

Options Investing Strategies: The Drivers and Outlook for Pension Plans, Endowments, and Institutional Asset Managers



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Institutions and asset managers are beset by massive pressures in the wake of the financial crisis. Heightened risk sensitivity by investors and regulators alike, lower asset values, and the realization that lower returns may have become a fact of life are all weighing heavily on institutional funds and their money managers.

Regulators have tasked the asset management enterprise with improving transparency, not to mention insight, into risk-related activities. The fallout from the spectacular counterparty failures at Bear Stearns and Lehman Brothers and the whipsawing of equity values as a result of the crisis have made understanding the risks of investing a compelling concern for financial institutions.

Asset managers and their clients saw returns from most asset classes decline with alarming speed and severity. With traditionally uncorrelated assets suddenly tracking each other and the accepted rules of diversification no longer providing a safe haven, institutions have begun questioning the fundamental tenets of investing. If a pension portfolio is to generate returns sufficient to meet benefit and other obligations, it must find some way out of the performance quandary. With the prospect of continued volatility and decoupling of returns in coming years, institutions are seeking means to protect and enhance the values of portfolios they manage.

Given the severity of the crisis, it is no surprise that leading institutions are taking a hard look at their management and investing strategies, including instruments such as options that they might previously have considered off limits. As they seek to obtain higher-quality insight and transparency into risks, to control volatility, and to enhance portfolio returns by incorporating more robust management of the investing process, their responses are reshaping the investment business landscape.

This paper presents the analysis of a survey of 30 institutions and asset managers that TowerGroup conducted in April and May of 2010 to determine the investing challenges of options usage and institutions' responses to the challenges. The primary goal of the survey was to discern the role that options investing will play in institutional investors' strategies as they deal with powerful forces influencing the securities business.

The survey found some diversity of perceptions of options' place in institutional portfolios, but respondents largely agreed that risk control and, to a slightly lesser degree, performance enhancement should be the main thrusts of options use.

A preponderance of respondents (65%) is planning to expand their trading in options during this time of market transition. Rather than frightening institutions away from options, the financial crisis seems to have spurred them to look more closely at the potential benefits of options and other alternative instruments in enhancing returns and moderating risk in an institutional portfolio.

The survey was designed to inform and validate TowerGroup's ongoing research in securities and investments. Before presenting the detailed survey findings, we offer background analysis of the current state of options investing for institutions.

Institutions' Use of Options: Overall Trends and Outlook

In 2010, although asset values have recovered, institutions and asset managers still face major repercussions from the financial crisis of 2008-09. The impacts of the crisis continue in the form of performance pressure, a severe loss of the trust and confidence of clients and plan participants, the need for demonstrably better risk management, and a profoundly altered global regulatory environment.

Over the next 12-24 months, a number of the key drivers of the asset management business will have implications for institutions' investing strategies. Forced to adjust to lower fee revenue, asset managers will have to focus on improving their cost position. To protect their organizations and reestablish trust and credibility among investors and regulators, they will need to improve risk management and transparency. And to prepare for uncertain future regulation, markets, and business conditions, they will continue to incorporate various asset classes, albeit with more robust and flexible approaches to investment.

Several recent industry-driven changes are affecting institutional buyers' use of options. As the penny pilot enters its final stage, with nearly 90% of all options volume covered by penny pricing, many institutions are experiencing the downside of narrower spreads: Lower visible quoted volume is forcing large buyers to resort to over-the-counter (OTC) trading for large orders.

At the same time that spreads have narrowed, the buy side's acceptance of electronic and algorithmic trading tools for options has not caught up to the market. The situation contrasts with the transition of cash equities to decimal pricing in the early 2000s, when the arrival of electronic tools almost immediately precipitated a shift to smaller lot sizes that could easily be parceled out and executed electronically.

In large part because the buy side continues to rely on traditional phone-based interaction, electronic trading has not yet become an effective means of accumulating liquidity in the options marketplace. Block orders continue to be done by phone over-the-counter on an agency basis or via upstairs dealers making markets of the size a large institution needs.

In addition, the exchanges are reinforcing market makers' hegemony by moving aggressively to maker-taker pricing schemes. By these means, newer exchanges and even established ones have gained market share at the expense of other players. Eight major exchanges are currently

active in the options business, each pursuing all available means to take share away from the other venues. The exchanges hope to win market share by providing rebates to liquidity-supplying market makers, who then have added incentives to display large quotes on the offering exchange.

Liquidity-taking brokers executing customer orders are seeing their costs rise commensurately in offset to the benefits that market makers reap from rebates. Although some exchanges still allow retail investors to trade free of charge, the trend toward maker-taker seems unstoppable (by some estimates, it accounts for 50% or more of all options trading volume today). The trend has several implications for institutional investors.

In the context of penny pricing, maker-taker has shifted the balance of power in favor of large dealers, through whom institutions will be more likely to have to trade as principals or facilitators. With the boost to dealers' profits from maker-taker schemes following the narrowing of spreads as a result of penny pricing, dealers are now more likely to provide institutional-sized bids and offers as they step up to provide liquidity, which has declined noticeably under penny pricing.

Of some concern is the likelihood that institutions will become more dependent on large dealers for size. Because of the real or perceived conflict between dealers' proprietary trading activities and executions on behalf of clients, institutions have reason to continue to be cautious in their options dealings with the Street.

Nonetheless, the greater liquidity that dealers will likely provide in this new environment should compensate for the increased risk of conflicts. As the "new order" of buy side/sell side transacting falls into place, options trading will enter a phase of great innovation in institutional order flow – all the more profoundly and rapidly as managers get comfortable with automated trading tools.

The New Focus on Risk and Transparency

The risk management failures that led to the financial crisis will force a renewed and powerful emphasis on risk and transparency. As organizations in all lines of the securities business — institutions, asset managers, and Wall Street firms — come under closer scrutiny by internal and external parties, clarity and effective risk control will become gospel for managing the business. Past failures to manage counterparty and instrument risks will drive a redoubled focus on measuring, monitoring, and communicating risk information on exposures, governance approaches, and processes.

Two top priorities will affect the asset management enterprise. One is data management to enhance risk management intelligence. The other is improving the reporting infrastructure to address regulators', clients', and consultants' demands for more extensive and frequent information available in near real time. Master data management at the enterprise level is essential. Without consistent, accurate, and integrated data, money managers can do very little to obtain a clear line of sight into risks across the business. As firms address this critical and expensive need, the securities business as a whole will become more secure. Once these changes become codified in operations and regulatory oversight, institutions are more likely to come out of their shells and deem the risk/benefit trade-offs in alternative assets such as options to have become more favorable.

Regulators and market participants alike are stepping up their efforts to instill greater transparency and control of products, activities, participants, and the infrastructure as a whole, particularly as regards the derivatives business. Regulators are seeking greater visibility into areas ranging from trading to position reporting to counterparty exposure to valuations. The New York Federal Reserve Bank asserted in January 2010 that "the complexity and limited transparency of the [over-the-counter derivatives] market reinforced the potential for excessive risk-taking, as regulators did not have a clear view into how OTC derivatives were being traded."

The US financial reform legislation of 2010 includes rules to migrate as many OTC contracts as possible to be traded on an exchange and cleared centrally instead of between direct counterparties. The goal is to foster transparency (and more tightly controlled collateral management). Another objective is also to reduce counterparty exposure by forcing more instruments to clear via entities that regulators can oversee and on which they can enforce stronger capital requirements.

A handful of major banks (firms such as Citi, JP Morgan, Goldman Sachs, Credit Suisse and UBS) dominate OTC derivatives trading and thus still constitute the major systemic risk component the reforms seek to address. Shifting substantial OTC derivatives volume to central trading and clearing would buttress the argument that derivatives had become a "safer" asset class. (By some estimates, the shift of a minimum of 10–20% of volume would do so.) It could also open a wider set of product choices for institutions for which exchange listing is a desirable or even necessary investment attribute. As such safety initiatives become part of the fabric of alternatives investing, the perception of options will also improve.

The focus on risk and clarity will serve to set the derivatives business, including options, on a firmer footing, one that even cautious institutions will be able to accept. Even now, market participants are going back to deploying options strategies in customary ways as a means of enhancing returns and managing risk more effectively. They are doing so without an overweening fear of negative financial, reputational, or other fallout. Increased transparency and rigor around risk management will enable a new, more stable evolution of institutional options use.

Other Regulatory/Industry Impacts

Other industry initiatives of the recent past, such as portfolio margining and dollar increments, continue to have an impact on the use of options for institutional investment by making it easier to own and transact positions. The Securities and Exchange Commission's program reducing margin requirements for dealers, hedge funds, proprietary traders, and other market participants broadened the appeal of covered asset classes (e.g., listed options on single stocks, indices, exchange-traded funds (ETFs), etc.) for all investors, including institutions.

Dollar strike-price increments have also upped liquidity and demand. As the gaps for in- and out-of-the-money options became \$1.00 for options with strikes between \$1.00 and \$50.00, the instruments become more desirable in the same way that narrower quote spreads (e.g., decimalization, penny pricing) spurred trading activity.

Although improving liquidity and the appeal of options to traders and investors alike, these initiatives are still ancillary to institutional investors' concerns about options investing generally. Investor sentiment remains fragile in the wake of the searing financial crisis. Although risk profiles and usage of listed options diverge widely from those of OTC derivatives (the latter most

vividly associated with the crisis), the perception of options as a complicated and potentially risky asset class persists.

Regulators' number one goal at the moment is to increase investor confidence in all regulated markets. The options industry is striving to ensure that customers continue to find options a useful and appropriately regulated part of those markets. Improved liquidity will enhance options' credibility, but jump-starting their use by institutions will still take considerable effort by regulators and market participants alike. Regulators will need to solidify market mechanisms, and market participants will need to deepen their knowledge of options subject matter. As the crisis subsides, those efforts may bear fruit in greater use of options.

The Benefit from Improved Operations Architectures

The rollercoaster ride of the last two years may not repeat anytime soon, but the memory of market upheaval is still fresh in the minds of asset managers. They are anxious to create operational and technological architectures that have a strong foundation and can react quickly to a variety of market conditions and provide flexible output and cost structures.

To respond to still-evolving regulations, monitor counterparty and asset risk more closely than before, and introduce automation to make operations bulletproof, firms will need to leverage existing infrastructure and evolve flexible data and process architectures. For example, post-trade derivatives processing on the sell side has become more automated, less costly, and less error prone through technology approaches such as software as a service (SaaS) and outsourcing of critical reconciliations and risk and data management functions.

The buy side is not yet up to the same standard of automation but is moving rapidly in that direction. In the race to capture and retain business, they will be forced to do so. Managers must not only be high performing but also demonstrate that their infrastructure is robust, controlled, and risk averse. The ability to acquire a clean Statement of Audit Standards No. 70 (SAS70) Type II report is fast becoming table stakes for asset managers looking to compete in today's institutional markets.

These initiatives will serve to more tightly control the operational risks of managing all investments, including options. As processes around collateral management, reconciliations, and electronic trade confirmation and delivery become more robust and closer to real-time, the entire operating environment of both OTC and listed derivatives will evolve into one that will allay a still-meaningful concern of institutions, managers, and consultants.

Strategic Options Usage: The Direction and Implications for Institutions

Clearly, one of the most urgent forces affecting institutions and asset managers is the need to improve returns. Following a decade of virtually flat performance in traditional equities, combined with the shock treatment of the crisis, money managers of all stripes are aggressively pursuing new and creative means to enhance portfolio value in a risk-controlled way.

Options strategies such as collar overlays offer a means of achieving both improved returns and lower volatility. A recent study by the University of Massachusetts looking at the 10-year period leading up to mid-2009 (and several sub-periods during that time) showed annualized performance improvements on a collared portfolio (long puts/call writes) of the QQQ ETF of as

much as 15% compared to performance of an unhedged holding.¹ Despite the higher returns, volatility in terms of annualized standard deviation was reduced by nearly 2/3 on the protected portfolio. Similar results were observed on a small-cap mutual fund portfolio. In that case, the study ascertained a 7.5% per annum return advantage from a collared portfolio, again with nearly 2/3 lower volatility.

Although hedging strategies are by no means perfect or easy to undertake, the advantages of potential performance improvement are clearly more than worth the effort to understand and implement them. Investment mandates are being loosened by clients and their boards to allow greater exposure to hedge fund and other alternative asset strategies, albeit cautiously. Institutions are willing to try new or unfamiliar things but are approaching their due diligence with heightened rigor and sensitivity.

The Chicago Board Option Exchange's buy-write indexes and other new benchmarks related to collar and buy-write strategies have helped to codify the targets against which managers compare their performance. Such standards serve to legitimize and publicize the notion that options are no different from any other asset class and therefore are strong drivers of the "institutionalization" of the business.

The drumbeat of bad news regarding exotic strategies does not help the case being made in investment committees for anything associated with the term "derivatives," however. The perception is still strong that, despite certain advantages, options strategies carry the risk of catastrophic financial, reputational and, particularly, personal career damage if things go wrong. No one wants to be the CIO of the next Orange County or CalPERS.

The complexity of options strategies means that education and direct contact is still vitally important all along the value chain, from the broker and asset manager to the institutions to industry opinion leaders. Phone contact between the buy side and sell side is still the preferred means of interacting on executions: As little as 20% of options trading is done electronically, compared to 70–90% of equities trading. Even experienced users feel they need ongoing personal support and insight, given the intricacy of some strategies, the large number of instruments, and the challenge of accessing liquidity in more arcane securities.

The results of TowerGroup's survey of institutions and asset managers largely confirm a focus on risk and performance improvement. Across all respondents, a clear bias was evident toward options' value as a risk mitigation strategy. The survey participants were asked to indicate the three main uses for trading options. As Exhibit 1 shows, nearly 80% of respondents believe that options are principally a means of hedging portfolios. Over 60% of respondents believe that options represent a cash flow-neutral means of protecting a portfolio's downside (i.e., by a collar strategy of buying puts and selling calls). And 50% of respondents indicated they believe in using options to enhance returns (i.e., via covered call writing).

¹Edward Szado and Thomas Schneeweiss, "Loosening Your Collar: Alternative Implementations of QQQ Collars." Isenberg School of Management, University of Massachusetts, September 2009.

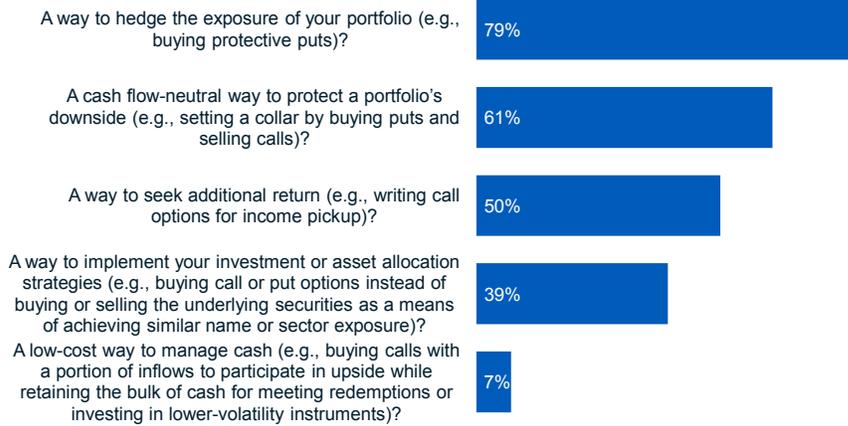
Exhibit 1



Survey Question:

What do you believe are the principal uses of options?

Percentage of respondents citing a use as among their top three



Source: TowerGroup Survey of Institutions and Asset Managers, April–May 2010

Exhibit 1

Exhibit 2 describes the concerns of organizations that are not using options (just under 1/3 of total respondents). Of this group, 2/3 cited the risks associated with the instruments or an institutional or cultural bias against them. The result suggests that nonusers still associate a real or a perceived threat with options.

Although roughly a third of nonusers cited investment mandate restrictions as one of their top three reasons for not using options, very few respondents were concerned about liquidity risk, complexity, or staffing or skills requirements, and only a small minority cited "headline risk" (bad publicity) as a major deterrent. Clearly, concerns over substantive risk and internal bias weigh more heavily on their minds. Respondents believe they can manage the knowledge and implementation requirements of options, but they want hard evidence that the risks generally are manageable.

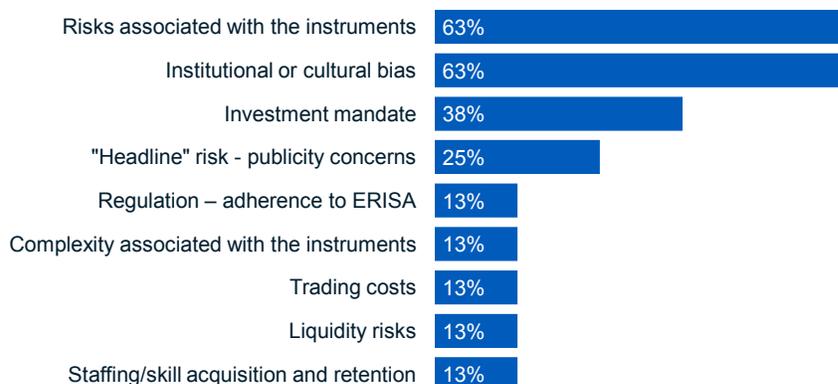
Exhibit 2

Survey Question:



If you are not currently using options, what are your organization's top three reasons for not doing so?

Percentage of respondents citing a reason as among their top three



Source: TowerGroup Survey of Institutions and Asset Managers, April–May 2010

Exhibit 2

Among users of options, a bias exists for listed options as opposed to the over-the-counter variety, again indicating a generally conservative orientation among institutions toward more liquid, less-arcaic instruments. As seen in Exhibit 3, 60% of firms engaging in options strategies use both listed and OTC, 40% use listed options only, and no organizations reported using OTC options only.

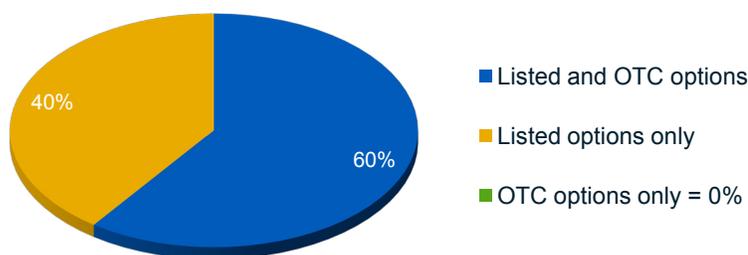
Exhibit 3

Survey Question:

Do you use listed or over-the-counter options as part of your investment strategy?



Percentage of respondents (N = 30)



Source: TowerGroup Survey of Institutional Investors, April–May 2010

Exhibit 3

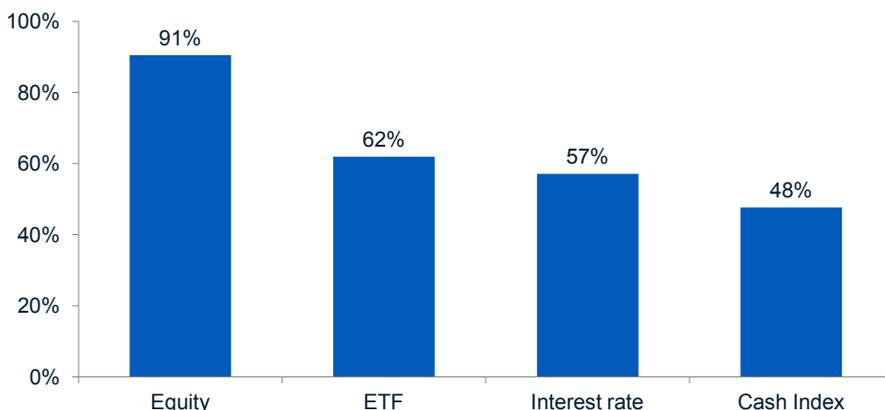
Exhibit 4 shows that 90% of institutions using options are availing themselves of equity options. Roughly 2/3 are using options on ETFs, and a significant proportion are using either cash index (48%) or interest rate options (57%). These findings highlight the prevalence of equity exposure in institutional portfolios as well as the breadth and depth of the associated options. With the rise of ETFs, the use of their options as a means of hedging other varieties of equity exposure has come into its own, as well.

Exhibit 4

Survey Question:

What types of options do you or your investment managers use?

Percentage of respondents (N = 30)



Source: TowerGroup Survey of Institutions and Asset Managers, April–May 2010

Exhibit 4

The survey results show that the substantive risks of options are still critical concerns for institutions. The buy side wants to understand what options can and cannot deliver to a portfolio and how they behave throughout the holding period, etc. The fashionable use and overuse of such strategies as portable alpha, leverage, and hedge fund exposure have given alternatives a bad reputation, often deservedly so. Insufficient due diligence on the part of fund managers and trustees, along with overreliance on the advice of third parties, brokers, and consultants, have been endemic. Failure to exercise the caution called for in pursuing unfamiliar or complex strategies has caused institutions to reap losses in a variety of alternative strategies far in excess of the losses the overall market experienced during the downturn.

For better or worse, the cost of building an infrastructure for trading, market data and risk management that supports options has often deterred institutions from entering the fray at all. Ironically such firms have thus avoided the dangers described above, but have also missed opportunities to outperform their benchmarks and their peers.

In the race for investors' mind-share, the post-crisis environment is extraordinarily sensitized to issues not only of trust and confidence but also of superior performance. A well-grounded understanding of the implications of options strategies, and competence in their use, are of paramount importance. A firm's inability to differentiate itself on the basis of advanced risk asset knowledge and performance means missed new business opportunities, at the very time when building share in new markets (and existing ones in turmoil) can be the difference between thriving and merely surviving the next evolution of the money management business.

The inability to harness data to fully understand and communicate both the risks and benefits of alternative investing approaches diminishes institutions' perception of the asset manager as a trustworthy counterparty. Clients, plan participants, and regulators (not to mention newly empowered C-level risk officers) demand a degree of transparency that many organizations are

not accustomed to providing - although they fail to do so at their peril. Overly long reporting timelines, delayed settlement or reconciliation processes, and a lack of real-time or near-real-time analytics for options exposure based on dependable data all undermine the firm's ability to make correct decisions and communicate them to key constituents. New product development involving alternatives is also limited by a firm's ability to aggregate multiple data inputs into a coherent framework for financial modeling, analysis, and delivery.

Ultimately, a weak infrastructure diminishes an institution's ability to do what it really needs to do: manage money to deliver the best possible performance for clients and sell its story to the marketplace in the most compelling manner possible.

With so many competing firms in the market, only a few instances of unsatisfactory answers to client or plan participant inquiries will put an institution on the defensive, or worse on the outgoing end of another transition. A firm that is unable to differentiate itself competitively on advanced asset-class knowledge will find itself adrift and will never win the performance race. A subpar grasp of these powerful investing tools threatens an organization's ability to project an image of skill and intelligence in the market, to maintain profits, and to pursue new opportunities. It may even threaten the firm's very survival. Portfolio managers have traditionally shied away from options or spent as little time as necessary dealing with them since they were seen as too risky or difficult to explain to clients and fund boards. Today, however, the thoughtful use of options is as important to ensuring the business's success as traditional money management itself.

What Institutions Should Do: Progressive Practices and Recommendations for Investors

To address the issues of competition and confidence faced by asset managers and the institutions they serve, as well as to respond most effectively to today's intensified risk sensitivity and business need for improved performance, cost control, and flexibility, institutions need to rethink how they approach alternatives investing in general and options investing in particular.

Leading organizations are engaging in straightforward strategies of collared hedging, but also educating themselves and engaging in more extensive use of options to enhance return and manage downside risk in highly volatile markets. Learning how to systematically harvest gains and cap risks from options investment strategies, and implementing a disciplined process to do so, mark institutions that wish to be seen as taking advantage of options in a well-founded and controlled manner.

Taking a lesson from institutions that have suffered at the hands of uninformed or unscrupulous dealers and other market participants, leading organizations have beefed up their due diligence on products and providers. They are implementing an options governance process, overseen by both risk and investment committees, to ensure that a highly structured and transparent options decision-making approach is followed at all times. Such an approach has the twin benefits of improving the institution's understanding of a given options strategy and demonstrating to clients, plan participants, and other outsiders that this unfamiliar asset class is being managed with appropriate care.

These same organizations have mastered the art and science of options investing and are able to articulate to clients and participants how their approach works and what benefits accrue to their portfolios. In this way, they are both educating and reassuring their constituents at a critical time in the investment world. They are also positioning themselves as subject matter experts and trusted advisors with whom clients can feel comfortable engaging in options investing.

To grow their options activities, these institutions are also building out the infrastructure and reengineering processes to eliminate manual steps, rekeying of data, and cumbersome hand-offs in trade processing and client reporting. They are implementing IT architectural approaches such as SaaS to replace legacy systems or manual processes with more agile and cost-effective ways of handling the options business. They are installing centralized repositories to aggregate siloed reference and other critical data, to service both routine processing and more advanced analytics and holistic risk position management. They are installing client and internal portals to make actionable information on options strategies readily available to clients and managers.

With such efforts, the best institutional investors are upgrading their knowledge as well as operational integrity and risk transparency while managing their options portfolios more cost effectively and servicing clients more richly. The highest-priority operations and IT initiatives with regard to options include:

- **Data management** to support counterparty risk management and asset valuations. The buy side has learned from the sell side's bitter experiences with Bear Stearns and Lehman bankruptcies.
- **Automating collateral management** with the sell side, beefing up counterparty monitoring, and managing security lending operations more tightly. Forward-thinking firms are moving from spreadsheets and faxes to robust automated platforms.
- **Subscribing to data standards and industry utilities.** This is a competitive advantage, particularly to asset managers that operate in multiple markets and asset classes. Leaders are connecting to industry utilities that help ease settlement inefficiencies and support reconciliation such as DTCC's Deriv/SERV and Omgeo's Central Trade Matching utility.
- **Automating infrastructure to report and assess risk exposures** internally and for clients and regulators. Because clients and consultants are demanding more frequent, detailed reporting, firms are standardizing what were once ad hoc reports, implementing client-facing customer relationship management applications or online client portals with dashboarding capabilities, etc.

It is clear that options have served institutions well in terms of reaching portfolio objectives. As depicted in Exhibit 5, fully 95% of respondents indicated that options strategies have been either reasonably or extremely effective in helping their organizations fulfill investment prerogatives.

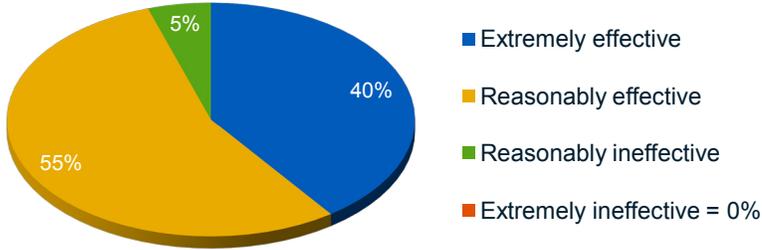
Exhibit 5



Survey Question:

How effective are options in helping you achieve your investment goals?

Percentage of respondents (N = 30)



Source: TowerGroup Survey of Institutions and Asset Managers, April–May 2010

Exhibit 5

Given that experience, institutions’ high propensity to expand options’ role in investment strategies should come as no surprise. As depicted in Exhibit 6, 65% of options users intend to moderately or significantly increase their use of the instruments.

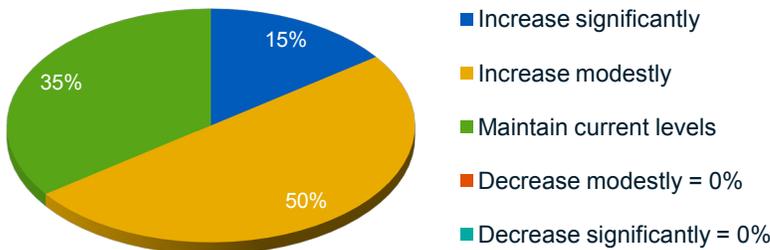
Exhibit 6



Survey Question:

Over the next 24 months are you planning to increase or decrease your use of options?

Percentage of respondents (N = 30)



Source: TowerGroup Survey of Institutions and Asset Managers, April–May 2010

Exhibit 6

Echoing the previous findings, the most compelling rationale for expanding options usage is risk control, as shown in Exhibit 7. 2/3 of survey respondents indicated that finding additional means of limiting risk was one of their top reasons for increasing their options commitment; 38% were also interested in finding a means of improving portfolio returns.

Exhibit 7

Survey Question:



If you are planning to increase your use of options over the next 24 months, what is the principal objective?

Percentage of respondents (N = 30)



Source: TowerGroup Survey of Institutions and Asset Managers, April–May 2010

Exhibit 7

A key element in leading institutions' approach to the options business is to find the most compelling means to address the lingering concerns clients and plan participants have regarding options. Help that would likely cause the survey respondents to continue or expand options use would come in the form of either basic education, or else more sophisticated analytical support. The findings in Exhibit 8 show that 43% desire a more solid understanding of options' ability to protect portfolios on the downside, a straightforward but vitally important element of baseline knowledge for engaging in options strategies.

38% of respondents are looking for something more technical: an understanding of the way options strategies perform during different market cycles. Given the recent volatility of the securities markets, it is no wonder that portfolio managers and their institutional clients are interested in just how much help options can provide them during times of uncertainty.

In tandem with these two needs, institutions expressed a desire to see more of the educational and content material that various industry groups provide. In this category are high-impact analytical work and white papers with content that illuminates options' technical aspects, but also those that convey the subject in straightforward terms accessible to non-technicians. For example, case studies of other institutions' experience with options strategies was seen as particularly valuable.

Institutions are also looking for something more ephemeral: a shift in their organizational culture toward greater acceptance of the value of options investing. While educational and other

materials will help address some part of this concern, it will take change across all elements of the options investing process. Such a shift in thinking of investment committees and CIOs will require further inculcation of risk focus in the business, successful investing outcomes, and simply the passage of time and fewer extreme and unexpected swings (such as the flash crash) in the markets. Some volatility is the friend of options strategies, but the dramatic displacements that have occurred in recent years benefit few players.

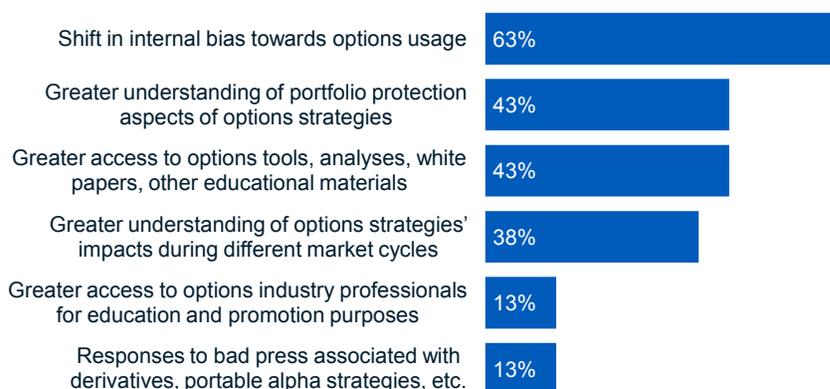
Exhibit 8

Survey Question:

Which of these changes, support tools, etc. would make options investing more acceptable to your organization?



Percentage of respondents (N = 30)



Source: TowerGroup Survey of Institutions and Asset Managers, April–May 2010

Exhibit 8

Leading institutions are exploring approaches to investing that would have been deemed risky in almost any environment, much less on the rollercoaster the markets are now riding. Perennial concern over the trade-off between the risk of the unknown and performance has tipped in favor of the latter. Firms are reaching for an answer that will allow them to reenergize their portfolios, and they are willing to try something new that is not necessarily inherently risky if understood properly: options and other alternatives.

These organizations have taken on wholeheartedly the risks of options investing. They are reaping the rewards of better investment performance, improved client and participant experience, enhanced regulatory response and risk posture, and competitive differentiation. The institutions that have achieved this “new balance” of options competence will find themselves much better positioned than their peers to meet the stresses and uncertainty of the money management business to come.

Conclusion

Institutions are gradually coming to realize, haltingly, the benefits of both straightforward and more arcane options strategies. They are reaching the conclusion that, applied carefully, the

instruments can achieve the seemingly contradictory goals of enhanced returns and lower volatility.

As asset management firms confront the fallout from the financial crisis, the lower-return, higher-risk environment is forcing them to rethink many of their traditional approaches to investing. Performance pressures and the need to provide transparency and rigorous management of risks are now not just desirable but necessary preconditions for continued survival in the business. Regulators, clients, consultants, and plan participants are all demanding that asset managers and funds demonstrate they are aware of and are carefully managing the risks they undertake. At the same time, they are expecting their fiduciaries to achieve performance levels that will meet or exceed the benefits payments and other obligations they face.

Institutional use of options strategies as a means of addressing these dual demands is at a crossroads. On the one hand institutions remain sensitive to any investment approach that looks and sounds like derivatives. On any given day a look at a newspaper or blog is enough to remind CIOs and trustees of the role the press and public ascribe, fairly or unfairly, to non-traditional investments in the carnage of the last two years.

On the other hand, the industry as a whole is starting to address infrastructure and transparency issues in all asset classes, and particularly in derivatives, a trend that will reduce the most apparent counterparty, instrument, and systemic risks. As these efforts bear fruit, they will also lessen the anxiety of investors generally, as well as those contemplating entry into or expansion of their options investing.

Leading institutions and asset managers are becoming better acquainted with alternative strategies, including options. They are communicating the benefits (and pitfalls) clearly and compellingly to their constituents, and are focusing their investment process on a careful and disciplined approach to implementing the strategies. As a result, they are achieving the performance advantage so critical to clients and participants, and carving out a differentiated position based on knowledge and articulation of advanced asset classes. By meeting head-on the wrenching changes the crisis engendered, these organizations are ensuring they will be in a position to thrive as the asset management business recovers.

Survey Methodology and Participants

In April and May 2010, TowerGroup surveyed 30 institutional investors on their challenges and strategies surrounding options investing. The survey consisting of 15 questions was administered via the Web. Respondents included pension plans, foundations, and endowments (17 institutions), and long-only asset managers and consultants (13 firms) that manage pools of money from under \$5 billion (USD) to over \$1 trillion. All survey responses were aggregated by size tier and other dimensions in order to draw valid conclusions regarding cohort performance and behavior.



The Options Industry Council commissioned TowerGroup to conduct independent research and analysis of options investing among long-only asset managers, pension plans, and endowments. The content of this report is the product of TowerGroup and is based on independent, unbiased research not tied to any vendor product or solution. Although every effort has been taken to verify the accuracy of this information, neither TowerGroup nor the sponsor of this report can accept any responsibility or liability for reliance by any person on this research or any of the information, opinions, or conclusions set out in the report.