SPONSORED FEATURE

PWM EXPERT SERIES
PROFESSIONAL WEALTH MANAGEMENT

Using options in portfolio management

Gary Delany, director of European Marketing and Education for the Options Industry Council, talks to PWM's Yuri Bender about the advantages and pitfalls of trading US-listed equity options and how they can be best used within investment strategies

Q Why should wealth managers trade US-listed equity options instead of buying potentially safer US mutual funds?

A There are a number of reasons. Firstly, the equity options are extremely liquid and transparent, so you can see how the product is constructed, you can mark to market and you can trade in and out. Also, options give you a non-linear return, so you can structure the product you're trading by using varieties of puts and calls.

A put gives the owner the right to 'put away' or sell the underlying, or part of it, at a set price before a specified date. A call is the opposite, giving the owner the option to 'call' the stock, or buy it. You can do that at the same price as the current market price, so called 'at the money', or you can do it at strike prices – exercise prices – above or below the market. So options can be 'at', 'out' or 'in' the money.

In addition to that, you've got a variety of maturities.

If you were to look at the underlying as being black or white, depending whether it's making a profit or a loss, you could say options give you – I won't say 50 Shades of Grey – but many shades of grey to mirror what you're trying to do.

Q Are there risks attached to the trading of options which might not be there if you were trading the underlying stocks?

A It depends on what you are doing. If you are writing options – that is taking on an obligation, saying, "If the market moves against me I'm committed to do this," I suppose you could say that that was a risk. But is that really more risky than holding the underlying and having it go against you?

Q Was there a time when you would start talking about derivatives and the potential clients you were explaining these instruments to would show you the door and say, "We don't want to expose our clients to these risky products. End of conversation."

A That is absolutely right. I've been working in the options space for over 30 years and if you had this conversation with potential users in the past, some of them would say, "Options or futures? Oh, I'm sorry, we don't speculate." And would show you the door.

But we have come a long way since then and 'derivaphobia', if I may term it this way, has ebbed, although of course the financial crisis of 2008 probably threw some more petrol on the fire.

Q How does the transaction actually work for the customer?

A In the US there are 12 US equity option exchanges, each with their own pricing metrics. In the case of small to middle-sized orders, customers haven't got to decide which exchange to go to, they can just go to a smart order router, which executes the order for them. So the multiplicity of exchanges shouldn't deter people from using the market. Larger, big institutional orders tend to be executed by phone.

Q Which of your client segments are using options most? Hedge fund managers, traditional asset managers or those managing private wealth?

A From studies we commissioned from analytics firm TABB Group emerge that European order flow represents around 10 per cent of our total volume. Of this, about 55 per cent comes from hedge funds. Private wealth managers account for 21 per cent of the European business, up from 18 per cent in 2011. Proprietary trading is 14 per cent. Vanilla asset managers and other users represent respectively 6 and 4 per cent of the European order flow.

Q Do you think private wealth managers can increase the use of options quite substantially?

A We have focused significantly on private wealth management in the US and we have had good success. On our website – optionseducation.org – a dedicated wealth management or financial adviser section includes tools or ideas to help wealth managers develop their business and use options in clients' portfolios.

For example, we talk about options as protection, or about increasing exposure to an underlying quickly. We talk about options as a way to increase the return on stocks, which has received a lot of interest particularly in this low-interest environment.

Q Wealth managers are being affected by a broad range of new regulations which are coming in and revolutionising their industry. MiFID in particular, is a headache for many wealth managers. How are these types of regulations affecting the use of options in portfolios?

A As more and more orders are pushed towards being centrally cleared, market users are becoming more relaxed with the fact that their exposure is with a clearing house. Our parent, the Options Clearing Corporation (OCC) handled about 4.2bn contracts last year.

I think we will see more and more people looking at the listed markets as a way of executing their business. The over the counter (OTC) market is another component. Although nothing is planned at the moment, it seems likely that more and more of the OTC products will be cleared, if not exchange traded.

Q US-listed options can be used in different strategies, such as exchange traded funds, volatility products or single stock products. Which ones are particularly relevant for private banking clients and how can options be used within these strategies?

A From the 2014 TABB report, we found that 100 per cent of people interviewed used directional plays – either for hedging or to increase exposure – about 60 per cent used volatility strategies and 60 per cent used premium generation income enhancement-type strategies.

Private wealth managers used a variety of those. If I'm looking to increase the return on my portfolio, I can hold the underlying, write a call on the back of that, which will give me then a premium income, for instance. If I'm worried about some explosion in volatility, there are lots of volatility products out there.

In Europe, indexes and volatility products seem to be the popular ones with a lesser focus on the individual vanilla options on, say, 100 underlying shares, but that makes sense.

Q Structured products were very fashionable before the financial crisis of 2008. In fact, they were probably the mainstay of wealth management and a key profit driver for many banks. Were those the glory years for you, where embedded options were the key highlights in structured products? Do you think we will ever get back to those days?

A It depends whether we want to see this as an opportunity or a threat. I would like to see it as an opportunity. The volume of structured products issued in Europe in 2007 was about $250bn. Since then it has decreased to about $100bn and the number of distributors has halved.

In the past, some of that volume found its way into our marketplace, some of it into the OTC market. What I like to think is happening now is that people are looking at the components of that and say, "Well, the option component was good there, it hasn't stopped being good but the way they are being built has perhaps changed."

I'm thinking of the regulatory trends which are moving the remuneration of fund managers from commissions to fees. We're already seeing an impact in the UK and in the Netherlands. In a way, you might argue that people are getting closer to the option product.

If you look at structured products, they are more 'set and forget'. An option product will need to be managed but markets are extremely liquid and flexible, allowing you to build many of the strategies formally available as structured products.

Q What type of feedback are you receiving from European wealth managers. What kind of trends do you anticipate?

A From the conversations we've had and the shape of regulation, I expect we will be seeing more products moving to a cleared basis, although this will take a while. Regulators cannot hit everything at the same time. I think people are becoming more used to dealing with a central counterparty, so that's a plus for us.

Weekly options have been very popular for short-term positioning. Volatility products, particularly from the Chicago Board Options Exchange, have received dramatic interest. Also, as you can trade an option on a wide range of underlyings, with ETFs developing, we have seen the options on ETF markets expanding.

Q How does the level of knowledge of European private bankers and wealth managers compare with that of their US counterparts?

A I don't have any direct statistics for that but I think European investors are 'at home' with the underlying, they are used to what's happening with, say, the fictitious stock X. An American investor would be probably quite familiar with stock X plus the option.

In the US, there is more of a history of self-directed investment compared to Europe. According to our 2011 study, around 92 per cent of respondents thought that options education was key to drive people to use the market more. That's why the Options Industry Council (OIC) has been set up.

The OIC is sponsored by the 12 US Equity Options Exchanges and the OCC, which is the world's largest equity derivatives clearing organisation. Our mission is very simple: it is to educate investors of all types about the pros but also the cons. We take the view that an educated investor is a better one. It's a continual process and effort, whether we're talking to retail, institutions, wealth managers or hedge funds. ●

To learn more about US-listed equity options and how to trade them, go to: http://www.optionseducation.org/en.html

Watch a video of this discussion on pwmnet.com

Published in association with

OIC The Options Industry Council
www.OptionsEducation.org