Creating the same payoff with zero-coupon bonds and options on the S&P 500, a commodity ETF, or a currency pair, potentially offers the same solution with less cost in more liquid markets. Investors receive 100% of the initial investment at maturity, plus any gains from the options-contract position.

Michael Cavanaugh, a Principal at RCM Wealth Advisors in Chicago, goes deeper. The Reverse Convertible is a structured product that includes both a debt instrument and a short-put option. The option is usually at-the-money, where the strike price is near the existing share price. If the price of the underlying asset stays stable, the investor benefits from the decay of the puts, and also receives income from the debt. On the other hand, the Reverse Convertible also has a predetermined knock-in level. If the stock falls below that price, the issuer can pay the investor back in the form of the depreciated shares. So there is limited upside opportunity in a Reverse Convertible as well as downside risk.

Mr. Cavanaugh suggests some of the Reverse Convertible notes charge relatively high fees and also scalp a percentage of the put premium. In this case, the investor could essentially do the same position merely by selling cash-secured puts—that is, selling put options on a stock and stand willing to buy the stock, using cash in their trading account, at the strike price of the contract if shares trade lower through the expiration.

Dominick Paoloni, Founder and CIO at IPS Strategic Capital, also uses puts and calls extensively when seeking alpha for clients. "Options allow us to build structures with specific time frames and defined risk." The goal is to "systematically control risk" while also looking for opportunities for income and/or capital appreciation.

At the same time, Mr. Paoloni understands the challenges advisors face when turning to listed options for opportunities. For instance, a common approach is to buy put options on the S&P 500 or other index products to hedge risk, which can create a drag on performance due to the fact that options are wasting assets and suffer from time decay.

Instead, he often prefers to invest the bulk of a client's assets in a fixed income portfolio, like a corporate bond fund with a relatively predictable yield to maturity, and a much smaller percentage in longer-dated options contracts. "$1 million into S&P 500 options is risky and can get you sued," Mr. Paoloni explained in a phone interview.

ONE ALPHA JOURNEY, MANY BROOMSTICKS

Consistently, advisors must work to match investment solutions to longer-term client objectives and larger portfolios. Structured products can make sense in lots of situations and might be worth the extra fees and the various downsides. Yet, given rising risk/return concerns, reliable alpha is for many but one priority. Advisors are increasingly finding solutions in the listed-options market, where trading in thousands of securities is often more cost effective, liquid, and transparent. With a little patience, education, and the guidance of a sub-advisor who can help you manage hedges, what felt daunting can soon become routine.

After all, getting out of that scary witch castle is a snap once someone hands you the map and a hose.

—Words by Frederic Ruffy

The Options Market Today

U.S.-listed-options trading started in 1973 on the Chicago Board Options Exchange [CBOE]. Ten years later, S&P 100® Index (.OEX) options started trading. Today, the biggest markets on the CBOE are the S&P 500® Index (.SPX) and CBOE Volatility Index® (.VIX®) trading pits—proprietary products listed exclusively on the Chicago exchange.

In addition to CBOE, 11 other exchanges make markets in listed options. Average daily volume (as of November 2014) was roughly 17 million contracts. Equity, exchange-traded funds [ETFs], and many index options list across multiple exchanges. Along with CBOE, the International Securities Exchange, NASDAQ OMX PHLX and New York Stock Exchange capture most of the daily options flow.

Meanwhile, The Options Clearing Corporation [OCC] serves as the central clearing facility for US-listed options trading. In addition to clearing for the above exchanges, OCC also serves markets like commodities futures, commodities options, and securities futures. OCC operates under the jurisdiction of both the SEC and the CFTC, and as a guarantor ensures that the terms of its cleared contracts are fulfilled.

At the same time many brokerage firms over the years have improved their online and offline options-trading tools to help advisors initiate certain strategies for their customers. TD Ameritrade, for instance, offers advanced technology for advisors and other institutional investors through its ThinkPipe platform. With a few mouse clicks advisors can implement both simple and complex options positions, even across multiple client portfolios.